Outstanding Investor Digest

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

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Volume XX Numbers 3 & 4 August 30, 2006

LEGG MASON VALUE TRUST'S BILL MILLER CONVERSATION WITH A MONEY MASTER
" 'AIN'T ONLY THREE THINGS TO GAMBLING:' THEY'RE ALL YOU NEED TO KNOW ABOUT INVESTING."

Bill Miller is best known for Legg Mason Value Trust's unprecedented 15-year streak of beating the S&P 500. But as we said in our last edition, what we find most fascinating is just how consistent his fund's margin of outperformance has been — looking back over 3, 5, 10 and 15 years.

However, like many other mutual funds and managers who emphasize buying high-quality/high-return businesses,

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CENTURY MANAGEMENT'S ARNOLD VAN DEN BERG ET AL.
"TAKE MY WORD FOR IT. THESE STOCKS ARE CHEAP. THEY HAVE ENORMOUS GROWTH POTENTIAL, TOO."

Arnold Van Den Berg is used to overcoming the odds. As a member of a Jewish family in Nazi-occupied Holland living just down the street from Anne Frank, Van Den Berg only survived (unlike 39 of 43 family members) thanks to the good judgement of his late father, Hugo, who arranged for a brave 19-year-old Dutch girl he knew was a member of the Dutch resistance to smuggle both the three-year-old and his older brother into a nearby orphanage.

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PFIZER'S HENRY MCKINNELL
"THE FOCUS IS ON OUR PATENT EXPIRATIONS TODAY. LONGER TERM, IT'LL BE ON OUR NEW PRODUCTS."

With many of the investors we follow buying Pfizer and several of them talking about it and/or other pharma stocks in this edition, we thought we should provide you with a bit of perspective about what's really going on at that company and within the industry generally. So we figured who better to provide that perspective than Chairman Hank McKinnell and some of his associates. The excerpts which follow were

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OAKMARK FUNDS' BILL NYGREN
"IT MAY BE DIFFERENT THIS TIME, BUT THAT'S NOT THE WAY TO BET."

For Bill Nygren, it's a case of déjà vu all over again. During the late 1990s, he warned about overvalued techs for so long that "by the time our message was important and accurate, much of our audience had lost patience with us." Having now been saying that high-quality businesses are attractively priced relative to lower quality, more cyclical companies for close to three years, he laments the fact that

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LEGG MASON VALUE TRUST'S BILL MILLER (cont'd from page 1)

Legg Mason Value Trust has underperformed the S&P 500 and its fund category year-to-date according to *Morningstar* by 12.5% and 11.2%, respectively. So the fund's streak of outperforming the S&P 500 is once again in danger of being snapped. (Yawn.)

A streak that *doesn't* appear to be in danger of ending anytime soon is that of our being intrigued and enlightened by just about everything Miller has to say. We're pleased to bring you our latest installment — which was excerpted from an event at this year's 50th anniversary Financial Analysts Seminar, hosted by the CFA Society of Chicago, held July 16th-21st in Evanston, Illinois.

We'd like to extend our thanks to the CFA Institute for helping to make it possible for us to share it with you. Perhaps the best advertisement that we can provide them in return is to point out that the senior portfolio manager in each of this edition's features has a CFA — whether or not he has an MBA or, for that matter, any formal education related to finance at all.

The event, "Conversation with a Money Master", consisted of an extended conversation between Miller and moderator Fred Speece of Speece Thorson Capital Group, followed by answers to attendee questions. We hope that you find these excerpts (which, incidentally, have been lightly edited by Miller) as fascinating as we do.

IF YOU'RE A LONG-TERM INVESTOR, AT LEAST, YOU CAN LEARN A LOT FROM MANAGEMENT.

You can learn a lot from management — over the long run.

Moderator: Some money managers don't talk to management. But you find this a useful tool. Could you tell us how you do that and whether that's an effective way for you to add value?

Bill Miller: It's more effective the longer your time horizon is — because in the *short* run, I don't think that you gain a lot by talking to management. Management's constrained by Reg. FD in the very short run. And in the short run, you don't have a context for understanding how that particular CEO or CFO has behaved in the past — again, if you're new to the thing and it's in the short run.

I think if you've owned a company for 3, 5, 10 years and had a lot of extensive contact with the management, you can learn a *lot* from the nuances in the way in which they answer questions, the way they think about strategy, and so forth.

For example, we learned Amazon was playing offense.

Miller: I agree with Buffett totally when he says that ignorance is not a virtue in our business. [He chuckles.] So any source of knowledge, any source of information, is useful as long as you understand its pluses and minuses. What these companies do is try and put the best spin or face on their situation. Rarely will managements tell you how bad things are.

But you understand that going in. So you're really trying to understand how they think about the business and how their views may have changed in recent years.

For example, a couple of years ago, Amazon was down around $7-8 a share. And we were the biggest shareholder — other than its chairman, Jeff Bezos. So one night at dinner, I asked him, "Jeff, what kind of things are you spending your time on these days?" And he said, "Oh, it's different from last year when I spent a *huge* amount of time on our financial situation — on our cash flow. These days, I'm spending it on the customer experience."

I thought, "That's really good." What that told me was that he was no longer worried about the way the business was developing — the financial situation. To put it in simple terms, he had been playing defense during the prior 12 months. Now he could switch from playing defense to playing offense.

Well, the stock was telling you that they were still playing defense. So that was really important information as we thought about that investment.

NOBODY *CARES* ABOUT PFIZER RIGHT NOW. TO US, IT SEEMS LIKE A PRETTY *EASY* ONE.

A less productive pipeline in pharma meant lower returns.

Moderator: Are there other kinds of things you want to discover, where you're not going to leave until you learn them? Do you basically interview them and look for windows of insight — not inside information, but insight?

Miller: It's actually all about insight, but it's about *long*-term insight. So to take an example, Hank McKinnell from Pfizer came in to see us. And he brought his entire management team including their chief medical officer. And we're not major shareholders of Pfizer. We have a few-hundred-million-dollar position. It's not one of our really big positions.

But one of the things that he talked about was the nature of the R&D pipeline in the pharmaceutical industry. And the reason we'd been underweight pharma for *years* was that we were aware of the fact that the marginal productivity of that pipeline was in a steady fall for most of the past 10 years. That was part of the reason why the multiples contracted — because that, in essence, was a window onto the future rates of return on marginal capital.

But there's a lot of evidence now that it's turning *up*.

Miller: I asked, "What's different about the business — is there anything we should know? What is it that people don't understand?" And he said, "They don't understand that in the long cycle nature of an R&D pipeline, the productivity of our R&D at the margin is turning up."

Well, if that's true, that's huge. So I said, "Well do you have evidence for that?" And he said, "Absolutely." And he gave data on how many typical drugs that go into Phase I make it to Phase II. It used to be that 40% in Phase I made it to Phase II. Now almost *70%* make it to Phase II because of new drug discovery programs....

And then, subsequently, Pfizer reported, and they actually raised guidance — which is really interesting, because they sold off their consumer products division, which was being valued more highly than their pharma division. And when they reported, they raised guidance moderately and referenced their pipeline. So there's a lot

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of evidence now that it's turning up.

Pfizer's implied rate of return makes it pretty easy to buy.

Miller: Pfizer has the lowest P/E ratio of the big pharmas — to take a simple metric. And now it has the highest dividend yield — or certainly one of the highest dividend yields. They've announced that they're going to buy back $17 billion worth of stock. They didn't disclose *exactly* what they're doing with the dividend, but they gave a strong indication that dividend growth would be at least double digits.

So it's like, OK, how much can the valuation degrade from 13 times earnings — actually 12 times next year's earnings? Well, I think the answer is not much — especially if the marginal productivity on capital is going up. And if the dividend's going to be growing at double digits starting out from a 3.5% yield and the valuation doesn't degrade, that's close to a 14% implied rate of return against an implied market rate of return of, say, 7-8%. That seems like a pretty *easy* one.

Now the problem is no one really *cares* about Pfizer right now. It's performed crummy over the past few years. So everyone says, "There's no sense of urgency. Who cares?" But for *us*, it's all about implied rate of return relative to the market — because that's where we'd want to put more capital now than we would otherwise.

Moderator: And the fact that they're raising the dividend is not a bad signal.

Miller: No. They've raised the dividend every year for a generation — but the fact that they believe they can continue to raise it starting out from an above-average dividend yield...

John Neff has *always* been rational....

Miller: [Speaking of dividend yield,] when I first met John Neff 25 years ago, we compared portfolios. And he said, "Your portfolio looks pretty good, kid. But where's your yield? It looks like it's below the market."

And I said, "John, I know you like above-market yield, but you know that an asset's value doesn't depend on how it pays out its return, unless you believe that the market systematically misvalues yield or you can allocate that return to earn a rate of return higher than the market can."

And he said, "Yeah, I believe *both*." [Miller chuckles.] So I said, "Well, that's why you have a high yield in *your* portfolio. That makes perfect sense then." So John was very rational even then.

Schering-Plough is fine. We just like Pfizer better.

Analyst: You mentioned Pfizer. And you talk about management and meeting with management of companies.

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I happen to have a tremendous amount of respect for Fred Hassan at Schering-Plough. And that's something that hasn't done very well recently. But I believe this man can add so much value over time. I'm just curious as to what you might think about that one?

Miller: We don't own Schering-Plough, but we do have a high regard for the CEO and what he's done previously. For us, it was a valuation call, not a management call.... Typically, what we want to do in any sector or industry... Historically, concentration has paid — even though it doesn't pay as much right now. However, even for analysts' training purposes, we want the analysts to collapse to what they believe is the single best trade-off of risk and reward.

PORTFOLIO REPORTS estimates the following were Legg Mason Value Trust's largest equity purchases during the 3 months ended 6/30/06:

1. AMERICAN INTL GROUP INC
2. GENERAL ELECTRIC CO
3. TIME WARNER INC
4. DELL INC
5. PFIZER INC
6. HEWLETT-PACKARD CO
7. YAHOO INC
8. SYMANTEC CORP
9. CA INC

So ideally, we only want to own one or two names in any given group — not now, but historically. So if we own Pfizer, we typically wouldn't own Schering-Plough and Merck and something else.

BECAUSE WE'RE LONG-TERM INVESTORS, MANAGEMENT'S CAPITAL ALLOCATION IS KEY.

How companies allocate capital will determine our returns.

Moderator: Dividends and share repurchases are tools that companies can use — they're also signals to their shareholder and potential shareholders. Do you view them as equally attractive?

Miller: We have a *huge* interest in how companies allocate capital — because we're long-term investors. Our turnover is 15-20% a year. So our time horizon is five, six, seven years on average. And that's a distribution across things we've owned for 15-20 years and things that we've owned for a year or two.

But broadly speaking, how companies allocate capital is going to determine what our returns are going to be. And as Buffett's noted, if you're the CEO of a company, and you earn 15% on equity and have a zero payout ratio, if you're a CEO for five years, you're going to allocate about half of the total equity capital that company has generated in its history no matter how long that history is.

If you allocate it at a return above the cost of capital, you'll create value. If you allocate it at a return below the cost of capital, you'll destroy value. So how a management allocates capital is critically important.

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With share repurchases, it's basically a matter of price.

Miller: So as to dividends and share repurchases, the only thing we try to do with our companies is just inform them of certain mathematical principles. For example, one of the things we tell them is that if they pay a dividend, the rate of return that their shareholders will earn on that dividend on average is the market rate of return. It's paid out to all of these different shareholders. Broadly speaking they will reinvest it. And they will not earn an excess rate of return. They'll earn the market rate of return....

On the other hand, if you repurchase your shares at a price below what the business is worth, then the shareholders will earn an above-average rate of return — because the business is worth the present value of future free cash flows adjusted for risk, etc. So if the company's shares trade at a big discount to what they're worth, they should be repurchasing shares. If they trade at or above what they're worth, they should be paying out dividends. And that's all that we try and make sure that they have in front of them....

DELL'S PAST BUYBACKS MADE LITTLE SENSE,
BUT THEY MAKE *PLENTY* OF SENSE TODAY.

Dell's management has not covered itself with glory....

Analyst: A year ago, I was doing a lot of research on Dell. At the time, it was selling at 17 times book. Stockholders equity was going down every year. And not that cash flow and income are the same — but basically, Dell's income was being used almost totally to buy back shares. If I were a shareholder, and I'm not, I'd find that very, very disconcerting.

So when you try and balance the dividend or the yield versus what the company's doing with the cash it generates, how do you play that off?

Miller: Dell has not covered themselves with glory in their share repurchase program during the past five years. We owned Dell from 1995-ish up until early 2000. And then it *collapsed*. So we bought a little bit back and then sold it. And then we were only in it again recently.

But Dell has done what a lot of other tech companies have done — and this was their error — which was to systematically repurchase stock to "offset option dilution". Well, that's idiotic — because what you're doing is

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effectively just a pure transfer from the public shareholders to the management and employees. And usually, if you're doing it *that* way, it's without regard to the rate of return that you're earning on that transfer.

So I'm not going to make any excuses for that use of capital, which was far from optimal.

Michael Dell understands what this business is worth.

Miller: That's different from what they're doing *now*. So now, quite apart from the options thing, Dell bought back 2-1/2% of their stock last quarter. And we value Dell on our multifactor model at up to $40 a share.

So our view is that if you buy back stock at its current price, you're earning *big* returns for the shareholders. And it's much better than a dividend at that level.

Also, when the company was buying back stock from the late '90s up until a year or so ago, its founder and chairman, Michael Dell, never bought a share. Well, Michael's now buying the stock *personally*. And it's not like he needs more exposure to Dell. [He chuckles.] So to me, that's a pretty good signal that this management understands what this business is worth.

A simple test to determine whether buybacks make sense....

Miller: I'm not sure that I answered your question. However, the wisdom of any share repurchase, in our view, always begins with, "What's the business worth? What's the present value of its future free cash flows?"

If a company's buying back shares *below* that value, then its management is adding value. If they're buying back shares above that value, then they're *destroying* value — other things being equal.

WHILE WE LOOK THROUGH TO FREE CASH FLOW,
IT'S OBVIOUS THAT SOME INVESTORS DON'T....

We're basically looking at free cash flows.

Moderator: Is the quality of earnings something that you work on hard?

Miller: We hope and trust that our analysts are thinking carefully about the earnings our companies are reporting and the quality of those earnings. We don't have any kind of a grid or any kind of a threshold with respect to quality of earnings because basically — and this is both a strength and a weakness, but... We tend not even to pay much attention to earnings — because, again, to go back to value, the value of the business is the present value of the future free cash flows.

So we're basically looking at free cash flows. We're looking at 'em normalized, we're looking at 'em reported — we're looking at all that kind of stuff. So whatever the company's reported, whatever its accounting conventions are, we look through those to its free cash flows. And historically, I think that's served us well over the years.

Sometimes we ignore reported earnings and others don't....

Miller: But it does have its downside — because in a lot of cases, we will tend to underestimate historically the impact of companies that kind of run fast and loose on the accounting side.

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Some companies use gain-on-sale-accounting, for example in finance.... We would say, "Well, we understand gain on sale. So who cares? We can look through that and convert it to portfolio accounting — we can make adjustments, etc." But guess what? Whenever companies convert to portfolio accounting, stocks collapse. So we finally learned after awhile that just because *we* can see through it doesn't mean that other people are thinking about it the same way.

I DON'T HAVE ANY TRAINING IN FINANCE (CFA ASIDE). BUT THAT'S PROBABLY OBVIOUS TO MOST PEOPLE.

I don't have any training in finance....

Moderator: In listening to your thought process, it sounds like you rely heavily on your background in psychology and philosophy as an analytical tool in the investment business. Is that a fair characterization?

Miller: Yeah, but it's only because I don't have any... I mean, everybody comes to the job with their own toolset, right? So I don't have an MBA. I don't have any training in finance — which is probably obvious to most people [chuckling] when they talk to me.

I do have a CFA — which is the only thing that I was able to start with.

Moderator: That's not a bad thing to have.

Miller: No, it's great, it's great. [He chortles.]

So if I invest philosophically, there's a reason....

Miller: But my technical toolkit actually comes out of analytic philosophy. That's what I bring to bear on the process. And I've found it very useful. But again, that's all the tools that I *have*.

[Editor's note: We find Miller's humility in this regard to be particularly striking since he's always struck us as being as facile and knowledgeable as anyone we know — and, indeed, substantially more knowledgeable than most — about the subtleties of finance theory.]

I think Charlie Munger has it right....

Miller: I have adopted what Charlie Munger says. His view is if you have a basic grounding in Psychology 101, Economics 101 — most of the various disciplines — and

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you can combine them properly, they can provide you with all you need. I do think that's mostly right. So you don't need a great understanding of psychology. Psychology 101 works well....

GIVEN THE HEAVY INFLUENCE OF PRIVATE EQUITY, LBO MODELS ARE A LITTLE MORE EFFECTIVE TODAY.

If a methodology has value, we'll use it.

Moderator: Do you *have* price targets? Is it the dividend discount model?

Miller: Well, no, we use a multi-variate model. So we use every valuation methodology known to anyone who's ever done this.

Moderator: Do you use a coin flip?

Miller: If there's any evidence at all that it has value, we will use it. So it can be very simple historical correlations. It can be DCF [Discounted Cash Flow] models, DDM's [Dividend Discount Models], LBO models... LBO models actually are probably in the current world a little more effective than some of the other models given the short-term nature of the market and the heavy influence of private equity. So we tend to put a little more weight on that than we have historically.

Moderator: And that's an interesting point. Because the private equity is so big and they're so active, they can't find enough private companies. So they're coming into public markets. Is the spread traditionally between private valuation and public narrowing?

Miller: It's narrowing slowly....

Private equity activity tells you something about valuations.

Miller: Part of the reason private equity is so active is that public market valuations are so attractive. At the current financing rates, there are a lot of businesses... When PETCO announced they'd be going private last week at a 49% premium, it's important to understand that the private equity guys think that they're going to earn an excess rate of return on *that*.

And so you can look at the Bronfman deal on music... There's all kinds of deals that have happened where the private equity guys have picked these things off — and even without taking 'em public again have been able to earn pretty good returns just by flipping 'em to other private equity guys. So I think public market valuations are really attractive — especially in the big-cap range.

HOW CAN YOU AVOID BUYING VALUE TRAPS? REMEMBER THAT ALL VALUE RESIDES IN THE FUTURE.

Value traps result from wrongly extrapolating the past.

Moderator: For all of us value types, our biggest enemy is time, patience, and the value trap. And you've said that you average down relentlessly. How do you protect your clients' money against the value trap with that bias?

Miller: ...The nature of a value trap historically... Almost every value trap is the result of people extrapolating

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past returns on capital and past valuations onto a different situation today. So they say, "Oh, Toys "R" Us' historic multiple was X. And now it's .8X — and so there's an opportunity here. Or "Look at what the pharmaceutical companies did for the last 50 years. And now they're cheap compared to that. So now they're a good value."

We don't buy many value traps — and here's why....
Miller: The problem is that in most value traps, the fundamental economics of the business have deteriorated. And the market's gradually marking down the valuation of those to reflect the fundamental economic deterioration.

So what we've tried to always focus on is, in essence, what the *future* return on capital will be, not what the *past* return on capital has been. What's our best guess at the future return on capital and how the management can allocate that capital in a competitive situation that is dynamic so we can avoid in essence, those value traps? We make a lot of *other* mistakes, [chuckling as he speaks] but that one is not one that we make a whole lot.

Value traps are a reason why "hope" is a four-letter word.
Moderator: And part of that whole collage is where you go from where you *believe* it's going to happen to where you *hope* it's going to happen — where that analyst you depend on hasn't picked up on that subtle transition. How do you help them and yourself to avoid that?...

Miller: We pay close attention to the descriptions and the semantics of the analysts. So when the word "hope" starts to hop into things, it's very bad. We want, "I think", "I believe", "I feel confident that" — as long as "confident" follows "feel." But when emotions start to creep into it...

"Hope" is definitely a deadly word — a *very* bad word.

ARE NEWSPAPERS A VALUE TRAP?
HERE'S EVERYTHING YOU NEED TO KNOW....

Newspapers' decline is slow enough to explain away....
Moderator: One value trap comes to mind that's maybe earlier in the cycle than the pharmas are — namely, the newspaper stocks. One of your sister organizations, Private Capital, is a big owner in newspaper stocks. What's your take on that business? Their valuations are at the low end of their historic range. Is it cheap enough?

Miller: The newspapers look like a value trap — or at least have appeared to be so over the past few years. Their long-term economics are under attack on a variety of fronts. The team at Private Capital knows these names as well as anyone and has a fabulous long-term record, so it's hard to be too critical of them since we don't yet know what ultimate rate of return they'll earn on their newspaper holdings.

Kodak is a name we own (they do, too, now by the way) that is dealing with secular challenges brought on by technology similar to those facing the newspapers. One difference is that the move from film to digital is happening so fast that Kodak has had to move very quickly. This has been extremely challenging, but we think they're over the hump, and that the next few years will be much better than the last few have been. The secular problems of newspapers are unfolding more slowly. That gives them more time to respond, but it's also permitted many of them to move too slowly, in my opinion.

All you need to know about the future of newspapers....
Miller: I was at a presentation on new and old media a year or so ago at which Warren Buffett was also present. He raised his hand and asked, "If the internet had been invented first, do you think we'd have newspapers today?"

[Editor's note: Is that a great question or what?]

Miller: After some pondering, the answer came back, "No, I don't think so." And I recall Warren saying, "That's all you need to know about the future of newspapers."

Sprint Nextel is cheaper — and it's actually growing.
Miller: Meg Whitman at eBay told me some time ago that their classified business was going really well — and she pointed out how much easier it is to navigate classifieds on the internet than it is via a newspaper.

And then there's movies. I think movie ads represent something like up to 10% of the ad revenue at some of the major newspapers. How effective are they at driving traffic versus trailers on the net, for example? I think movie ads in newspapers are likely to decline pretty significantly. And I understand that Sony is looking at whether those ad dollars are really necessary in a connected world. So the challenges are endemic.

And many of the newspapers trade at 8-9 times EBITDA or thereabouts, with declining circulation — and declining or, at best, anemic organic revenue growth. So why own them when you can buy Sprint Nextel at 5 times EBITDA with subscribers growing? After all, it's a subscription business just like newspapers.

PORTFOLIO REPORTS estimates the following were Legg Mason Opportunity Trust's largest equity purchases during the 3 months ended 6/30/06:

1. LEAR CORP
2. KB HOME
3. SPRINT NEXTEL CORP
4. MITTAL STEEL CO NV CL A
5. YAHOO INC
6. XM SATELLITE RADIO HLDGS CL A
7. CENTEX CORP
8. PULTE HOMES INC
9. CAREER EDUCATION CORP
10. LENNAR CORP CL A

U.S. MEGA-CAP STOCKS ARE VERY CHEAP.
WE LIKE 'EM FOR ANOTHER REASON, TOO.

U.S. mega-caps are very cheap.
Analyst: You seem to be relatively favorable — or, at minimum, neutral — on the valuation of the large stocks, whereas most of the other speakers today have portrayed a somewhat bearish prospect for U.S. equities. And it seems

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that their bearishness is based more on a top-down basis — that profit margins seem to be at all-time record highs. Might I ask your view on the market?...

Miller: Our view is that reasoning from the macro to the micro tends to be very dangerous. Margins are at historic highs. I think it's actually very interesting — because when you go back and look at what profit margins have been on a long-term basis, they are at historic highs, but the trend is *up*.

GMO's Jeremy Grantham has this whole regression to the mean thing. And I have a systematic problem with that — because the mean is not a stationary item. It migrates. So if you can identify the mean and think it's stationary, then I'll *buy* it. However, I don't necessarily believe that.

Let me put it this way — U.S. mega-cap stocks are really cheap relative to U.S. small and mid-cap stocks on an historic basis. They're also very cheap relative to their returns on equity and their reinvestment rates. You can see that, basically, reinvestment risk is what people are worried about in those things.

But take Microsoft's announced $40 billion buyback. That will tend, I think, to assuage people's concerns about reinvestment risk. And because Microsoft is a bellwether, a lot of other companies will probably follow their example. So that's partly why we're quite bullish on U.S. mega-cap.

A predictor of high future returns — terrible past ones....

Miller: And we're bullish on it for another reason. One of the markers, in my opinion, of a high future return is where the *worst* rate of return has been during the preceding five or six years. And it turns out that one of the worst things that you could have owned during the last five or six years has been U.S. mega-cap. Everything else — small-cap, mid-cap, commodities, emerging or what have you — has done great.

[Editor's note: Of course, this method *should* work well for any number of reasons: First, a group which has lagged is likely to represent relatively attractive value. Second, it's more likely than not to be characterized by unfavorable investor sentiment — sentiment which should at the very least tend to have much more room to improve than to deteriorate further.

Also, because of the preceding reasons, as Robert Noel used to tell us, it's less likely that capital will be flowing into such areas — where it would fuel additional competition and drive down future earnings and returns. In fact, as Third Avenue's Marty Whitman has told us repeatedly, relatively efficient capital markets are even likely to motivate and enable participants to unlock relatively attractive values in those areas through a combination of share buybacks and M&A activity.]

Miller: Meanwhile, U.S. mega-caps... Lots of people criticize Home Depot's Bob Nardelli or GE's Jeff Immelt. But all of these stocks have been cut in *half*. And meanwhile, their earnings have been doing fine. So I think that's another marker of a likely high future return.

THE MOST IMPORTANT ADVICE ABOUT INVESTING — COMPLIMENTS OF POKER CHAMPION PUGGY PEARSON.

Bill Ruane's most important advice about investing....

Moderator: Bill, this has been just phenomenal. We really appreciate it. Do you have a silver bullet for us?

Miller: Well, back when I first got in the business, I remember meeting with Bill Ruane, who sadly died last year — he was Warren Buffett's good buddy. And somebody had asked Bill, "What would be the most important advice you could give us about investing?" And Bill said to me, "Yeah, I told the guy that if he were to read Ben Graham's books — *Security Analysis* and *The Intelligent Investor* — and then he read all of Warren's annual reports, if he really understood what Graham and Buffett were saying, he'd know everything that there is to know about investing."

And I thought about what Ruane had said for a number of years.

Ruane got it right, but Puggy Pearson got it more succinct.

Miller: Then I heard this comment from again, the sadly, recently-deceased, two-time World Series of Poker champion, Puggy Pearson, on gambling. And what Pearson said was, "Ain't only three things to gambling: (1), knowing the 60/40 end of a proposition; (2), money management; and (3), knowing yourself.

And when I saw what he said (and I actually *talked* to him about it later) I said that actually is more succinct than the lessons Bill Ruane pointed to from Ben Graham and Warren Buffett — because that actually encompasses everything that you really need to know about investing.

Puggy's three rules tell you everything you need to know....

Miller: Here's why I say that: Knowing the 60/40 end of a proposition means knowing when the odds of your investment being a successful one are in your favor. However you compute them, the odds must be in your favor.

Then money management involves knowing how much you commit to that position. Do you invest 1%, 5%, 10%? If anybody hasn't read the book *Fortune's Formula*, I would recommend it to you. It's about Claude Shannon, J. L. Kelly and the Kelly criteria — which is a far better way to think about optimal position size than mean variance analysis, in my personal opinion.

Finally, when Puggy says knowing yourself, what he means is knowing how you react to adverse circumstances — knowing your psychology. So I think those three rules tell you everything that you need to know about how to approach investing.

—OID

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After the war, his parents — who also beat the odds by surviving Auschwitz — took their children to America where they settled in East Los Angeles. Physically underdeveloped as a result of several years of malnutrition in the orphanage (he was barely able to walk at age 6) young Arnie was an all-too-easy target in a neighborhood where weak and skinny kids didn't thrive.

Determined to change the equation, he decided that he would try to overcome his physical shortcomings by taking up rope climbing. In fact, he took up the sport with such commitment that he set a record in the event — climbing 20 feet in 3.5 seconds — a record which lasted until the event was discontinued about 15 years later. And he actually placed ninth in the national *collegiate* event — while still in high school.

After high school, with no other formal education, Arnie became a salesman at a local securities firm which specialized in mutual funds. But he became upset with how poorly those funds had performed in 1969 and 1970. In order to understand why, he became an avid reader of Ben Graham and a student of security analysis.

He soon decided he wanted to manage money. But lacking the background or the credentials to enter the field, he was stymied — until someone suggested that he apply the same commitment that he'd applied to rope climbing nearly 20 years earlier. Then and there, Van Den Berg made the commitment that, however long it might take, he'd begin his own advisory firm. And apply that same commitment he did — converting his tiny studio apartment into a research office, in the process moving everything out except for his desk, his books, and his bed.

Well, so far, so good. During the past 31+ years, clients of Van Den Berg have earned a compound return of 15.6% per year after all fees and expenses (before fees, they've earned 17.1%) versus 13.5% and 12.4% per year for the S&P 500 and the NASDAQ, respectively. By the way, those figures include clients' holdings in cash and bonds. It turns out that the equities portion of his clients' portfolio during that same period have earned a remarkable 21.4% compound annual return before fees and 19.9% after fees. (All performance figures provided by Century Management and, we understand, verified by Ernst & Young.)

We're pleased to bring you the following excerpts from presentations at Century Management's Client Conferences which took place March 4th in Austin and March 25th in Houston and the subsequent question and answer sessions, followed by excerpts from conversations with Van Den Berg and senior research analyst Tom Lewis. We never fail to find Arnie's insights and perspectives to be particularly sharp and colorful, and hope that you will, too.

WE BELIEVE INTEREST RATES WILL REMAIN LOW — AND WE SEE A GREAT OPPORTUNITY.

Interest rates are going to stay low and maybe go lower.

Arnold Van Den Berg: I'd like to just give you a brief outline of what we're going to talk about today. The first thing that we're going to talk about is why we believe that interest rates are going to be low, and could even go lower, why inflation will stay low for quite a while, and why contrary to what everybody believes, we believe the Fed's primary objective is to fight inflation, and that they're continuing a stand of very, very close monitoring of that problem.

Large caps — an outstanding bargain and great opportunity.

Van Den Berg: Next, we're going to talk about why we're buying large-cap stocks, and why we believe that they represent an opportunity we haven't seen in many, many years. In fact, we don't remember a time since 1983 in which we've owned as many large-caps as we do today. That was basically the beginning of this bull market. And they've been going sideways now since 1999 or 2000 — building up, getting lean and mean, and correcting some of their accounting problems.

The result is that they're probably as cheap as we've seen them in more than 20 years relative to interest rates and inflation. And I believe that before this seminar is over, you'll recognize, as we do, that these large-cap stocks are truly an outstanding bargain and a great opportunity.

WE USED TO THINK THE BIGGEST RISK WAS INFLATION. ON FURTHER REFLECTION/STUDY, WE NO LONGER DO.

In 2004, we thought our economy could go either way....

Van Den Berg: In 2004, the economy was coming out of a recession. And for the first time in many, many years, the Federal Reserve was very concerned about us potentially going into a deflationary period....

The ball could have been tipped either way. If the government had decided to print more money, we could have headed into a period of higher inflation. If they kept the money supply too tight, we could have entered a period of deflation. So it was a very critical time. And we weren't sure which way the Federal Reserve was going to go.

And so we laid out the possibilities in our newsletter.

Van Den Berg: In our December, 2004 newsletter, we described four very different, but possible scenarios. And we told you what the stock market would do under each of those scenarios.

We showed you what it would do under the best case scenario of low inflation and low interest rates. We showed you what it'd do in the event of deflation — in other words, in a period of declining prices like Japan experienced over the past 15 years. We showed you stagflation — which is almost the worst of both worlds — where you have very low real returns and very high inflation. And finally, we showed you the worst of all worlds — which we hope we'll never see here, because it's absolutely the worst economic scenario that you can have — and that's high rates of inflation.

Economists worried about deflation. We feared inflation.

Van Den Berg: In fact, at that time, Ben Bernanke, who was not yet Federal Reserve Chairman, was working on a study of the Japanese economy. That's how concerned they were about deflation....

But despite the fact that everybody was concerned about deflation, we thought the most likely scenario was higher inflation and higher interest rates....

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On further reflection and study, we changed our mind.

Van Den Berg: But six months later, when we really studied the Fed and saw how they were fighting inflation — watching the money supply, etc. — we changed our mind. We concluded that for once the Fed would stay the course, and keep the money supply tight, irrespective of the consequences, and prevent inflation. And when we became convinced of that, we started to purchase long-term bonds, and began to build our models based on that scenario.

INFLATION IS *ALWAYS* WORTH WORRYING ABOUT.
CURRENCIES AREN'T THE ONLY THING IT DESTROYS.

We knew how serious a problem inflation could be.

Van Den Berg: And what was it that caused us to change our mind? Well, first of all, we looked at history. We knew that every time a government gets into problems, it's printed money. And that is so automatic that there are very few exceptions. That's how the Roman empire ended. It expanded all over the world and spent well in excess of its tax receipts. And they had to keep depreciating their currency until their empire finally collapsed.

[Editor's note: In fact, in *For Good and Evil: The Impact of Taxes on the Course of Civilization*, Charles Adams says that taxation became so oppressive by the later days of the empire that Roman citizens welcomed the barbarians — in effect, preferring to take a chance on the devils that they didn't know over the devils they knew all too well.]

No society can function without a reputable currency.

Van Den Berg: Now the Romans didn't have a Federal Reserve. What they did have were gold coins. So they shaved the edges in order to produce more gold coins. And therefore, the price of everything went up as more and more coins were put into circulation. Then they switched from gold to silver — and then from silver to base metals. And by the time they went through this whole evolution of depreciating their currency, the Roman empire completely broke down. It could not function — no society can — without a reputable currency.

And so this is the lesson that we've learned from Roman times on: Any time a country has problems and starts printing money, you have a complete disintegration of the society.

So it's understandable why people worry about inflation.

Van Den Berg: With that in mind, I would like to read you a quote from Diocletian in 310 AD in which he talked about the situation in the Roman empire. He said,

(continued in next column)

"Who is so hardened of heart and so untouched by a feeling of humanity that he can be unaware, nay that he has not noticed, that in the sale of wares which are exchanged in the market, or dealt with in the daily business of the cities, an exorbitant tendency in prices has spread to such an extent that the unbridled desire of plundering is held in check neither by abundance nor by seasons of plenty...."

Diocletian knew that to revive the Roman empire, he had to have a stable currency. He tried to go back to gold, but he wasn't successful because there wasn't enough gold in the Roman empire. So everything crumbled.

So you can see why people are concerned about the government printing money — and why every government has done just that when their back was against the wall.

THOSE WHO EXPERIENCE HIGH INFLATION
KNOW JUST HOW SERIOUS IT CAN BE.

I got a taste of high inflation in Century's earliest days.

Van Den Berg: Back when I started in this business, in 1968, the annual inflation rate was running around 2%. Several years later, it was running around 5%. And by the time we started Century Management, in 1974, it had risen to 10% and was completely out of control. When our government decided to print money to take care of its liabilities, the result was one of the greatest financial crises in our history. It was a big, big problem.

The Dow dropped 40% — the average blue-chip stock dropped 65% to 70% — and we were in the worst recession that this country has had since the Great Depression. And although it wasn't a great time to start a business, it was a *wonderful* time to buy stocks, because they were the cheapest they'd been since the Great Depression.

Back then, Franz Pick was sounding the alarm....

Van Den Berg: There was a currency expert at that time named Franz Pick. I studied all of his books, I read all of his newsletters, and I listened to his tapes. And he was truly an incredible individual. He had studied every currency you can imagine in the history of the world. He would get up in his seminars and say, "This currency became toilet paper. This currency became toilet paper." And he would take 350 years of currency history and show how every one of them had declined to where they were worth virtually nothing unless they were backed by gold.

It was at about that time that President Johnson was trying to get the Great Society programs underway and finance the Vietnam War at the same time. And he was in the position, like most Presidents, where he didn't have enough money to go around. So what they usually do is start printing it.

And Franz Pick was just outraged about that. So in his seminars, he would stand up and say, "This government is printing money. We're going to have 10% to 12% inflation. Your money is being depreciated. Therefore, if we stay on this path, in a few years, your currency is going to wind up being worth zilch. It isn't going to be worth *any*thing."

As a young man, Pick had learned what inflation can do.

Van Den Berg: However, that didn't seem to bother the attendees. And so Pick said, "I can't believe that you're just *sitting* here." Finally one person got desperate enough

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to ask, "What can we do about it?"

So after thinking about it for a moment, he said in his very heavy Austrian accent, "I don't understand vy there's no revolution in the streets. I don't know vy ve don't take these people, put them against the vall, and *shoot* them."

The reason why he worried about inflation so much was that he'd experienced that type of situation personally. He would tell the story about how his father had worked two jobs to save up enough money to send him to college — and by the time he had saved enough money to send him to college, it was only enough to buy a postage stamp. That's how bad the inflation had been.

THE FEDERAL RESERVE CAN DEBASE THE DOLLAR. HOWEVER, FORTUNATELY, THEY *KNOW* THEY CAN.

The Federal Reserve can print as much money as it wishes.

Van Den Berg: So again, we have to be concerned about inflation, because throughout history, every nation whose currency has not been backed by gold has eventually seen its currency collapse. And of course, the U.S. abandoned the gold standard and its modified versions in full in 1971 when President Nixon "closed the gold window." In other words, the dollar was no longer convertible into gold at the U.S. Treasury. Therefore, the Federal Reserve has the power, if they choose, to resort to the printing press. And that's always been on our minds. We monitor it *very* closely.

However, fortunately, they *know* it....

Van Den Berg: And just to show you that the present Federal Reserve Chairman, Ben Bernanke, is aware of it, too, I'm going to give you a quote from one of his speeches. Bernanke said: "Like gold, U.S. dollars have value only to the extent that they are strictly limited in supply. But the U.S. government has a technology, called the printing press (or, today, its electronic equivalent), that allows it to produce as many U.S. dollars as it wishes at essentially no cost."

So the Federal Reserve is aware that they have the ability to create dollars at will.

The question is whether they're going to *do* it. And in fairness to Chairman Bernanke, he said, "I don't mean to suggest that we're going to print dollars willy-nilly." But in a pinch, they could do that. And history's shown that when governments get into problems, that's the course they take. And when they do, it eventually causes their whole economy to disintegrate along with their currency.

Today, many expect the Fed to take the easy way out.

Van Den Berg: Therefore, that's what people are expecting today. They're expecting more inflation and higher interest rates because they know the debt we have, they know all the financial problems we have, they know that it's important to keep the economy going, and they're expecting the government to resort to the printing press.

THE PRINTING PRESS IS A THEORETICAL OPTION. BUT IT'S AN OPTION THAT THE FED CAN'T USE.

Not only *won't* they print, but they *can't*....

Van Den Berg: Now, here's why we believe that they not only *won't* do that, but that they *can't*. And this is a

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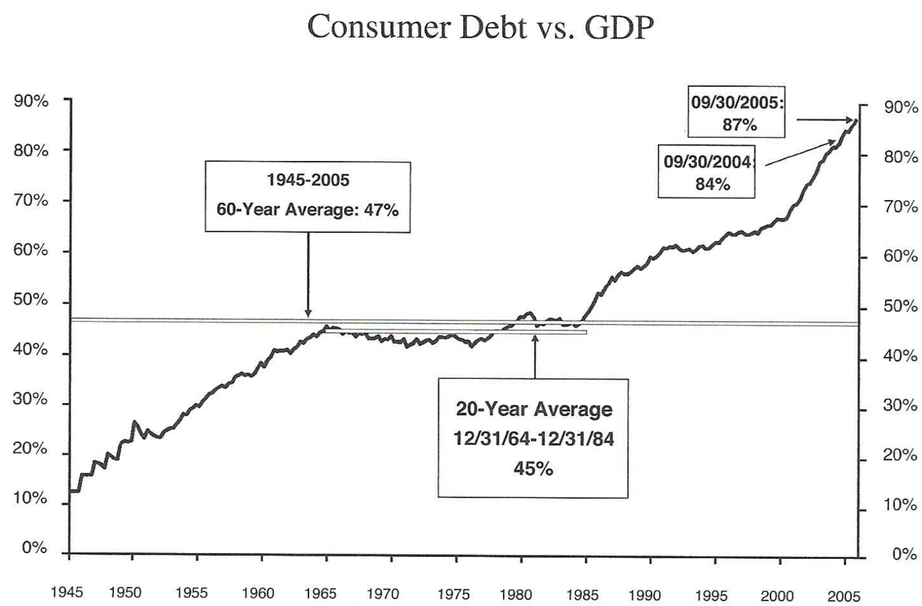
CHART 1



Source: Federal Reserve, 3/1945-9/2005

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very unusual situation. No nation in the world has ever been in the position that America finds itself in today. And here's why I say that:

In the '70s, when the government was printing money and the dollar started to depreciate, everybody sold dollars. It caused a stock market crash, it caused the economy to go into a terrible economic recession, it caused inflation, and it didn't solve one problem — because all it did was create black markets in commodities, price controls, and a host of regulatory problems.

Foreign investors have learned — as has the Fed....

Van Den Berg: All of the foreign bankers who held American securities — stocks and bonds — got burned. Can you imagine putting your money into America because it was a safe country and watching your purchasing power decline in value from $1 to 85¢? After awhile, you get the idea that that's not a good idea — and so you sell them off. So that created panic in all of these markets.

That's the time that we started Century Management. And I can remember those days very well. There were people who believed that we were at the end of our rope. In fact, the Arabs threatened not to take dollars and instead were going to begin requiring gold for payment of their oil. So it was a real crisis for America.

But the Federal Reserve has learned, too. They know that if they started to print too much money now, with the whole world having learned this lesson and watching them, even if they wanted to, it would be the worst thing that they could do. And that's because it would immediately start a panic in the stock market, the currency market, and the bond market — and it would cripple the economy. So we'd be in *worse* shape....

So this is no longer an alternative. It's something that the Federal Reserve can *technically* do, but it's not something they're *going* to do. And everything we're going to show you today will show you they're not doing that.

Here's another reason why the printing press is out....

Van Den Berg: Here's one of the reasons why they can't do it. Take a look at the consumer debt chart. **(See CHART 1.)**

As you can see, consumers are hocked up to their ears in debt. Over the past 60 years, the average level of consumer debt to GDP has been about 47%. Today, it's about 87%. And what is truly astounding is that it was 65% as recently as June 30, 1998.

Thus, U.S. consumers have continued to borrow against their homes and to use every conceivable technique to maintain their standard of living. So if the government were going to start printing and raise interest rates, every 1% increase on $11 trillion of debt would increase the cost to the consumer by $100 billion, and result in widespread bankruptcies, defaults and so on. Therefore, among other

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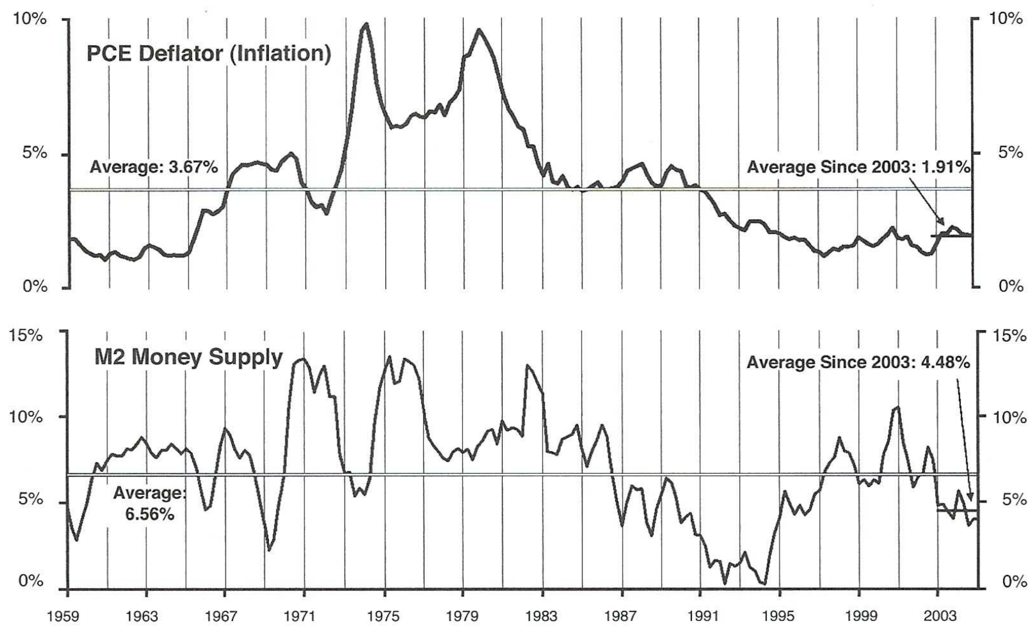
CHART 2

PCE (Excluding Food and Energy) Measure of Inflation: 1959-2005



Source: Federal Reserve and Bureau of Economic Analysis, 12/1959 through 12/2005
M2 Money Supply measures currency, checking, savings, CD's and money market funds.
(See CHART 3 for PCE Core Deflator definition.)

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things, it would cause a recession. So the government can't print — because it would raise interest rates and cripple the consumer.

Higher interest rates would hurt many consumers.

Van Den Berg: And let me give you an idea of the consumer situation. The net worth of the bottom 40% of the U.S. population — that's 45 million households, or about 119 million people — only account for about 1% of the country's wealth, which means they basically don't own *any*thing.

The next 20% of the population account for 5% of the country's wealth. So there you have 60% of the people with very few assets, yet most still have debt. So all it takes is for their costs to go up a little bit, and they are really in deep trouble.

So the worst thing the government could do right now would be to raise interest rates — because that burden on 60% of our population would tip us into a recession....

And it would raise the interest cost on the national debt.

Van Den Berg: And then, when you look at the government debt of $7-1/2 trillion, if they were to raise interest rates 1%, that would be another $70 billion deficit on the budget. So it's not in the *government*'s interest to create higher inflation. And that's why they have gone to such great effort to keep inflation and interest rates down — because that's the only way we'll be able to work out of this situation and keep the dollar strong.

The bottom line of all this printing history, irrespective of what happened in Rome and in all of the civilizations after that time: No country has ever been in this position with their back against the wall, where printing money would absolutely cause the worst type of situation.

BECAUSE THE MONEY SUPPLY'S BEEN TIGHT,
WE EXPECT INFLATION TO REMAIN LOW.

Note the correlation between money supply and inflation.

Van Den Berg: Now let's move on to the next chart — which is the PCE [Personal Consumption Expenditure] price deflator. It's one of the things that the Federal Reserve watches to monitor inflation. It's similar to the CPI. However, unlike the CPI, it adjusts for buying patterns. For example, if the price of oil goes up and people start converting to other types of energy, then it factors in the price of whatever they convert to. Similarly, if the price of beef goes too high and people start substituting less expensive alternatives, it adjusts for that. **(See CHART 2.)**

The line on the bottom represents changes in money supply as measured by M2. So it basically tells you how much the government is utilizing its printing press.

During the 1970s, high M2 growth led to high inflation.

Van Den Berg: Notice how that line moved up during the '70s. And look what happened to inflation as shown in the top chart. The first bump was in the '70s. We printed more — and look what happened to inflation.

Then inflation came down a bit. And in '74, we went into a recession, the Fed pumped up the money supply again, and back we went into a period of high inflation.

So every time we increase the money supply too fast,

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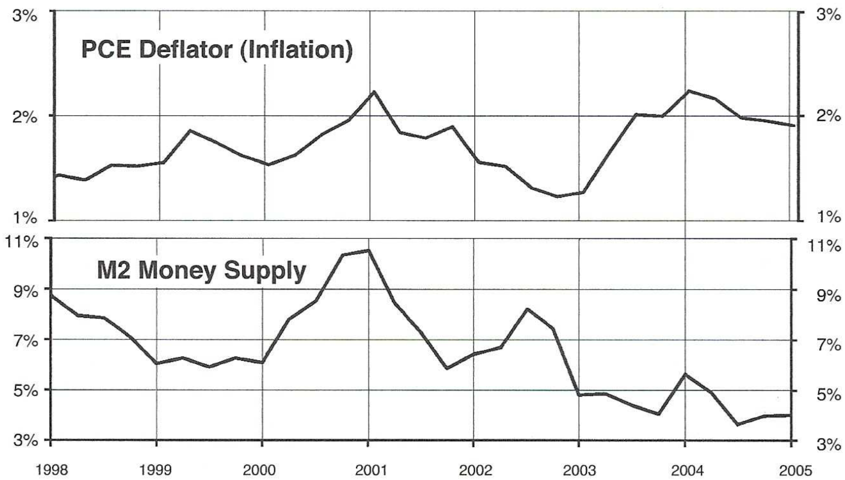
CHART 3

PCE (Excluding Food and Energy) Measure of Inflation: 1998-2005



Source: Federal Reserve and Bureau of Economic Analysis, 12/1998 through 12/2005
PCE Core deflator is a measure of the change in prices of all new, domestically produced, final goods and services in an economy. The basket of goods is allowed to change with people's consumption and investment patterns. Therefore, new expenditure patterns are allowed to show up in the deflator as people respond to changing prices. PCE Core excludes Food and Energy costs.
(See CHART 2 for M2 Money Supply definition.)

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we have inflation; whereas when the money supply grows slowly and the dollar goes higher, you have lower inflation.

Then, under Volcker, low M2 growth led to low inflation.

Van Den Berg: What happened is that things got out of control. So they brought in Paul Volcker. And Volcker was a man who took a stand. He was a man of principles. He said the only way that America can survive is if we have a strong currency and earn back the respect from the rest of the world that we lost in the late '70s.

So he made a commitment that irrespective of the cost, he would drive down inflation. And he said, "Anybody that bets against us is going to *lose*. Inflation is going to come down. We're going to have recessions, and we're going to have defaults — but we have to pay the price to restore the credibility of the U.S. dollar."

And note that for the next 13 years, the money supply kept going back down and down and down. And if you look at the top chart, you see how inflation went down along with it.

In the 1990s, instead of inflation, we got the Tech Bubble.

Van Den Berg: There was only one exception to that — and that was with Chairman Greenspan in the '90s. Because of the Asian crisis, there was a lot of debt being defaulted on in the Asian countries — and their stock markets were panicking. And at the same time, we had an academic experiment by a bunch of professors who started a hedge fund, Long Term Capital Management, that had an incredible reputation. They had two Nobel Prize winners and Ph.D.s as far as the eye could see.

And they thought that all of these wonderful programs that they taught their students in the classroom would just make gobs of money in the real world. But they hadn't been *tested* in the real world. They worked great in the classroom, but they didn't work so well in the marketplace.

They had $1 trillion leveraged out there. And then they started defaulting. What happened is that some of their theories were tested by the merciless frictions of life. And they proved to be somewhat wanting.

Anyway, here was Federal Reserve Chairman Greenspan facing an Asian economic crisis and $1 trillion worth of debts floating around — and he chose to print. And so there again, up went the money supply....

One unfortunate thing: If he hadn't printed, and thus kept that bubble going, we might not have had the bubble in the stock market that we did.

But once again, the Fed learned....

Van Den Berg: I'm speaking in hindsight now, so it's not a criticism of the Fed. But if you look at it, if they had stood firm and let Long-Term Capital default — like they should have — and kept that money supply steady, it might not have spilled into the stock market, and we might not have had quite the technology bubble we did. Those stocks wouldn't have gone as high as they did, but they wouldn't have gone as low either.

But the Fed realized that later. And shortly afterwards, as you can see in this next chart, while the money supply went up until 2000, after that, they've been grinding it down and down and down ever since. As you can see in the lower chart, the money supply as measured by M2 has basically been trending down since 2001. **(See CHART 3.)**

And a tight money policy today means low inflation ahead.

Van Den Berg: And that is very good news for the future — because there is a time lag between growth in M2 and the resulting inflation. Therefore, the inflation we are experiencing today is the inflation caused by the aggressive expansion of the money supply in 2000 and 2001.

From May 31, 2000 through September 30, 2001, the M2 money supply grew at an annualized rate of nearly 9.5%. To put this in perspective, since 2003, M2 has only grown at an annualized rate of about 4.5% — and the 47-year average has been just under 6.6%. The reason we have inflation today at 2%, as measured by the PCE, is due to the time lag that typically occurs from the time that money is printed until it works its way into the economy. In other words, the money has now been fully integrated into the economy.

Over the past three years, the Fed's been withdrawing reserves from the economy, thus creating a tight money supply. So we would expect that after the normal lag time occurs, we should begin to see lower inflation.

UNLESS THERE'S ALSO A LOOSE MONEY SUPPLY, HIGHER COMMODITY PRICES AREN'T INFLATIONARY.

Commodity prices are running wild? I don't think so....

Van Den Berg: Now here is one of the most important things that I can tell you: People see commodity prices going up, and they say, "Oh, there's going to be inflation".

Well, let me point out a couple of things. First of all, in 1980, the Commodity Research Bureau Index was around 249 — and it hasn't gone anywhere for 23 years. It's only up about 1/2 of 1% a year when annualized.

So while commodity prices have doubled during the last couple of years, that just represents a catch up from this low, low commodity inflation that we've had in the past 23 years — and it's nothing to be concerned about.

And higher commodity prices aren't necessarily inflationary.

Van Den Berg: Let me give you the most important thing that you need to understand as you listen to the news media about commodities. They always say that commodity prices are running wild — and therefore, we're going to have inflation.

Well, that inflation fear is founded on the fear that the Fed is going to continue to print. But I've just shown you that they're *not*. So if you're on a $3,000 a month budget, and the price you pay for gas goes up, but you don't make any more money, what are you going to do? You'll either cut back on your gas purchases, or you'll pay more for gas and spend less on some other things. For example, you might not spend as much on entertainment and clothing.

So as long as no more money is being printed, prices will even themselves out. If the price of oil goes higher, the prices of some other things will go lower — because there'll be less money available for them. So it will equal out.

In fact, without a loose money supply, they're not.

Van Den Berg: The only time rising commodity prices

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lead to inflation is if they're also printing money — and they're not doing that today. So the difference between today and the '70s is that they were printing money then — and they're not today.

Back in the '70s, when commodity prices went up, people demanded higher wages, and interest rates rose. Basically, the price of everything went up in a vicious cycle. But today, they're holding the reins tight. Therefore, even though commodity prices are going up, they'll eventually go down if the Fed doesn't make more money available.

That said, I do understand why some people see inflation.

Van Den Berg: And I was debating this point with a very good friend of mine — a very sophisticated guy who talks to other very sophisticated people about the economy all day long. And my friend was telling me about this editor at *Forbes* who keeps talking about high inflation and how the government is printing money.

And I said, "That reminds me of a guy who was interviewing a football player. He asked, 'Do you guys prefer to play on grass or Astroturf?' And the football player said, 'I don't know. I've never smoked Astroturf.' "

So my friend asked, "What does that have to do with inflation?" I said, "If this editor can look at these charts — for wages, for the money supply, and for commodities — and see inflation, then he must be smoking something. And I don't think it's Astroturf."

If you don't print money, you're not going to have inflation.

Van Den Berg: Here is the way that inflation starts. It cannot start without the government printing money. That is the first requisite step. If you don't print money, you're not going to have inflation. But once you print money, then it goes into commodities and commodities shoot up.

Then, as commodities go up, and the cost of goods that utilize those commodities goes up, people see their money depreciating. Therefore, they go to their unions and their bosses and they say, "Hey, my money depreciated 5%. I want a 5% raise."

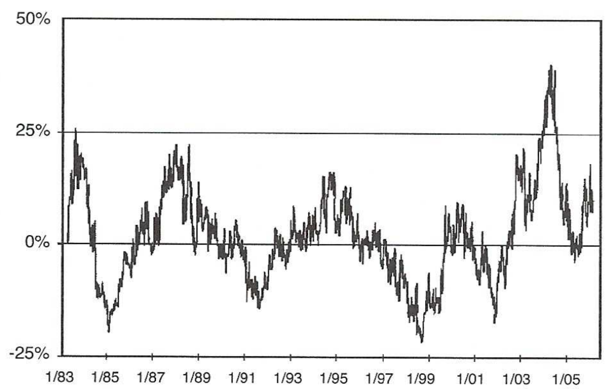
So now you've got the prices of commodities going up, you've got interest rates going up, you've got wages going up, and you've got a cycle that's out of control.

But if you *don't* make that money available, then commodity prices can run up, but the overall price level will eventually even out and price stability will reign.

CHART 4

Median Percentage Change of 21 Commodity Prices Over 52 Week Periods

March 1, 2006



Source: Dr. Wayne Angell of Angell Economics

IF YOU PUT THEM IN THE PROPER PERSPECTIVE, YOU SEE COMMODITY PRICES HAVE BEEN PRETTY TAME.

This next chart is compliments of Dr. Wayne Angell.

Van Den Berg: Now let's look at this next chart, because this is truly a revealing chart. And it should give all of you who are worried about inflation a lot of peace — because it shows that this commodity bull market is already slowing down. **(See CHART 4.)**

By the way, this is not a chart that we worked up. So I want to be sure to give credit for it to Dr. Wayne Angell. Dr. Angell is a Ph.D. in economics who served on the Federal Reserve Board from 1986 to 1994.

This gentleman was one of the lone voices and the strong believers — along with Paul Volcker — in a strong currency, low inflation, and the integrity of the currency. And I've always admired him for his outspoken ways.

When you read the Federal Reserve's comments, you tend to get a little bit of this and a little of that. So after you read it all, you wonder, "What the hell did they say?!" But Wayne Angell always spoke with clarity and conviction.

It's very simple, but very effective....

Van Den Berg: So when we were struggling with how to resolve our inflation outlook, I had an individual from our staff track Dr. Angell down, we had a long conversation, and I'm pleased to inform you that he's now a consultant to our company.

So when I called him last month before our seminar and we were talking about commodity prices, I told him, "I'd really like to use your charts to help our clients understand why we are not worried about inflation". And he gave us permission to use them. This is what he uses to monitor commodities. And it's such a simple approach, but it's so effective.

Commodity price increases are factored in one time only.

Van Den Berg: Most people, when they're looking at commodities, are looking at the fact that the prices are going up. But that doesn't tell you what future inflation is going to be. For example, if the price of oil goes from $30 to $65, then energy costs are going to go up in your budget. Right? However, if it's now at $65, and it stays at $65, then next year, there's no gain. So this commodity increase is already in the price of the commodity. It's already in the inflation rate — and the inflation figure as measured by the PCE Core Price Deflator is still less than 2%.

So here is this huge run-up in commodities. It's

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already in that inflation calculation. And now we're going forward.

Is this commodity cycle over?

Van Den Berg: So what Dr. Angell does is take the price of 21 commodities from last year, and compare it to prices the next year. And look what's happening:

In 2003, it peaked out. And for the most part, it's been going down. This is a chart as of March of 2006. And as you can see, it's almost at the zero line right now.

In the latest chart that we have, which is 23 days later, it's actually even a little lower. So when I called him, I asked him, "Are you ready now to announce that this commodity cycle is over?" And he said, "I'm not ready to give it a Hallelujah yet, but it's coming very close."

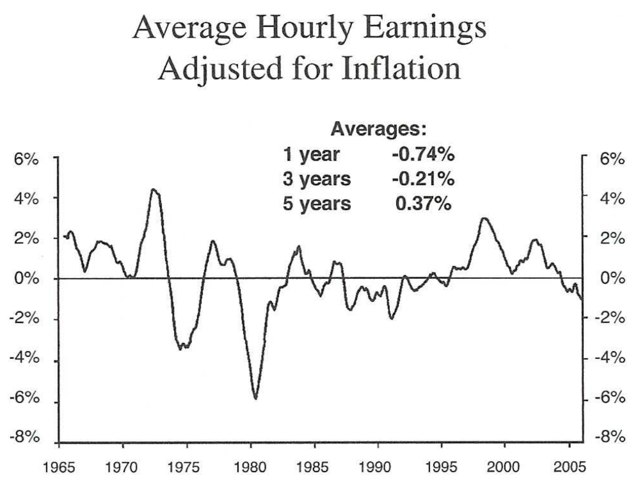
So we are monitoring the money supply and commodity prices. But what these charts show is that the money supply hasn't been going up, and commodity prices are coming down.

THERE'S NO EVIDENCE OF INFLATION,
BUT WE'LL REMAIN DILIGENT....

Nothing is more sensitive to inflation than wages.

Van Den Berg: And now I'm going to give you the most important evidence of all — and that is wages. There's nothing more sensitive to inflation than wages. You may remember how back in the 1970s, the unions had tremendous control over the economy. Why? It was because inflation was going up at 10% a year — and it took a strong union to convince employers to increase those wages the same 10% a year. Well, you can imagine what happens to corporate profits if your costs are going up — including your wages — at 10% a year.

CHART 5



Source: Bureau of Labor Statisics

So the real test of whether or not we're going to have inflation is in wages — because everybody is very sensitive to the fact that they've got a very good argument with their employer that if inflation is going up 5%, they should get a 5% raise just to stay even. And as you can see in this chart, in the last five years, there literally has not been any increase in wages after inflation. **(See CHART 5.)**

There's no evidence of inflation. But we'll stay vigilant.

Van Den Berg: So you've now seen evidence that the rate of growth in the money supply has been very tame, that the money supply's been very tight, that commodity prices are cooling down because of that lack of growth in the money supply, and, finally, that over the last five years, real wages have remained stable. If these things stay in place, we're going to have low inflation and low interest rates into the future. Changes in any one of these things will alert us to the fact that the Fed is starting to print.

And now I'm going to give you the easiest way to monitor it — it's just one simple indicator. All you have to do is watch the U.S. dollar. People who monitor inflation, who are experts about the money supply, the economy and so forth, say that the ultimate test of a currency — whether it's acceptable and has credibility — is whether it remains stable. And the U.S. dollar's been very stable for two years. It ran up a little more than it should have, and came down since. However, the U.S. dollar has been extremely stable over the last couple of years. So there's your proof.

So we've now gone through all of the indicators. And there's no evidence that the Fed is departing from its vigilant stance. If they stick with it, which all of the evidence indicates they're doing, we're going to have low interest rates and low inflation.

So I hope I've convinced you that our evidence of a low inflation/ low interest rate environment is holding up.

ONE OF THE GREATEST OPPORTUNITIES
THAT WE'VE SEEN IN A LONG TIME....

We're in a very unusual situation today....

Van Den Berg: An environment of low inflation and low interest rates is *great* for long-term bonds. Today, we believe those bonds have the ability to appreciate between 15% and 25% — which is not exactly a conservative return. And the big-cap stocks, which we're going to talk about next, are going to be the greatest beneficiaries — because their multiples are going to expand.

Mind you, our discipline doesn't tie us to any particular market category. We buy small-caps, mid-caps, and large-cap stocks. However, the problem is that most of the time, the great companies aren't cheap — because they're the ones everybody wants and follows. And therefore, they're rarely available at bargain prices. But this is a most unusual situation. And I'll explain why, but let me give you some history first.

In 2000, the opportunity was in small-cap stocks....

Van Den Berg: In the year 2000, small-cap stocks (the 300 smallest stocks in the Russell 3000) were

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incredibly undervalued. Those are your smaller, less seasoned companies. And they tend to have less seasoned, less sophisticated managements, accounting and so on. They include a lot of good companies — simply not as good as the crème de la crème.

And these small-cap stocks normally trade at a 15% discount to the large-caps. But in 2000, they were actually trading at a discount of *55%*. Why? It was because everybody was chasing the big technology stocks — and nobody cared about these small manufacturing companies. They called 'em the "old economy" stocks — and they were out of fashion.

Small-cap stocks were trading at only 11.4 times earnings in 2000. So these stocks were incredibly cheap. But look what's happened since. Today, small-cap stocks are trading at 26.1 times earnings. So the reason why we've been selling nearly all of our small-cap stocks is that they continue to meet our price objectives.

One of the greatest opportunities we've seen in a long time.

Van Den Berg: And meanwhile, we've been moving into these bigger company stocks because they're so cheap. In fact, we believe this is one of the greatest opportunities that we've seen in a long time.

This is an unbelievable phenomenon. It's kind of like if you went to the best part of town and could buy a house for less than you could in the worst part of town.... In the stock market, most people don't understand value. And there are a lot of people who are buying stocks for reasons other than value. Therefore, you wind up with these valuation discrepancies.

And that's what's happening in the stock market today. Large-cap stocks (the 300 largest stocks in the Russell 3000) had an average P/E multiple of 25.5 in 2000. At that price, they were 35% overvalued relative to interest rates. And one confirmation of that point is that their P/Es have since dropped 27%. Today, the large-caps sell at only 18.6 times earnings. Isn't that hard to imagine?

So homes in the best neighborhood are selling for less than homes in the worst neighborhood. And while we can argue about what they're worth, relative to each other, the difference is dramatic.

Do you notice a pattern here?

Van Den Berg: Consider what happened between 1983 and 1990. In 1983, small-cap stocks — the stock market equivalent of homes in the worst neighborhood — were selling for more than large-cap stocks. They were selling at 17 times earnings, while large-cap stocks were selling at only 12.8 times earnings.

That was an amazing phenomenon — and I want to explain to you why that happened. Any time that things in the stock market get out of kilter, it's due to psychology. By contrast, in 1974, the small-caps got so blistered and beat up that they got to a discount that was unbelievable. I remember having 30 companies lined up — every one of them selling at P/Es of 6-1/2, 6, even 5 times earnings — and I was agonizing over which ones to buy. But looking back, it wouldn't have mattered *what* I bought. I could've thrown a dart. You didn't have to be too smart — because you were buying them at 75% below their intrinsic value.

However, naturally, because these small-cap stocks were so cheap, their prices subsequently went up and up until psychology kicked in the *other* way. People began attributing valuations to small-cap stocks they didn't deserve. They thought, "Look how much better small-cap stocks have performed than large-cap stocks. We want to own *them*." And they kept going up until, by 1983, they got way *over*valued.

[Editor's note: According to *Ibbotson Associates*, during the six-year period from January 1, 1984 through December 31, 1989, small company stocks returned 7.3% on average versus 17.9% for the S&P 500.]

Van Den Berg: And in 1990, they got blistered again. Despite the fact that interest rates went from 11% to 8% — which suggests their prices should have gone up — small-caps fell to 8.6 times earnings while large-caps rose. Now there is an example of a recession sobering people up.

[Editor's note: Again, according to *Ibbotson Associates*, small company stocks returned 24.5% on average for the subsequent five years versus 16.6% for the S&P 500.]

Today, we have a rare opportunity....

Van Den Berg: Similarly, today, the average P/E of the biggest of big-cap stocks has fallen from 25.5 to 18.6. But that's not the whole story. And here's why I say that: Since 2000, the yield on the 10-year Treasury has declined from an average of 6.03% to 4.29%. So the average P/E should actually be *higher*.

However, there's always a psychological reason why valuations temporarily get out of line — and this time is no different. Only in the stock market does the best merchandise occasionally sell cheaper than the lower-grade merchandise. And it just so happens that we're at one of those points in history right now.

In fact, I'd say that such an opportunity only comes along about once every 10 or 12 years — in fact, it may come along only once every *20* years. It's very, very rare....

If you don't believe me, just look at *BusinessWeek*.

Van Den Berg: Incidentally, if you'd like to have some psychological confirmation that what I'm saying is correct, there's an article in the March 13th *BusinessWeek* entitled: "Are large-cap returns really due to pull ahead? Don't bet on it." Well, we *are* betting on it — in part because *BusinessWeek* has now given us a confirmation. They are truly a wonderful contrary indicator. Here's *BusinessWeek* telling people to stick with small-cap stocks — because they've got the greatest future. And that's the problem. When you look at your investments through a rear-view mirror, you see what happened in the past, but you don't see the oncoming truck that you'd see if you were looking through your windshield. So we look through the windshield, not the rear-view mirror, to get investment ideas.

But that's the way we use *BusinessWeek*. We take all their covers and say, "This is what *BusinessWeek* says. What's the best way to do the opposite?" And then we start researching that area — and invariably, we find some very good leads....

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AFTER MANIAS, YOU CAN FIND GREAT VALUES.
IT'S THE MOST AMAZING THING I'VE EVER SEEN.

John Kenneth Galbraith had it right....

Van Den Berg: Anyway, there's a psychological explanation of why these *extraordinary* divergences happen. I'll start by reading a quote by John Kenneth Galbraith: "There is nothing unique about the Crash of '29. It is something that happens about every 20 to 30 years, because that is the length of the financial memory. It is about the length of time needed for a new set of suckers to come in and imagine that they have a new and wonderful fix on the future."

Here's what happened in the 1949-1972 bull market. And once we show you that and what happened to the psychology of investors, you're going to understand exactly why these big-cap stocks are so cheap.

First, a bull market; then a mania; then a bad hangover....

Van Den Berg: After World War II, consumers were flush with cash. That's because during the war, they didn't have a chance to spend all the money they were making — because they were all either working or fighting. So they built up this mammoth cash position. And then, all of a sudden, the war was over — and all these consumer products came out, which created one of the biggest bull markets in stock market history. It was truly one of the great bull markets — probably one of the three biggest bull markets in American history, along with those that ended in 1929 and 2000.

And these consumer stocks — like Procter & Gamble, Coca-Cola, McDonald's, and IBM — just became darlings. People decided these companies were "one-decision stocks" — all you had to do was buy 'em and hold 'em. And this was true for 20 years. They were called the "Nifty-Fifty".

Well, what happened? Like all manias, it builds — and it goes higher, and higher, and higher. Soon, valuations lose touch with reality. People start buying these companies because they're going up, not because they're great values. And then something happens, and the bubble bursts — and the result is a terrible, terrible hangover.

After manias, you can find extraordinary values.

Van Den Berg: I want to show you two things in this next chart that I hope you'll remember. **(See CHART 6.)**

First, after the 1973-74 crash, the market went sideways for eight years. This is when it worked off the overvaluation. This is when the pain heals. And it's when companies become lean and mean. It's after this period that you're able to find extraordinary values. And that's exactly what happened after the 1973-74 crash. After an eight-year consolidation, we had the next bull market....

And if you look ahead in the chart, you'll see that we've now been in a six-year consolidation period since the bull market that ended in 2000. I'll come back to that, but I'd like you to take note of that right now.

Nifty-Fifty stocks suffered an average decline of 65.8%.

Van Den Berg: And what happened following the 1973-74 bear market is truly the most amazing thing that I've ever seen or experienced. For two straight years, these major companies got pummeled, and pummeled, and

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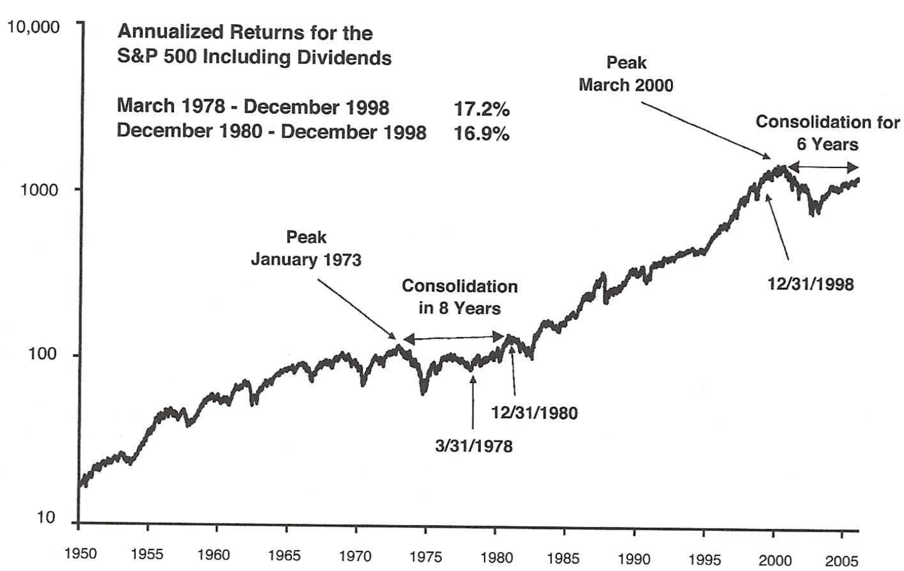
CHART 6

S&P 500 Consolidation Periods



Source: Compustat

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pummeled. On average, they dropped 65%. And they were the crème de la crème.

How did it happen that the world's greatest companies took such a dramatic hit? Well, one of the reasons — and the most important reason — was we had high inflation and high interest rates. And as we all know, a bond trades inversely to interest rates — and so do stocks. Therefore, the higher the interest rates, the more stocks have to go down in order to be attractive relative to their competition.

On average, these stocks suffered a decline of 65.8% — and it took them an average of 12 years just to get back to their 1972/73 highs....

AFTER THE MANIA AND THE CONSOLIDATION, COCA-COLA SHOT UP LIKE A CORK FROM A BOTTLE.

Even Coca-Cola was still down 60% eight years later.

Van Den Berg: This next one is my all-time favorite. It's a classic example. This is without a doubt one of the greatest companies in the history of the world. In fact, I'd say that there's only one other company that rivals it — and we're going to talk about that company in a bit.

But Coca-Cola went public in 1919 and had growth of 15% per year from 1919 until 1972. No other company had ever grown that consistently for that long. So, naturally, it was *the* darling of that era. And look what happened. It went from $75 in '73 to $22 during the '73/'74 bear market — and it was still trading at only $30 eight years later in '82. Just *think* about that — you could have still bought it for $30 eight years later.

And it's not like the company was standing still....

Van Den Berg: And it gets better. Just listen to these numbers — because I think that they explain why we're so excited about the companies we're buying today. From its 1973 peak to its 1981 low, Coca-Cola's stock went from $75 to $30.50. That's a 59% drop in the stock price.

But the company wasn't exactly standing still during those eight years. During that time, Coca-Cola's sales went from $17.94 per share to $47.64 — which is an increase of 166%. Its earnings per share went from $1.80 to $3.62 — an increase of over 100%. And its dividend went from 90¢ to $2.32 — a 158% increase. Meanwhile, its P/E went from 42 to 8 — which is a decline of 80%. Just *think* about that. This company's earnings per share rose 101% and its sales per share rose 166% — and yet, eight years later, its stock was 59% lower.

It wasn't about investment fundamentals, but psychology.

Van Den Berg: Why does that *happen*? Why would people not rush back into Coca-Cola when it was trading at less than half the price and the sales and earnings had doubled or more?

Well, part of the answer is that once people get burned by something, they don't want to *hear* about it. How many of you want to hear about technology stocks? You don't now, but you will in a couple of years. It's been about six years since the technology bubble burst. So in a couple of years, you'll be ready to go again — because enough of the pain will have healed, and their earnings will have doubled. And once their earnings have doubled, you'll start getting interested in 'em again.

So this is not an unusual case. In fact, I could show you *20* examples like that, although I'm only going to show you two. But then I'm going to show you some examples in today's market exactly like these two.

Finally, the stock price shoots up like a cork from a bottle.

Van Den Berg: But first, let me show you what happened *after* that consolidation period. Coca-Cola's split-adjusted average price between '72 and '82 was 81¢. That was the average price of Coca-Cola stock during the 10-year period after its stock had dropped 59% and its sales and earnings had risen 166% and 101%, respectively.

And look what happened to Coca-Cola's stock price in the next two decades. It was up about 66 times. And we're only taking its average price in that 10-year period. We're also only using $53.51 as our sale price — not its peak price of $77.73. So we're being very conservative when we say that for every $1,000 you would've invested in Coca-Cola during that period, you would have wound up with $66,000. That's a compound annual return in excess of 19% per year.

Once a major company's stock has been pummeled, and then it goes sideways for years, and its sales and earnings continue to build up, eventually, the stock price has to shoot up — like a cork out of a bottle. That's exactly what happened with Coca-Cola's stock....

THERE WAS THE SAME PATTERN WITH GE — AND THE SAME STELLAR RETURNS.

We saw the exact same pattern with General Electric....

Van Den Berg: Let's just take a look at one more — and that's General Electric. General Electric's stock hit a peak of $37.90 in 1973. In 1981, it got as low as $25.60. So nearly 8 years later, its stock was still down 32%. Meanwhile, its sales per share went from $31.77 to $59.80 — which is an increase of 88%. Its earnings per share went from $1.61 to $3.63 — which is an increase of 125%. Its dividend went from 75¢ to $1.58 — an increase of 111%. And its P/E declined 70% — from 24 to 7.

So here's the exact same pattern as Coca-Cola....

And your returns in GE would've been equally eye popping.

Van Den Berg: They go down, they consolidate, they heal themselves, they get lean and mean, they grow their sales, they grow their earnings, and *boom* — the stock takes off. And that's what happened with General Electric. Over the next 20 years, its stock gave you a compound annual return of 19.76% per year — from an average price of 47¢ per share split-adjusted all the way up to $35.60. So it was up over 75 times.

And I'm only using $35.60 as the sell target — whereas it actually reached a peak of $53. If I used the $53 price, the result would have been a compound annual return of *25%* per year. So that's the story.

Don't look now, but history seems to be repeating itself....

Van Den Berg: Now I'd like to show you that the

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same thing is happening today right underneath our eyes, with this wonderful lesson from history staring you right in the face. We all know what happened in the year 2000 — the market got carried away because of this tech bubble. Investors drove these stocks way up.

But now they've come down. It's the same thing, even the same names: Abbott Labs, Campbell Soup, Coca-Cola, Disney, Eastman Kodak, Pfizer, Philip Morris (Altria), etc. The crème de la crème of companies declined an average of 49% from their highs to their lows in 2002.... And believe it or not, we've had a consolidation period of six years. We had a consolidation period of eight years the last time. So you can see the pattern holding up. And today we've got another thing that we didn't even *have* in the other era — which is lower interest rates and lower inflation....

INTELLIGENCE ISN'T THE SECRET OF SUCCESS — IT'S HABITS AND DISCIPLINE THAT COUNT.

Don't let your intelligence be overruled by your emotions.

Van Den Berg: Next, let me read you one of the greatest quotes you could ever read when it comes to the stock market. It's by Dr. Karl Menninger, the famous psychiatrist. He said, "The voice of intelligence ... is drowned out by the roar of fear. It is ignored by the voice of desire. It is contradicted by the voice of shame. It is biased by hate and extinguished by anger. Most of all, it is silenced by ignorance."

This is a phenomenon that I've been very interested in from a psychological standpoint. I'm sure that all of you know highly intelligent people who do foolish things. And you've probably wondered, "How in the world could they do such foolish things when they're so intelligent?"

Well, it's because the voice of intelligence gets drowned out by fear and greed and these other emotions — emotions that dominate participants in the stock market. So people, acting as a herd, do some very foolish things because of emotions that block out reason and intelligence.

Of course, that doesn't only apply to the stock market. You've seen it in personal relationships, business dealings and everything else. So intelligence is not the real secret of success. It's discipline and the commitment to principles and so forth that allow you to use your intelligence in the way that it's meant to be used. So intelligence is one thing — but habits and discipline are what enable you to do the things that you need to do in order to be successful.

So don't let your emotions dominate — because that's what creates a lot of pain for people, both in the stock market and elsewhere in their lives.

To earn a great return, you must be willing to stand alone.

Van Den Berg: But let's talk about stockpicking.... First of all, when it comes to buying stocks, you want to buy contrary to the prevailing sentiment. You never feel good when you're buying a great bargain. When you buy a great bargain, you're doing it with sweaty palms, you're leaning against the crowd, engaging in contrary thinking, and you're pretty much alone. And almost everybody in the press is telling you that you're doing the wrong thing.

To buy stocks that are going to provide you with a great return, you have to be willing to buy stocks that are out of favor — and you must be willing to stand alone. And you better believe in what you're doing and be disciplined — because otherwise I can guarantee you that you're going to get shaken out of your position.

IF YOU WANT TO BUY FROM IRRATIONAL SELLERS, HERE ARE THE STATES YOU SHOULD LOOK FOR.

The first great psychological state is apathy....

Van Den Berg: Now there are basically four great psychological states you should look for. And you want to buy stocks that are selling for one of these four reasons. When we've bought stocks for these reasons, they've been the most profitable to us. And the first one is apathy. An example of a stock which became a bargain because of apathy is Coca-Cola. It dropped 50% — and went nowhere for eight years.

Do you know what the thinking was about Coca-Cola when I was telling people that its sales and earnings had doubled by 1982? They said, "Who *cares*? I've owned it for eight years, and I haven't made any money. I just want to sell it."

Well, that's apathy. You're so sick of holding a stock that isn't making you any money that you're just tired of it and you want to try something else. There's a lack of interest and emotion — that's apathy. And apathy is one of the psychological states of investors that creates bargains.

And disgust is nice, but fear and panic are better.

Van Den Berg: The next one is disgust. You find that when investors have lost money, or a stock's gone sideways for a long time, shareholders just want to get rid of it. The stock's disappointed you, the company's earnings have declined, its sales have declined — and you're just disgusted with it. That is truly a deep psychological state. And that's one of our favorite times that we like to buy our stocks — when people are absolutely disgusted.

Fear and panic is the next best state. People own a stock, and they're apathetic about it. Then, all of a sudden, there's bad news and it starts going down. That's the final straw. So they get fearful, they panic, and they sell it. Fear and panic is the third state to look for — because when people are in a state of panic, they're not thinking rationally. They're just selling because they're scared. They're in the same state as people in a theater after somebody has yelled, "Fire!" — where everybody wants to rush out the door at the same time.

So you've got apathy, disgust, and fear and panic.

The most irrational state of all....

Van Den Berg: But the ultimate state is anger. There is no emotion that is more destructive than anger — both to your intelligence and to everything else that you do. As Marcus Aurelius said, "How much more grievous are the consequences of anger than the cause of it."

So anger is the most irrational state. And that's a *wonderful* time to buy a stock — when people are so angry at

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the stock that they want to get rid of it at almost *any* price. When people have lost a lot of money in stocks, and then have watched 'em go sideways, they're first apathetic. Then they watch 'em go down more — and they get disgusted. And finally, around the time that it hits the bottom, they are so angry that they just want to get out. "Get rid of this piece of you know what." They'll sell it at a lower price when they're driven by anger than they will even when they're driven by fear and panic....

WHEN CLIENTS ARE ANGRY ABOUT A STOCK, WE KNOW THAT WE'VE GOT A WINNER.

Here's how we know when we've *really* got a winner....

Van Den Berg: When you get angry in the stock market and therefore lose control of your emotions, you will cause yourself some serious problems. In fact, we have a wonderful bellwether in our operation. Whenever we buy a stock that people are angry with, our switchboard lights up. Clients will say, "What are you doing buying that stock?! I don't want that thing in my portfolio!"

Now, why are people angry? Why is anybody angry? When somebody steps on your toe and you get hurt, you get angry. So anger is a result of pain. And when people have lost a lot of money, it creates a lot of pain — which creates a lot of anger. That's why they're acting so irrationally — and that's why you get to buy a stock at a cheap price.

So when people call us up and tell us they're angry about a stock we're buying, we *know* we've got a winner [attendees laugh] — because it's such a contrary indicator. In fact, if we could just buy "angry" stocks, there's no question in my mind that we could provide you a 25% per year return. We just can't get *enough* of 'em. [Attendees keep laughing.]

But over the years, we've had about eight to 10 of 'em that really stand out. And I'd like to briefly give you a few examples....

And everybody knew Murray Ohio didn't have a *prayer*....

Van Den Berg: The first one was Murray Ohio — a bicycle manufacturer that was losing money because of competition from Korean manufacturers. When we began buying that one, all of our clients were calling up saying, "What are you doing buying a bicycle manufacturer? Korean competitors are killing 'em by producing bikes at a quarter of the cost. This thing's losing money, and it's not going anywhere. They don't have a *prayer*. What are you *doing*?!"

But what they had overlooked was that Murray Ohio had 57 acres of land right next to a General Motors plant that GM had begged to buy. And because Murray Ohio was in financial difficulty, they finally decided to sell it. And it was worth twice the price of the stock. So what did I *care* about their bicycles? It was a bargain. And if you understand the value, you can take advantage of it.

Well, it earned a 27% compound annual return.

AND *NOBODY* LIKED COMPUTER ASSOCIATES — EVEN THE COMPANY'S OWN CLIENTS.

In Computer Associates, we got a *double* confirmation.

Van Den Berg: Then on September 30, 2002, thank God for *BusinessWeek*, their cover story was about massive fraud at Computer Associates — and the president of Computer Associates was featured on the cover. Well, there had been some fraud — some irregularities. However, they also happened to have an income stream that you could count on for the next 10 years.

And when our clients called us... I can remember Jim Brilliant [Head of Research], when he came up with the idea, telling me, "You know, Arnie, a lot of people really *hate* this company."

So our clients were angry — and then we got confirmation from *BusinessWeek*. [Attendees laugh.]

Actually, make that a *triple* confirmation....

Van Den Berg: But we had a *triple* confirmation on that one — because besides our clients and *BusinessWeek* hating it, a lot of times, we'll have a client in the industry who knows more about what we're buying than we do. And that's what we had with Computer Associates — we had a client who worked with a competitor of theirs.

So he called us and said, "Look, this is the first time I've ever questioned you guys, but I'm concerned. I never tell you guys what to do, but I really know this company. This is my industry. I compete against these rascals. And this is a *terrible* company. I don't want it in my portfolio. And I can't believe that you guys are buying it."

And in CA, we earned a compound annual return of 93%.

Van Den Berg: So we said, "Okay, let's talk about it." And we told him about its cash flow and so forth. And he said, "You know what? If you talk to any of their customers, they'll tell you they *hate* the company." So we said to him, "If the customers hate 'em so much, why are they still *with* 'em?" He said, "Well, they're locked in a contract. They can't get out of it." So we said, "Okay. Well, that might be better than having a situation where the customers love you, but they don't want your product anymore. It may not be such a bad deal if people hate you if they're locked in."

For example, at Century Management, we've used a piece of financial software for 14 years that we don't particularly like. But we can't get rid of it because it's the best in the industry, it would cost a lot of money to change, and we wouldn't have anything better to go to. So even though we don't like the company, we're not going to change.

And that was the case with Computer Associates. And a year later, it nearly doubled — and we wound up earning a 93% compound annual return on our money....

ACROSS ALL OF OUR ANGRY STOCKS, WE'VE AVERAGED A 25% PER YEAR RETURN.

When we bought Salomon, we actually got fired.

Van Den Berg: The one that will always stand out in my mind is Salomon Brothers. We bought that one the day they announced that they'd been playing games in the Treasury market. No doubt, you remember when Salomon was in the headlines because it was embroiled in a bond

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trading scandal. They were caught misbehaving in the Treasury auction. And the Treasury Department was very upset about it. It was all over the front pages. And Salomon was at risk of losing their approved position at the Treasury auction.

Well, there are two things that can happen when people are angry: They can get very vocal about it, and express their dissatisfaction to you with great emotion, or they can fire you. Well, on this one, we actually got fired. The client said, "If this is the kind of stock you're buying in my pension plan, I don't want you managing my money." And he fired us.

Well, as you may recall, Warren Buffett stepped in and made sure things were cleaned up. And by the time the smoke cleared, our clients had earned a compound return of 19% per year for 6-1/2 years in that one.

I only wish that *all* of our stocks made people angry....

Van Den Berg: And here's my point: During the past 31+ years, our clients have earned a compound return of over 15% per year. Meanwhile, in those angry stocks, we've averaged a compound annual return of about 25%. Can you imagine if we were able to have a portfolio that consisted entirely of stocks that everybody was angry about? That would be *incredible*.

[Editor's note: It appears to us that the 15%+ figure which Van Den Berg references above is quite conservative for several reasons. First, based on verified figures from Ernst & Young, the figure through year-end was 15.6%. Second, it's net of fees. Before fees, it was 17.1%. And third, the portfolios included not only equities, but also cash and bonds. The equity-only figure before and after fees was 21.4% and 19.9% per year, respectively.

So if Van Den Berg wasn't buying only "angry stocks", many of them were, at the very least, quite aggravated.]

Van Den Berg: However, it's not just because people are angry that makes these stocks cheap. It's that an angry emotional state drives these stocks to price levels that are irrational. That's what creates the opportunity.

WHAT MAKES MICROSOFT CHEAP? A CLASSIC CASE OF INVESTOR APATHY.

Please be sure to call in and let us know how you feel.

Van Den Berg: Would you like a couple of leads? Would you like to know a couple of the latest stocks that people are angry about — and one in particular? Well, the switchboard lit up when we bought Wal-Mart. And you wouldn't believe it. I was in a meeting with Jim, and he said, "You know Arnie, our service team is taking tremendous heat for us buying Wal-Mart. I think we should *double* that position." [Attendees roar in laughter.] And I said, "I agree." Therefore, thanks to our clients, our biggest position now is Wal-Mart. So please be sure to call in and let us know how you feel. [Attendees laugh and applaud.]

That was a $50 million decision — and it was one of the easiest decisions we could make. And I'm not saying that you should buy *any* stock that people are angry at. It's also got to have all of the fundamental qualifications. But if it's got all of the fundamental qualifications and people are angry at it, boy, have you got yourself a bargain.

Shades of Coca-Cola and General Electric....

Van Den Berg: Here's another stock that's in today's portfolio — Microsoft. Some of you may have heard about it — probably about six years ago. During the tech bubble, if you were a money manager, you *had* to own Microsoft. It was the best, the leader — the one that was going to make you rich. That's when investors were most enamored with Microsoft — when the stock was $60. It's since gotten as low as $23.80. That's a decline of 60%. Meanwhile, its sales have gone from $1.93 per share to $3.72 — up 93%. Its earnings have grown from 70¢ to $1.16 — up nearly 66%. And its P/E has gone from 86 to 21 — a decline of 76%.

Doesn't this remind you of Coca-Cola and GE? Microsoft's stock is down 60% or more from its peak, it's gone sideways for six years — and its sales and earnings have doubled. This is just an *amazing* situation....

A classic example of a stock selling on apathy....

Van Den Berg: So what I'm showing you is that on a fundamental basis, this stock is selling based on apathy. Nobody's interested.

As a matter of fact, I just got a call the other day from a prospective client. His secretary called me up and said, "Dr. So-and-so wants to know what you think about Microsoft." And I asked, "Why?" She said, "Well, he's a little tired of it. He thinks it's a good company, but he doesn't know whether we should keep it." I said, "Well, tell him to do whatever he wants to do — but we're buying it."

It's a classic example. He could easily be convinced to sell this stock — and not because it isn't a good company, but because he hasn't made any money in it for six years. But it's still a tremendous company. It's just that it got a little pricey. But we believe it's pretty cheap today — and we're buying it.

WE THINK PFIZER'S A CLASSIC BARGAIN — THANKS TO APATHY, AND FEAR AND PANIC.

We believe Pfizer's an extraordinary opportunity.

Van Den Berg: Let's take a look at another one — and that's Pfizer. If you look at Pfizer's chart and compare it to General Electric and Coca-Cola, you'll see the identical pattern. People got burned by the stock. Then the stock builds its value. However, the people who got burned by it are just *sick* of it. That's the situation with Pfizer today.

The stock went from $50 to $20. But meanwhile, its sales have gone from $4.21 per share to $6.95 — up 65%. Its earnings per share are up 122% — and its dividend is up 145%. And yet its P/E is down 82%. What else do you need to know? We believe it's an extraordinary opportunity.

With Pfizer, the worst-case scenario wasn't all that bad....

Van Den Berg: But Pfizer was also selling on fear and panic. What was happening with Pfizer is that they have a drug called Lipitor — which represents a *huge* percentage

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of their sales. And an Indian company, Ranbaxy, was threatening their Lipitor patents. So there was a possibility, albeit very small, that they could lose their patent on Lipitor and an enormous chunk of their sales.

Well, the stock had been drifting down — and people were already feeling apathetic about it. But then people started feeling fear — and right before the ruling on the Lipitor patent case, there was also panic in the stock. So Tom Lewis, our new analyst, got together with Jim Brilliant, undertook a cash flow analysis of the company, and figured, "OK, what is it worth if they lose Lipitor?"

One of the best ways to look at a problem is to look at the worst-case scenario. If the worst-case scenario comes to pass, what would the company be worth? Well, it can lose a lot of sales, but that's okay. Just figure out what the company's worth without the sales — and that's pretty much your worst-case downside.

So they did the analysis and they determined that if they lost Lipitor, the stock would still be worth $19 to $22.

And we believe Pfizer is worth a great deal more....

Van Den Berg: Well, Pfizer prevailed in the lawsuit over the Lipitor patent with Ranbaxy (although, of course, Ranbaxy is appealing the ruling.) But the chances of them losing their patent are remote.... It's an original patent. And Ranbaxy has only been successful once challenging a patent in 30 tries in the past. Therefore, we figured that the chance of Pfizer losing its Lipitor patent was very small. So because we concluded that it was a small risk, we took the position.

Our average cost is around $24. Again, we figured that we had very little downside — maybe to $19-$22. And if it had gotten there, we would've just bought more — and we would have had an even *greater* value. But Pfizer won the case. And we were able to buy a good position in a great company, at an average cost of $24, that we believe is worth a great deal more.

Knowledge and intelligence isn't always enough....

Van Den Berg: And here's another classic example: We just happen to have a friend of our family who is not only a pharmacist, but also a strategic planner for a chain of drug companies. So he knows drugs inside out. And he asked me to handle his portfolio. After looking at his holdings, I said to him, "Gee, you have some interesting stocks." And he asks me, "What's interesting?" I said, "Well, Pfizer, for one."

And he says, "You know, I've owned it for six years. And I know it's good because I handle the products, but I'm about ready to sell it. What do you think?" And I said, "Well, you can go ahead and sell it, but we'll be buying it from you — because we believe it's a great value."

So here's another individual who knows more about a company than we do, who understands its technology, and who knows it's good. Yet he's ready to sell it — because after six years, he figures that something must be wrong.

Well, nothing is wrong. It's just going to take a couple more years of incubation — and then it could *double*. But other than that, there's nothing wrong with it....

TAKE MY WORD FOR IT. THESE STOCKS ARE CHEAP AND HAVE ENORMOUS GROWTH POTENTIAL, TOO.

On the surface, Colgate doesn't look as exciting....

Van Den Berg: Now let's move on to Colgate. As you know, they're a consumer products company. Its stock declined from $66 to $48 — down 28% — so it hasn't declined as much as the others we've talked about. And its sales have gone from $16.51 per share to $22.35 — up 35% — so they're not up as much either. And its earnings have grown from $1.70 per share to $2.63 — up 55%. Meanwhile, Colgate's P/E has gone from 39 to 18 — down 53%.

So even though Colgate's stock is down, and its fundamentals have improved, on the surface, it doesn't look quite as exciting as some of the others we've talked about.

But it's an extraordinary value and opportunity, too.

Van Den Berg: However, Colgate's free cash flow — that is, the money that this company could put in the bank each year after funding their capital expenditures and working capital requirements — has gone from $1.53 per share to $2.85. That's an increase of 86%.

And yet the stock of this global company, with worldwide markets, has gone nowhere for five years — since its peak in 2000. So Colgate-Palmolive is truly an extraordinary value and an extraordinary opportunity, too.

Our timing may be wrong, but we've got the value right.

Van Den Berg: I'm sure that you get the idea from these examples: First there's pain, then there are years of consolidation, and finally, there's a bull market. We may very well be early in these stocks I've mentioned. However, there's no question that we're right about their value.

And our present environment has something going for it that those other periods historically didn't. We have lower interest rates today than we did 30 years ago. So we believe that this combination of factors portends for a great future.

THE UNIONS HAVE TAKEN A GREAT COMPANY AND MADE IT ONE OF THE MOST MALIGNED.

The unions have run a very effective smear campaign.

Van Den Berg: Next we're going to talk about a stock that is trading based on anger. This is the ultimate buy. And unless something goes seriously wrong with this company, we have high hopes for it. And that's Wal-Mart. But before I get into its fundamentals, let me explain why people are so angry at this company.

Here's the problem in a nutshell: There is a smear campaign that was started by the unions that is one of the most effective campaigns I've ever seen. They've taken a company that is probably one of the greatest contributors to this economy — and turned it into one of the most maligned companies in the world.

And so you don't have to take my word for it, consider that Wal-Mart was the #1 most admired company, according to *Fortune*, in 2003 and 2004 — two years in a row. Now here we are, two years later, with the unions having gone at 'em, and they've fallen all the way down to 12th. And

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it's not based on some change in their operations. You have no idea of the power of the press that these unions have orchestrated.

Now a lot of people feel that because I'm talking about the unions, I'm making a political statement. Well, we try not to make political statements in these seminars. We just want to give you the reason why this stock is so cheap — and why it's selling on anger.

And the unions are being hypocrites....

Van Den Berg: And to give you an idea of the campaign underway by the unions, let me give you a quote from Joe Crump, who's a long-time UFCW leader. He said: "After a three-year struggle, the battle of Family Foods is over. Do we represent the employees? No. The company went out of business. But perhaps even more important is the message that has been sent to non-union competitors — that there is no free lunch in our jurisdiction."

The unions say Wal-Mart puts the small businessman out of business — but here they are, deliberately putting this company out of business just because it didn't want to unionize. So it's a very, very powerful campaign which the unions are launching against this wonderful company.

For some clients, it's like we committed a mortal sin....

Van Den Berg: When we bought Wal-Mart, we got more calls on it than almost any stock we've owned. Now it's true that we have more clients now, but it was *really, really* bad. And just to give you an idea of the kind of reaction we get, there's a wonderful, spiritual woman, who's been a client of ours for 25 years, who called me up and said to me with a quiver in her voice, "Arnold, I'm *so* disappointed in you — that you'd buy Wal-Mart." She sounded as if I'd just committed some terrible sin.

And to avoid identifying her, let me just call her Mary. So I said, "Mary, we bought Wal-Mart for the same reason we buy *all* of our stocks — because it's a value, and because we believe it contributes to the economy."

And she said, "But Wal-Mart gives all this business to China." I said, "I know that they give business to China. In 2004, they purchased about $18 billion worth of merchandise from China. But Wal-Mart spent $150 billion with 61,000 U.S. suppliers buying merchandise and services here at home. In addition, they also support over 3 million supplier jobs in the U.S."

But for many, emotion rules over facts....

Van Den Berg: So I laid it all out for her. And she finally said, "But you know, Wal-Mart is taking jobs away from Americans and giving it to people overseas." So I said, "Mary, I thought that *all* people were God's children — not just Americans. [Attendees laugh.] What's wrong with giving people overseas a job — especially since nobody here wants to run to China or Thailand to be a greeter at a Wal-Mart?"

There are people in Thailand who, because of poverty, are sold into sex slavery. So how bad can Wal-Mart be? It may be hard to believe — but if you've ever been hungry, anything can happen. And I know, because I was hungry during World War II. I can tell you that it *does* something to you. So anyway, I said, "I know Wal-Mart may not pay the highest wages, but don't you think these girls would be better off working at Wal-Mart than in some brothel?"

So finally she said, "Okay." But she still had us sell the stock. She just could not live with the fact that we bought Wal-Mart. That's the kind of irrational thinking that we're seeing from wonderful, well-meaning people. And it's all because they don't know the facts — or understand the value.

IT'S THE POOR WHO BENEFIT FROM WAL-MART MOST — MILLIONS OF EMPLOYEES AND CONSUMERS ALIKE.

It's the poorest segment that benefits most from Wal-Mart.

Van Den Berg: Wal-Mart has *$300* billion in sales. They've created 1.8 million jobs worldwide — 1.3 million of which are here in the U.S. — many of them opportunities for people with very few skills. It's truly extraordinary how a wonderful company like this, that was the most admired company two years in a row only two years ago, has become the most maligned company today. I mean, if you didn't know better, you would think that they were running a concentration camp.

Here's something else: A UBS/Warburg study found that Wal-Mart grocery prices are 17-29% less than other supermarkets. So they've been able to save the average household $2,300 a year to help them keep their costs down. And that's significant, because a lot of their customers have lower incomes. Even when you're talking about $2,300 on a $50,000 income, that's significant. But when you're talking about $2,300 on $10-12,000, it's *really* significant. That's a very big deal. So the poorest segment of the population are the people who benefit the most from Wal-Mart.

Wal-Mart's compensation package ain't all that bad....

Van Den Berg: And Wal-Mart pays its full-time hourly employees nearly double the federal minimum wage — $10.11 per hour on average. By comparison, H&R Block pays $8, Foley's pays $6.50, RadioShack pays $5.25, Seven-Eleven pays $7.35, and McDonald's pays $6.25. So why aren't the unions complaining about *those* companies?

They've singled out Wal-Mart because they believe that if they can succeed in unionizing it, they can drive prices up and their grocery union can stay competitive. But that would be a total disservice to the U.S. economy and to the consumer.

And Wal-Mart provides health insurance to 1 million of their people in the U.S. They offer 18 different plans — and they recently began a new program for $11 a month.

Full-time employees are covered by health insurance after six months, and all part-time employees are covered after two years. There are few retailers that provide as many benefits. And in addition to health insurance, they also have a stock option program, and a 401(k) plan.

If Wal-Mart unionized, they would say goodbye to low prices.

Van Den Berg: Just look what happened in Canada. The union drug up some barmaid who left a bar to work for Wal-Mart. And she was unhappy with Wal-Mart — and she started organizing with the union. And I keep asking myself, "Did she have a stock option or 401(k) program at the bar? Did she have health insurance at the bar?" And they were

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mistreating her at Wal-Mart? This is the kind of nonsense the union promulgated.

So do you know what Wal-Mart did? They said, "Fine. If you're going to unionize, we'll close the store." And that's exactly what they did. They closed the store, and all those people lost their jobs — because Wal-Mart knows that if the union gets in there, they can forget about their low prices.

WMT contributes greatly to charity and people's welfare.

Van Den Berg: Wal-Mart makes a 3% profit on sales. Is that too much for a successful business? I don't think so. I don't think that a company can *survive* on anything less than that. This company produces jobs, and creates opportunities. In 2004, Wal-Mart paid $1.4 billion in state taxes and $4.1 billion in federal taxes. So they're certainly a contributor to our government. And in 2005, they donated $200 million to charity. That's an incredible contribution to charity — and more than a lot of companies have in sales.

Wal-Mart has won every conceivable award from minorities — from black and Hispanic foundations, among others — because of the number of Hispanics and blacks they employ in their stores. They have a work force of approximately 775,000 females, 139,000 Hispanics, 208,000 African-Americans, and over 220,000 seniors. Now if that isn't diversity... I'd like to see any company in America that has this kind of record. It is truly amazing.

At one time, this was one of the most admired companies. And quite frankly, given the contributions to the world that Sam Walton has made, I've long felt that he should have won a Nobel Prize — because 50 years ago, this man took $6,000 and started one of the most successful companies that's ever existed. Thanks to Sam Walton, people have the chance to own their stock, they have 401(k) plans, and they have health insurance. And consumers truly have lower prices.

Wal-Mart employs many who'd otherwise be unemployable.

Van Den Berg: But here is the most important thing that I love about Wal-Mart: They give people with literally no skills, who would normally be on welfare and on the unemployment lines, an opportunity to work.

My wife, Eileen, and I have done some work with the homeless. And I can tell you that the homeless are not just people who are drunks and who've given up on life. There are a lot of homeless people who are good people, but they just can't get a job because they don't have any skills. And when you don't have any skills these days, you're in trouble. So you can see what a wonderful contribution Wal-Mart makes to this economy — because without them, *more* people either would be homeless, unemployed, or unable to get a job.

(continued in next column)

My point is that there are a lot of people employed by Wal-Mart who could not get a job anywhere else. They take people off welfare, they take 'em out of the unemployment line, and give 'em a new start in life. And most of Wal-Mart's managers started in entry-level positions and worked their way up. Now for somebody who doesn't have good skills, that's a pretty appealing situation. And it just amazes me that Wal-Mart can integrate these people in their company — and have such an incredible operation. And to see this company so maligned when they do so much for this economy is truly appalling.

Current and potential employees are voting with their feet.

Van Den Berg: Again, Wal-Mart employs 1.3 million people in the U.S. alone. And you know that free markets sort everything out. Well, we've heard stories about the huge lines of people applying for jobs when Wal-Mart has opened stores. For example, when they opened a store in Oakland, California, there were *12,000* people applying for 350 jobs. If they were abusing people as bad as the media claims, do you think that there would be 12,000 people applying for these jobs? Do you think they're *stupid*? No, those people understand what's going on. They like the opportunity.

At a store they were opening in Chicago, there were 25,000 applicants — that's right, *25,000* — for 400 jobs. And that's the real test. No matter what *anybody* says about Wal-Mart, if you have that many people applying for jobs, you know that they're offering something of real value to these people....

WE NEVER BET OUR LIFE ON ONE STOCK.
BUT IF WE HAD TO, WAL-MART WOULD BE IT.

If I had to choose one opportunity, this would be it.

Van Den Berg: So you now know why good people are angry at Wal-Mart — because of this vicious campaign being run by the union. But let's review the actual numbers. Wal-Mart is selling at a totally irrational price. This is truly astounding.

When Wal-Mart was the most admired company, its stock was at $70. It fell to $42. That's a decline of 40%. Meanwhile, its sales per share have gone from $37 to $76 — up 105%. Its earnings per share have gone from $1.28 to $2.63 — so they're up 105%. Its dividend, from its peak stock price in 1999 to its 2005 low, has increased from $0.19 to $0.58 — up 205%. And its P/E is down from 55 to 16 — a decline of 71%.

It's hard to believe that one of the greatest companies in the world — with *incredible* growth potential all over the world — is selling for almost half the price, despite an increase in earnings and sales and opportunity.

So that's the story on Wal-Mart. And that's why it's our third largest position. We can't guarantee you results on any one stock — and we don't bet our life on one stock.

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But if I had to choose one extraordinary opportunity — absent something *really* bad happening — this would be it.

People will only be bamboozled about Wal-mart for so long.

Van Den Berg: This just shows you that a smear campaign — whether it's political, a union, or any other campaign of propaganda — can literally create a situation where a company that has made an enormous contribution to this economy, to consumers and to its employees, can become irrationally priced and sell at a bargain level.

Let me close on Wal-Mart by telling you it's like the old saying: There are three things you can't hide — the sun, the moon and the truth. People will eventually see through the smear campaign and understand what this wonderful company is really about.

WE JUST GO WHERE THE VALUE IS —
AND TODAY, THE VALUE'S IN BIG-CAPS.

Opportunities like today's don't come along every day....

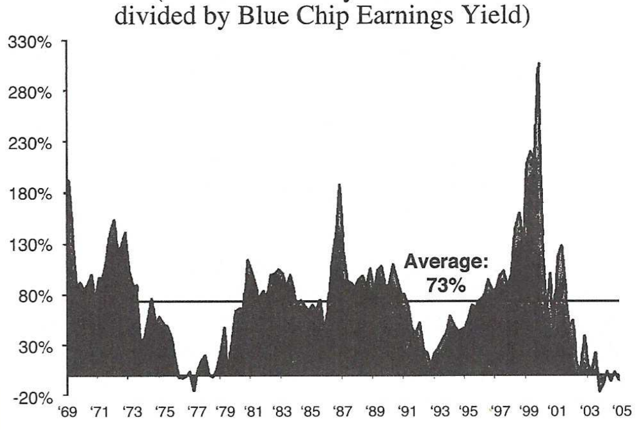
Van Den Berg: This last chart is a compilation of everything we've said in this seminar so far. And I think that it should sum up the opportunity in big-cap stocks. **(See CHART 7.)**

We've compared the earnings yield [i.e., earnings divided by stock price] on the top Blue Chip stocks to the yield on 10-year Treasury Bonds. I got the Treasury yields from Compustat. Then we estimated the earnings yields of the top 33 stocks in the Leuthold Group's Royal Blue Index — which is the crème de la crème of American companies. And when we did, we determined that, on average, historically, those Blue Chips have sold at 73% above par. In other words, on average, historically, they've been priced to yield over 40% less.

CHART 7

Blue Chip Earnings Yield Compared to 10-Year Bond Yield

(10-Year Treasury Bond Yield divided by Blue Chip Earnings Yield)



Source: Compustat and The Leuthold Group

Why is that? Why does a stock usually sell for more than a bond? It's because the interest payment on a bond doesn't grow. For example, you may get a 5-6% yield on a bond, but the interest payment on that bond doesn't grow. With a stock, you can typically get growth of 6-7% — and sometimes even 10-11%.

So when a big-cap stock offers the same yield as a Treasury Bond, you've usually got a huge bargain — because not only do you get the same initial yield as a bond, but you also get the company's growth for free. So when you can buy a great company at the same yield as a bond, it's generally a great opportunity.

And as you can see in this chart, that's only happened three times during the last 30 years. So it's not something that you see every day. But that's the situation today.

Blue Chips at Treasury yields are great bargains.

Van Den Berg: And if you look at the '72 period that we talked about earlier, the Nifty-Fifty got up to about 150% of par before they went down. And when were they the real bargain? The real bargain was when they sold below the 10-year Treasury Bond level in 1977. It took five years for that consolidation. They bumped up a little bit, and then came back down. And in 1979, they were, again, a bargain when they hit a level equal to the Treasury Bond.

Do you know why that's such a great value? Think about it. If a top crème de la crème company gives you the same yield as a Treasury Bond, and then you're getting the 8-11% return from growth on top of that, it's a no-brainer. Look how much better off you are. So when these Royal Blue stocks provide the same yield as a Treasury Bond, they're a tremendous bargain.

And if you look at the next 25 years, you see that in 1987, the Royal Blue stocks got up to about a 180% premium before they came crashing down. And in 1993, after the recession, they got within a few percent of par.

All the stars are aligned. It's an extraordinary opportunity.

Van Den Berg: Then in the tech bubble, they got to *280%* of par. If any of you would have been looking at this simple chart, you'd have known, without question, that these stocks were *grossly* overvalued. They were selling at a 280% premium to the Treasury Bond, when the greatest premium at which they'd ever sold before had been 180%. So you can see what an extraordinary overvaluation it was.

And the premium's been coming down ever since. And after six years, the yield is once again equal to the Treasury Bond. Just think about that. If you look back at a 35-year history of this index, there have been only *three* times when big-cap stocks had earnings yields equal to the Treasury Bond. And right now, they're even cheaper than they were in '77 and '93 — and those were during bear markets. That's not in absolute terms, but relative to interest rates and inflation.

So everything is now aligning — low interest rates, low inflation, 6 or 7 years of consolidation, and an increase of 100% in earnings. All of the stars are aligned today. That's why this is such an extraordinary opportunity.

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We go where the value is. And today, it's in the big-caps.

Van Den Berg: The last time we had this many big-cap stocks in the Century Management portfolio was 23 years ago, when we were almost completely in big-caps. If you go through our 1983 portfolios, you'll see that we were loaded up to the gills. So we're not small-cap, mid-cap, or large-cap managers — we are *value* managers. We just go where the value is. And today, the value is in big-caps.

And as I showed you, we have a lower interest rate today than at almost any time during these years. So we've got a lot of cushion in our thesis.

The owners of these stocks have been suffering a long time.

Van Den Berg: The only other thing I can say about this situation is that we may be a little early. But it's so extraordinary, we'd rather be too early than too late. And so right now, we're in the zone of being able to buy a very small segment of the market owned by people who've suffered great pain since 1998 or 1999 and have had to go seven years with no gains. So these people are tired of these stocks — and they're selling 'em.

And do you know who the *biggest* sellers of these are? What was the biggest fad in 2000? Indexing. All you had to do was buy an index. You didn't need a money manager, or an actively-managed mutual fund. All you had to do was just buy an index and hang on.

Well, indexing is a great concept. I believe in indexing, but I believe in buying it when it's *cheap*. It doesn't matter whether you manage your portfolio or you buy an index — you've still got to buy it cheap. But lots of people bought indexes at the top of the market. And now, when they're selling an index, they're selling all of these stocks — and they're selling 'em to *us*. This is the most unloved sector of the market — and that's why we love it.

These stocks are extremely cheap, and have great futures.

Van Den Berg: I believe we've demonstrated that there are many times when markets can swing from extremes of optimism to extremes of pessimism. And three conditions have combined to create a situation where you're truly able to buy a house on the lake today for less than you can buy a similar house in a lesser neighborhood. This opportunity only comes along once every 15 or 20 years. We believe that these stocks are extremely cheap....

We may be a little bit early, the journey may be a little bit bumpy, but I think you're going to enjoy the ride. All aboard.

THE PSYCHOLOGY SURROUNDING 3M IS LOUSY. BUT WE THINK ITS PROSPECTS ARE GOOD.

With 3M, it's about investor sentiment, not its prospects.

Shareholder: Why are we buying 3M?

Jim Brilliant: In 2004, 3M sold at $90 — which is the highest it's been, split adjusted, in the last 10 years. At that time, business was going well, everybody was excited about the company's prospects, and Wall Street came in and wrote all kinds of glowing research reports.

However, as with most of the S&P, people became disenchanted with 3M stock and sold it. Why? It wasn't because the company's prospects weren't good — after all, the company's earnings have continued to go higher. People sold their 3M and their other big-cap stocks, because they were badly lagging the small caps. As Arnie would say, they sold it based on apathy. They weren't making any money on 3M, and the stock was going down — so they just kept selling it and selling it and selling it.

One reason for analyst disappointment — Aldara.

Brilliant: The company has a medical business that recently introduced a unique pharmaceutical product — a topical ointment called Aldara — that actually penetrates the immune system and can combat skin cancer. But analysts expected it to have sales of around $800 million. And instead, they wound up being only $250 million. So Wall Street's disenchanted.

But why exactly were their sales so disappointing? Well, it turns out that the product has to go through dermatologists because it's by prescription only — and there's a conflict of interest with the dermatologists. The dermatologists would rather cut out skin cancer or freeze it — because that's what they get reimbursed for — than give their patients a skin treatment in a prescription ointment, because they don't get paid on a prescription.

PORTFOLIO REPORTS estimates the following were CM Advisers Fund's largest equity purchases during the 3 months ended 5/31/06:

1. MICROSOFT CORP
2. 3M CO
3. GENERAL MILLS INC
4. PAXAR CORP
5. HANDLEMAN CO
6. WAL-MART STORES
7. BRIGGS & STRATTON CORP
8. FOSSIL INC
9. GANNETT CO
10. HUTCHINSON TECHNOLOGY INC

So were 3M's sales of Aldara disappointing because it's a bad product? No, it's because of a conflict of interest in the supply chain. However, what Wall Street says is, "To heck with it — it's a failed product."

But let me try to put it in perspective. Again, analysts expected sales to be $800 million — and they came in at $250 million. However, that's one division — and it's a small part of a $22 billion a year business.

But the main reason is their own psychology....

Brilliant: So do sales of $250 million that were expected to be $800 million on a $22 billion a year business really matter? Maybe it does if you recommended the stock at $90, and you've been dead wrong about it, and it's gone nowhere but down for the past two years. In that context, any kind of mishap will upset an analyst — because he's been embarrassed.

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CENTURY MANAGEMENT'S
ARNOLD VAN DEN BERG & JIM BRILLIANT
(cont'd from preceding page)

So now they're looking for reasons to say, "Sell it" — with 3M right at the bottom. So they recommended 3M at 22 times earnings. However, at 16-1/2 times earnings and 16-1/2 times free cash flow, they've had it. Why? Because they've been getting grief from their clients for two years.

But this is a cheap stock and a great business. And it has one of the best cultures of any company in history. They've been around for more than 100 years. So it's a wonderful business, it's a cheap stock — and I think that its prospects are very good.

WE LIKED THE RISK/REWARD RATIO IN COMMODITIES, BUT TODAY WE LIKE IT BETTER ELSEWHERE....

It's all about the risk relative to the reward....

Shareholder: What is your view on energy stocks for the rest of the year?

Brilliant: We had a big investment in energy — just as we did with commodities and the industrial companies — coming out of 2002-2003, as we saw industrialization increasing the demand for those products when the markets were supply constrained. However, during the last half of 2005, we sold a lot of these companies.

The way we look at things is we've got buy points and sell points. And we work on the basis of risk and reward. When we buy something, we want it to have no more than one unit of risk for every four or five units of reward. And once that risk/reward ratio flips, so there are more units of risk than there are of reward, we start selling it.

At the same time, we're looking for other stocks that will fit that 4-to-1 or 5-to-1 risk/reward ratio. So with respect to energy and commodities, we see that as having shifted. In other words, there's now more risk for less reward. By contrast, with Colgate, Wal-Mart and the like, we feel they provide us with a higher ratio of upside — or more reward per unit of risk.

Commodity prices skyrocketed. Don't look for a repeat....

Brilliant: So specifically for energy stocks, I'd just say two things: First, whenever you look at energy — or any commodity, for that matter — it's priced at the margin. So what drives energy stocks? What drives a commodity stock? There are two phases: First, what's the price of the commodity doing? Take copper, for example. If the price of copper goes from 65¢ to $2.50, that's a significant move on the price of copper on every pound of copper you sell.

Then, the question becomes how many pounds — or units, if you will — of copper are you selling? If the number of units you're selling is rising, say, 5% per year, but copper prices go up four times, you're going to make a lot of money.

For example, when we bought Phelps Dodge in 2002, they were losing money. Now they're making $10 or $12. But that's because copper prices have gone up four times. Do you think that they're going to go up *another* four times over the next five years? Does anybody here think that copper's going to rise from $2.50 to $8.50 over the *next* five years? *I* don't think so. And that's why we sold it.

So now what do we have? Well, we have copper at high prices, and units still growing 5%. But it's not like we're going to have Phelps Dodge go from losing money to making $10 or $12. I don't think that we're going to see Phelps Dodge earning $50 a share in the next five years.

Therefore, now that commodity prices have gone up, we have to rely on *units* expanding — because I don't think we're going to see oil go to $150 a barrel.

Consumers and suppliers respond to price....

Brilliant: Commodities are priced at the margin. And it's true that during the last five or 10 years — even 20 years — we've underinvested in commodities. But what happens with commodity prices is that when they get up there, everybody's got a pick, everybody's got a shovel, and everybody's got a drill bit. And they try to capitalize on it.

So all of a sudden, supply starts coming onto the market. And as soon as supply gets onto the market and either exceeds demand or demand slips, what happens to those commodity prices or the commodity stocks themselves? Well, they'll go down dramatically.

In the fall of last year when gasoline prices got to $3, we saw that it started to impact demand. There was the beginning of demand destruction. So gasoline prices came down — and everybody was back, and excited and happy, driving their SUVs again.

But there's a study that says if gasoline prices stayed at $3.00 and above, 25% of U.S. car drivers would want to go to an alternative energy vehicle. Once it goes to $3.50 and stays above that price level, 50% do. And at $4, almost 75% of Americans said they'd start switching.

We're not going to see commodity prices continue to rip.

Brilliant: Now the population in this room are in the minority — 50% of Americans live paycheck to paycheck. So you can see what happens if gasoline prices go above $3. It really starts eating into these people's disposable income. And if their disposable income declines and they aren't buying as many other goods, then what happens to our economy? That's the point at which it starts to roll over.

So if energy prices get so high that 50% of Americans have to start cutting back on the things that they buy, the economy will start to slow down and roll over. So we're not going to see commodity prices continue to rip, like they have, as long as the Fed remains tight, like they are — and as long as incomes aren't growing dramatically, which they're not.

Wal-Mart and Colgate offer a better risk/reward ratio.

Brilliant: So I think that the risk/reward ratio is in favor of companies that are outside the commodity area. Do I believe that energy is going to roll over and go away? No. What will oil do between now and the end of the year? I don't know.

But from a stock standpoint, whether we're talking about energy stocks or commodity stocks, I think the biggest gains have been had relative to risk. I think that companies like Wal-Mart or Colgate, where you've got a consumer class that's moving in a direction you can expect to continue for the next 10 or 20 years, offer a better risk/reward ratio.

—OID

(Interview with Arnold Van Den Berg begins on next page)

CENTURY MANAGEMENT'S
ARNOLD VAN DEN BERG & TOM LEWIS
(cont'd from preceding page)

TREMENDOUS DISGUST SURROUNDING BIG CAPS MAKES FOR A POWERFUL CASE FOR BUYING 'EM.

OID: You made a very convincing case for buying some large-caps at your most recent client conference.

Van Den Berg: We keep coming across big-cap stocks that from every conceivable angle are cheaper relative to interest rates and other stocks than we've seen in many, many years. And at first we thought, "Oh, it's just because we're lucky." But the more we dug, the more we found.

In fact, it was really bothering us that the only thing that we could find to buy were big-cap stocks.

OID: You wanted to make sure you weren't doing it just because you had more assets under management.

Van Den Berg: That's right. And that's what people *suspected* we were doing. But if we can't find something worth buying, we just stay in cash. We don't have a problem holding cash. In fact, in December of 2004, we were 70% in cash.

OID: I wish I could say that...

Van Den Berg: So we thought, "How can these stocks be so cheap?" Then it dawned on us. The indexing craze peaked in 1999-2000 for the S&P. And it's been underperforming ever since. It peaked at close to 1,500 — and it's still down around 1,300 today. As a result, people who bought it haven't made any money for six years.

OID: Along with almost everyone who's owned the underlying big-cap stocks.

Van Den Berg: Exactly. So even though most of these companies' revenues and earnings have doubled, people have just gotten *disgusted* with 'em. So they've been under tremendous selling pressure.

OID: Makes sense.

Van Den Berg: And meanwhile, whenever they've sold an index fund, they've gone into whatever is hot. And that's hedge funds and commodities and small-cap stocks.

[Editor's note: And, as has been pointed out by the folks at Longleaf, private equity. And private equity firms, thus far, have been unable to buy megacap companies. Therefore, their prices *haven't* been bid up, while the prices of many of the smaller-cap companies stocks have.]

Van Den Berg: It's classic. These stocks have just gone through the same pattern that they always do. They got overpriced. They went nowhere for eight or so years. Meanwhile, their fundamentals caught up with their price.

If you look at the big-cap valuations, you'll find as good a value as there is in the market today. Given how much disgust there is surrounding these big-cap stocks, we think it makes for a very powerful case why people should be buying these stocks today.

[Editor's note: Excerpts from Van Den Berg's most recent client conference begin on page 8.]

PFIZER'S BEEN LANGUISHING FOR EIGHT YEARS — AND HAS NOTHING BUT UNCERTAINTY. THAT'S GOOD.

OID: Speaking of disgust, I noticed that you guys have actually been buying Pfizer.

Van Den Berg: That's right. It's a great story.

OID: I'm sure it is. And the only question then becomes whether it's a long story or a short story...

Van Den Berg: Well, we believe that it's a great long story. First of all, it trades at one of the lowest multiples of free cash flow of any big-cap stock in our portfolio.

OID: So far, so good — although I understand that there are lots of reasons why.

Van Den Berg: There are. But the main reason why Pfizer is so cheap is that when Wall Street is wrong about a stock and clients have gotten angry about it... Imagine if we'd bought it back in 1998 or 1999 between $35 and $50. Well, here we are eight years later — with the stock in the $20s, with all kinds of uncertainties. Would we want to raise our heads and say, "Mr. Client, we've just updated our research report on Pfizer."?

They're not going to want to write about something that they've been wrong about for eight years.

OID: That would certainly explain the psychology.

Van Den Berg: Oh, yeah. This thing doesn't have any sponsorship. That's what drives portfolio dressing. That's why they sell their losers at the end of the year. They don't want their clients asking questions about 'em. It's human nature. My own service department used to come and tell me, "Why don't we just sell this damn stock. I spend 20% of my time answering the clients' questions about that one stock."

OID: That's funny. You say they "used to"?

Van Den Berg: I just asked 'em, "What do you think you're here for? If we only had winners in the portfolio, then I wouldn't need *you*."

Just think about what happens to the psychology of these people who've been sorely wrong for a long time. They don't want to remind people about their losers — whether they're money managers, brokers, editors...

OID: There's no need to get personal...

Van Den Berg: Frankly, if we had owned Pfizer for the past five years, we might not be talking with you either. And you might not *want* to talk with us.

OID: I hope that's not true.

Van Den Berg: So anyway, Pfizer's been languishing down here for eight years. And on top of everything else, it's got nothing but uncertainty.

What a perfect time to sit down, have a cup of coffee, really go through these numbers and say, "Let's just forget about everything that's happened and just pay attention to where we are today." And that's exactly what we've done.

We even prepared a scenario which assumed that the Indian company, Ranbaxy, would win its challenge against the Lipitor patent — even though we knew that it was *extremely* unlikely. A new analyst at our firm, Tom Lewis,

(continued on next page)

CENTURY MANAGEMENT'S
ARNOLD VAN DEN BERG & TOM LEWIS
(cont'd from preceding page)

was adamant that we shouldn't even *consider* the possibility — because it was so remote. However, since he agreed that it remained a possibility, he ran the numbers anyway. And even in our worst-case scenario, we figured that we'd be OK.

OID: And of course, it looks like they won't lose it — absent the unlikely event that they lose on appeal.

Van Den Berg: That's right. Pfizer won. So they now have patent protection for Lipitor until 2011. And factoring in that victory, we think $40 is an *extremely* conservative valuation for Pfizer. With Lipitor's patent valid through 2011, we can easily get to a valuation of $50 or more.

[Editor's note: Make that March 2010 — for now. According to an August 2nd press release from Pfizer, a panel of the Court of Appeals for the Federal Circuit "upheld the exclusivity of the main patent covering atorvastatin, the main ingredient in Lipitor, maintaining patent protection in the U.S. until March 2010". However, it also ruled that a second patent, which would have expired in June 2011, was invalid on technical grounds — what sounds like sloppy drafting of the original application.

In the same press release, Pfizer said that there is a process for correcting such defects in the U.S. Patent and Trademark Office and that they intend to pursue it.

While we have not heard anything about the odds of Pfizer being able to reclaim the 15 months of exclusivity, we understand, should they be unable to do so, the impact is expected to be less than 35¢ of earnings in total.]

Van Den Berg: Basically, we foresaw an OK return if they lost Lipitor, an acceptable return if their cardiovascular franchise suffers a big downturn in 2011, and an *exceptional* return if one of their new drugs, Torcetrapib, gets approved and extends the life of that franchise out to 2017 or 2018.

If you want, I'll get Tom to lay out the numbers and let you be the judge.

I'M ACTUALLY THE SKEPTIC AT THE FIRM.
YOU COULD ARGUE IT'S WORTH $60 OR MORE.

Van Den Berg: Tom has researched this company just *so* intensely. He's got a spreadsheet that factors in each of their drugs using a variety of different assumptions all the way out to 2012. And he believes some combination of the cardiovascular drugs in Pfizer's pipeline are likely to replace Lipitor — and *then* some.

OID: So he doesn't think the company will shrink.

Van Den Berg: No. And with its win in the Lipitor

(continued in next column)

case, as far as we're concerned, Pfizer became a shoe-in. So we feel very confident about the analysis. And if you'd like us to go through it with you, just let us know.

OID: My place or yours?

Van Den Berg: However, we've not only been buying Pfizer, but we've been buying Wal-Mart, Kimberly-Clark, Marsh & McLennan, Dow Jones, Newell Rubbermaid, Colgate-Palmolive and Automatic Data Processing — just one big-cap company after another.

And we haven't owned these companies in 20 years. The last time we were predominantly in big-cap stocks was back in the 1980s. So it's actually been close to *25* years. It's almost like we're a big-cap manager. [He laughs.] It's just *amazing*. But I'm thrilled — because we're finding some real good values.

PORTFOLIO REPORTS estimates the following were Century Management's largest equity purchases during the 3 months ended 6/30/06:

1. MICROSOFT CORP
2. HUTCHINSON TECHNOLOGY INC
3. GENERAL MILLS INC
4. MARSH & MCLENNAN COS
5. SEAGATE TECHNOLOGY
6. BRIGGS & STRATTON CORP
7. PFIZER INC
8. IMATION CORP
9. WAL-MART STORES
10. DOW JONES & CO

OID: If you don't want to talk about Pfizer, feel free to just say so — although that was a mighty smooth way that you changed subjects there...

Van Den Berg: Before I have Tom join us, let me confess that I'm the conservative one in the group.

OID: There's no need to bring up politics. We prefer to offend people by talking finance and economics — although imperialist fascism in religious clothing seems to have become a topic of interest lately, too...

Van Den Berg: When you talk to Tom, he can make a case for *$60*. He even has a scenario way above that.

OID: I like this guy already.

Van Den Berg: And he has some very good reasons to back up his valuations.

OID: Even better.

Van Den Berg: I tease him that it's probably his bias — because he comes from a sell side background — that causes him to come up with numbers considerably higher than I would personally come up with. I wouldn't argue with him, but I wouldn't want to publish it.

OID: And you won't have to. We'll handle that part...

Van Den Berg: I wouldn't want to hang my hat on it. So I hope you'll understand if I insist that he stick to the more conservative scenarios.

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CENTURY MANAGEMENT'S
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(cont'd from preceding page)

OID: As long as we get to do the final edit, certainly. So where's the wild-eyed guy, already?

PEOPLE ARE FOCUSING ON WHAT CAN GO WRONG, AND IGNORING THE THINGS THAT CAN GO RIGHT.

Tom Lewis: Let me just start by saying that if you would have told me a year ago that I was going to join Century Management and we'd be buying stocks like Pfizer and Wal-Mart and companies like that...

Van Den Berg: And Microsoft...

Lewis: Yeah. [He laughs.]

Van Den Berg: He thinks we're *joking*.

OID: Not at all. I'm laughing about the irony of it all. It sounds funny. Think about it: Deep value manager buys Wal-Mart, Pfizer and Microsoft.

Van Den Berg: It *is* ironic.

Lewis: I haven't been watching the market quite as long as Arnie. But the last couple years, I began to wonder whether or not the big-caps offered good relative value. However, I didn't focus too hard on it.

But when I joined Century Management, I learned that these guys are great at laying out decades of data and just slicing and dicing it and figuring out what it all means. They look at it like a seasoned physician looks at an EKG. And when you look at it that way, it jumps out at you — the whole relative value thing. It becomes obvious that we're in the middle of a once-in-a-generation opportunity.

Van Den Berg: Tom made a very important point to me when we were first talking about Pfizer. He said, "You know, this is so classic — after a stock's been declining for seven or eight years and it's gone from $50 to $24, everybody is focused on all of the things that can go wrong. What they aren't focusing on are the things that can go *right*."

The stock peaked near $50 about seven years ago. And at that time, it was only earning 87¢. By comparison, this year, it's expected to earn something around $2.00. So the stock's dropped by half while the earnings per share have more than doubled.

[Editor's note: And while the free cash flow has roughly tripled.]

OID: That sounds very similar to Coca-Cola in 1982.

Van Den Berg: Exactly. People are just selling these stocks out of disgust. They've begun to look at it as dead money. That's just the story generally with *most* big-caps.

Lewis: So reason #1 of why Pfizer is cheap is disgust.

TODAY'S REGULATORY REGIME IS MORE CAUTIOUS — BUT THERE'S *ALWAYS* UNCERTAINTY IN THIS FIELD.

Van Den Berg: But with Pfizer, there's also fear.

OID: I assume you're talking about the liability that Pfizer faces from Bextra and Celebrex lawsuits?

Lewis: No, but that's an interesting question. I took a real hard look at Merck before I joined Century right after Vioxx had been pulled from the market — and I studied some cases back then. And that's one of the things that helped me get a running start on Pfizer when I got here.

When you look at the outcomes in the epidemiological studies involving tens, if not hundreds, of thousands of outcomes and you make comparisons, there did appear to be a slightly higher risk of a cardiovascular event with Vioxx. But you actually had a slightly *lower* incidence with Celebrex.

OID: In other words, rather than showing Celebrex to be harmful, the large-scale studies suggest that it was actually protective.

Lewis: Exactly. So it would appear to vindicate Celebrex. And if there's an instance of Bextra harming somebody, I think the lawyers would've shown up by now. And I *looked* for that — and couldn't find it.

OID: You don't think that those ~~jackals~~ lawyers are just picking the low-hanging fruit first — and that they'll get around to Pfizer once they've picked Merck's bones clean for having sold Vioxx?

Lewis: No. Celebrex appears to have been vindicated in the same clinical studies that suggested that there's an increased risk associated with taking Vioxx.

When Arnie says that fear is another reason why Pfizer's stock is so cheap, what he's talking about is something else. The company said it this way on one of their conference calls, although they'd hinted at it before. What they said is that they make their money from patented products, but those patents all have a finite life. And everybody knows that some of their most important products are coming *off* patent — a couple of 'em in the last year or so, a couple of 'em over the next year or so. And that's a certainty.

Meanwhile, the benefit management companies and the generic drug manufacturers have gotten really good at driving generic substitution. Whereas it used to take around seven months to get to 90% generic, it's gotten down to maybe two or three months now. So when patents expire, those revenues essentially go away — and everyone knows it. That's a virtual certainty.

OID: And didn't Congress effectively shorten the life of patents for drugs, as well?

Lewis: As I recall, they tweaked it. However, what's been more of a factor has been the FDA. You know that the way they behave will be cyclical, but you can't predict when those cycles will begin and end. And today, for a variety of reasons, the FDA is choosing to err more on the side of caution.

OID: Because they — and virtually everyone else — know which way the political winds are blowing.

Lewis: Exactly. So that drags out the time it takes to get new drugs through the FDA approval process. And meanwhile, the clock is running on companies' patents while they're waiting to have it approved. So if the time that it takes to get a new drug approved stretches out from one year to three years, they lose two years of revenues

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and profits. That's been an issue.

So you have virtually certain loss of revenue that's supposed to be made up by revenues and earnings from future products that are *completely* uncertain.

OID: And that, in a nutshell, might go a long way towards explaining today's valuations.

Lewis: That's right. But let me give you an idea of just how uncertain the future success of their new products really is. Pfizer acquired Lipitor with Warner-Lambert. And in the process of getting to understand Lipitor, I learned that at one point, Warner-Lambert was so uncertain about the future of what would become the biggest drug ever — which now has $12 billion in annual sales — that they actually tried to license it out. In other words, they almost gave it away.

OID: Wow.

Lewis: So if the companies that live with these drugs for years and years and earn their livelihoods from them are only that good at predicting the future of their products, how good can those of us sitting out here in the cheap seats be?

OID: In that case, I hope that you'll feel free to just round Pfizer's 2012 earnings to the nearest penny...

Lewis: But what we do know is that the company expends a tremendous amount of time, effort and money — they spend $7 billion or so — on R&D. And they came up with a goal of 20 new drug approvals in the 5-year period ending in 2006. And the company seems to be on track to meet their target.

[Editor's note: Or, at least, come mighty close to it. (See Pfizer Chairman Henry McKinnell's comments on page 46.)]

Lewis: Obviously, not all of those drugs are going to be blockbusters. I think of it like a portfolio of stocks — there's probably going to be a couple of duds and then some that do way better.

OID: Or vice versa in the case of yours truly...

Lewis: But we know that what the investor at the margin loathes is uncertainty. And you've got the certainty of revenues of certain products going away — last year, this year, next year — including Neurontin and some other names that I could bore you with. So everybody knows to the day what drugs will go *off* patent 12+ years in advance.

But nobody knows exactly how big their *new* drugs will be — or even what applications they'll be approved for. For example, here's something that's gotten better since I first paid over $26 for this stock last August. They have a drug called Lyrica. I understood that it was in the process of being approved as an epilepsy drug. However, epilepsy is not a huge category — unlike, for example, high cholesterol. Don't get me wrong — it's meaningful, but it's not huge.

However, in addition to epilepsy, they also use it to treat neuropathic pain. And there's something being said about using it to treat what's known as general anxiety syndrome. As an epilepsy drug, it didn't seem like much. And the other two were kind of on the come. Well, a panel in Europe recently recommended approval of Lyrica for this anxiety syndrome — which apparently affects something like 5% of the population of the Western World at some time in their life.

OID: So it looks as though Lyrica might be on its way from being a niche drug to something much larger.

Lewis: That's right. I don't know exactly *how* large, but I do know it could be a whole lot bigger. I can't look through the drugs in Pfizer's pipeline and tell you how big each one is going to be. But that's the way it works. You get an initial indication that a drug's approved for, but it doesn't necessarily stop there. So Lyrica has turned out to be one of Pfizer's fastest launches ever. And it's not because of its use in epilepsy, but because of other uses.

So surprising things happen — and not all of them are bad.

OID: However much it might seem that way today.

Lewis: Exactly.

FOR US, THE LIPITOR LAWSUIT WAS A NON-EVENT.
THE CHANCE PFIZER WOULD LOSE WAS REMOTE.

Lewis: Our starting point was to determine Pfizer's value in what we considered to be the worst-case scenario. So among other things, we assumed that they lost the Lipitor patent case to Ranbaxy. We assumed that their potential blockbuster, Torcetrapib, winds up being a bust. And we assumed conservative margins for what was left. But no matter how pessimistic a scenario we ran, we concluded that their stock was, at worst, *fairly* valued.

And needless to say, we're not looking to buy stocks that are fairly valued. But that was the big "if" at the time. That was the big concern people seemed to have on top of all of the other really obvious concerns about the rash of patent expirations Pfizer and other big pharma companies are facing. And frankly, we thought that the odds of them losing in court weren't very high, although it wasn't zero. Of course, subsequent to that, courts in the U.S. and the U.K. upheld the validity of Pfizer's patent.

And if the Lipitor patent winds up being valid until its expiration in 2011, then we can't come up with a valuation of less than $40-50 in the next three to five years.

OID: Do you mind me asking your average cost?

Van Den Berg: I believe our average cost has been somewhere between $24 and $25. As I recall, we've paid as little as $21 and change and as much as $26.50 or $27.

OID: So you've paid the current price.

Van Den Berg: Oh, yeah.

Lewis: We started buying Pfizer before its victory in the Lipitor patent lawsuit against Ranbaxy, but not before we had the opportunity to read Pfizer's brief on the case and everything about every patent challenge that we were able to get our hands on. And one of the things that we learned was that in something like 39 attempts in challenging patents, Ranbaxy had been successful only once.

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OID: What a great factoid.

Lewis: And nobody had *ever* been successful in the heart of the matter in this case — no pun intended — which revolved around "composition of matter". Of course, some patents have been successfully challenged — although the successes have been few and far between — but not on "composition of matter".

[Editor's note: Lewis elaborated: " 'Composition of matter' refers to the atoms that make up the molecule and, importantly in pharma, their orientation to each other. As I understand it, molecules with the same parts (i.e., atoms) oriented differently are called isomers. Two very similar (mirror image on some plane) isomers are called enantiomers. Sometimes one is more efficacious than the other. So removing the less effective one leaves you with a more powerful drug."]

OID: Very interesting.

Lewis: And fortunately, I remembered just enough about organic chemistry from the courses I took in college 30 years ago to be able to follow the discussion when they started talking about isomers and enantiomers and that sort of thing to see that it was virtually impossible that Pfizer wouldn't prevail. That said, you know about betting on the impossible in this game...

OID: Never say never — especially when it involves the American legal system.

Lewis: Amen. But we also knew that it wasn't a jury trial. And we ascertained that the presiding federal judge had extensive experience on pharmaceutical patent matters.

OID: And a history of rationality, I presume.

Lewis: And no apparent bouts of insanity.

ON A WORST-CASE BASIS, IT'S DEAD MONEY. AND THE WORST CASE IS EXTREMELY REMOTE.

Lewis: So, again, there's certainty surrounding the expiration of lots of Pfizer's patents and enormous uncertainty about the performance of the drugs that will be replacing them.

So here's how we dealt with that uncertainty in valuing Pfizer. First of all, we wanted to determine the impact of Pfizer's Lipitor franchise going away completely. And when you run the numbers there, you see that the rest of Pfizer's portfolio generates a pretty puny margin.

OID: Are you sure this one's a long?

Lewis: So one of the things I tested — and I got all the way down to about Line 700 on one of my spreadsheets as I'm studying scenarios...

OID: Line 700?!

Lewis: I basically broke it down into three categories. Obviously, one was Lipitor. And then I took what I call "The Big Five" — which are four significant products that are about to go off patent or had just gone off patent plus Celebrex. Like Vioxx, it got pulled. Pfizer's still selling it — which is a whole other issue.

However, it went from being a $3.3 billion product to a $1.6 billion product. And there was some question as to whether or not they would keep it on the market.

Van Den Berg: [After a long pause] He's just got to dig through 700 lines. He'll be right with you.

Lewis: Pfizer had two drugs in the Cox-2 inhibitor class — Celebrex and Bextra. And in 2004, they had sales of $3.3 billion and $1.3 billion, respectively. And in late 2004, the Vioxx scare came along — so they pulled Bextra. And I have Celebrex at a run rate of $400 million or so per quarter today — which is where it looks like it's stabilized.

[Editor's note: It looks like there may be a disconnect between widespread perception and reality on that one: During the second quarter, worldwide sales of Celebrex rose by 17% to $471 million. And here's what Pfizer U.S. Pharmaceuticals Vice President Pat Kelly had to say about Celebrex and its prospects given increased competition from generics — the most recent addition being Mobic — during their latest conference call (held on July 20th):

"The arthritis market has been primarily generic for quite awhile anyway. And ibuprofen and naproxen are much more significant players than Mobic will ever be. So we don't think the specific expiration of Mobic will have much impact on Celebrex.

"Our future story's all about rebuilding physician and patient confidence in what is the most efficacious agent — branded or generic. Celebrex provides the strongest and most effective pain relief for patients with arthritis. And we're continuing to rebuild those expectations.

"At the same time, we're continuing to find ways to *expand* the Celebrex franchise. Just last month, we filed the juvenile rheumatoid arthritis claim for Celebrex — which will add, once again, another new use to this agent which is already widely utilized, but hopefully headed towards even greater utilization."

Outgoing Vice Chairman Karen Katen chimed in: "During the second quarter, we also filed in Europe for ankylosing spondylitis.... So there's another new indication there ... for increased use of this important medicine.

"So we're very optimistic about Celebrex's future — *despite* the generic availability of a product like Mobic."]

Lewis: But I've included Celebrex in "The Big Five" category of drugs that are essentially going away. And I estimate that those drugs that are going away shortly comprised $15.7 billion of the $46.7 billion total sales of the Human Health division in 2004.

OID: I think I'm with you so far.

Lewis: And I don't know the profitability of Lipitor or Pfizer's other drugs individually. But we knew that their overall operating margin was 43.7% in 2004. Therefore, the operating margins of some of Pfizer's drugs are above 43.7% and some below it — for various reasons, of course.

So I stress tested the profitability of Pfizer ex-Lipitor by assuming different levels of Lipitor profitability. (And by the way, for purposes of our analysis, I assumed a *lot* of different levels.) However, if Lipitor has a 70% margin which is what we settled in on — and the Big Five have a 48% margin — then one of the things that will drop out of

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our analysis is an implied margin on the rest of the company's product mix.

And using those assumptions, we concluded that the operating profit margin on the rest of Human Health was only around 21% — 20.9% to be precise.

OID: Given the uncertainty in this business, please feel free to just round to the nearest percent.

Lewis: I appreciate it. But remember that we're talking about implicit numbers — because we don't really know that Lipitor has a 70% margin. We do know that the higher I assume it is, the more conservative we're being about the margin on the rest of their business.

Basically, what we're trying to determine is what the remainder of Pfizer's business would look like financially in the event that Lipitor does go away, and it turns out that it was way more profitable than we thought.

OID: For, in effect, your worst-case scenario.

Lewis: You've got it. So we know that Lipitor's margin is higher than average, but we know that it's lower than 83% — because that's the upper limit of what it ever gets to under the *best* of circumstances.

By the way, I also assumed an above-average profit margin for "The Big Five", and their revenues going from $12.4 billion in 2005, to $7.9 billion in 2006, to $5.8 billion in 2007, and $2.5 billion thereafter.

OID: As a result of upcoming patent expirations.

Lewis: That's right. And I assume that at that point those patents are gone, and that Celebrex is only making a small contribution. In effect, I've programmed in what I believe are aggressive estimates of the potential profits that Pfizer will be losing.

OID: And that tells you...

Lewis: That tells me a number of things. It tells me roughly how profitable the rest of Pfizer's revenues are, and how fast it has to grow in order to offset that decline. And if my assumptions about the rest of Pfizer's business are reasonable, it also tells me some things about their likely future earnings and free cash flow growth.

(continued in next column)

OID: And the bottom line is...

Lewis: Mind you, Pfizer may not even agree internally about the level of profitability of one product to another — because they might not agree about the most appropriate way of allocating certain costs and so forth. But based on the analyses we ran that we spent the better part of two months on, if we do away with our 70% profit margin for Lipitor — assuming Lipitor and the drugs whose patents are scheduled to expire during the next few years just go away — it suggests that Pfizer's earnings would be about $1.13 per share. And if so, they would likely stay in that range for a couple more years and then start to grow.

And as growth in what's coming into the pipeline lately and what's *about* to come into the pipeline starts to more than offset the patent expirations that are so concentrated in 2005, 2006 and 2007, and considering Pfizer's balance sheet and the stability of its earnings and all of that, we got very comfortable with a downside on an absolute worst-case basis — short of a scenario where your money's no good anyway — of about $21-$22 a share.

Van Den Berg: That's using a simple multiple of 20 on their worst-case free cash flow. And we won't bore you with our entire analysis and all of the reasons why we're confident that our analysis is conservative...

OID: Bore us, please.

Van Den Berg: Let us come back to that later. However, for lots of reasons, we're *very* confident that it's *plenty* conservative.

Tom's analysis gives Pfizer a pretty good haircut. And that's how we came up with $1.13. It could well be that Pfizer's earnings and free cash flow ex-Lipitor and the Big Five are higher than that. Absent some kind of cataclysmic event, however, we view that as our absolute downside. So basically, the worst case is dead money.

Lewis: And don't forget that you also get a yield of over 3.5% while you wait.

IN OUR "MODERATE SCENARIO",
FREE CASH FLOW WOULD BE $2.30-3.30.

OID: So what's your "moderate" scenario?

Lewis: In our moderate scenario, depending on our assumptions, we come up with something between $2.30 and $3.30 of free cash flow per share.

OID: What were the assumptions you used in order to come up with the $2.30 per share of free cash flow?

Lewis: If I take their base business and I grow it at a 13% rate, which I think is reasonable — again, excluding the Big Five that I assume are going away — and I put a margin of 33% on their revenue, which is almost exactly what it was in 2004, I figure that it would grow to $2.30 per share of free cash flow by 2011.

OID: And your $2.30 scenario assumes that Torcetrapib doesn't make it.

Lewis: That's right. That's just taking the revenues from the drugs whose patents won't be expiring during the next few years and growing it 13% per year. Admittedly, that's kind of conservative given what's in their pipeline.

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And then I apply a 33% margin to that revenue, tax effect it, and divide by 7 billion shares outstanding — which is slightly below today's level of shares outstanding because they are buying back shares.

That $2.30 would be in 2011 after Lipitor is gone — and Pfizer's cardiovascular franchise has gone away, except for a generic operation. In that scenario, I assume that Pfizer continues to sell Lipitor — only as a generic at a much reduced level of both revenues and margin. So the $2.30 is a number with very little contribution from Lipitor and none from Torcetrapib.

OID: And even on that basis, you say that you think Pfizer should be worth $40-45 or more in 2011.

Van Den Berg: That's right. But let's just see what their free cash flow would be assuming their *normal* margin — just to give you the difference.

OID: Bless you.

Van Den Berg: I do think a 33% margin is too low. You come up with the worst case, the mid-case and the best case, but what you want to use is the most probable.

OID: Praise the Lord.

Van Den Berg: So if we adjust the Human Health operating margin to 47%, which is less than it was in the first half of 2006, that would bring free cash flow in 2011 to a little over $3.00 per share.

OID: So your most likely case in the event that Torcetrapib is not approved would be $3.00.

Van Den Berg: The most probable would be a bit more than $3.00 per share — but we're using $2.30. And neither of those scenarios is wildly optimistic.

OID: So you're calling the scenario where you get $3.00 of free cash flow in 2011 your middle case?

Van Den Berg: Well, to be fair, I think that's *still* conservative. But that's moving towards the middle case. I think that $2.30 is sort of the low case. Maybe $3.30 is the middle case.

Lewis: Yeah. If we assume Lipitor grows at a more moderate rate over the next few years until it reaches the end of its patent life in 2011, we're looking at $3.30 per share in free cash flow in 2011. And I think a $45 value would be justifiable on that basis.

OID: Piker.

Van Den Berg: Yeah. If I had to value Pfizer three to five years out, I'd probably say that it's a $40-45 stock. And I could easily see it going to $50, but I prefer $45.

IF TORCETRAPIB GETS FDA APPROVAL,
THEN OUR NUMBERS COULD BE *WAY* LOW.

OID: You're killing me. You're telling me you think Pfizer won't even be worth 14 times free cash flow?!

Van Den Berg: Well, I think it would be safe to say that Tom has a much more positive viewpoint than that.

Lewis: We do have a couple of scenarios that would make Pfizer's value a *lot* more than that.

OID: Let's just save time and go straight to those, because they're what we're going to publish anyway — unless you have something higher...

Lewis: Beginning in 2011, Pfizer's competitors will be able to offer generic Lipitor. But something that could lead Pfizer to do way better than what we've talked about so far is if Torcetrapib, which is in Phase 3 testing, gets approved — which could, in effect, extend the life of Lipitor's franchise a dozen or so years beyond its scheduled patent expiration.

I truly believe that Torcetrapib has the potential to be a real miracle drug that could really do a number on cardiovascular disease. The action of Lipitor and the other statins is to lower low density lipoproteins — the so-called "LDL" or "bad" cholesterol — which of course, is a good thing. And by the way, a positive side of this that I've only become aware of during the last few years as I've started to rub shoulders with older people...

OID: And added Pfizer to your portfolio...

Lewis: I've learned that for many people in their 60s, these medications can be the difference between being middle-aged and being old.

OID: And here I thought that was Pepsi.

Lewis: Epidemiological studies show that at a time when for a variety of reasons (including demographics and life-style) cardiovascular disease should be increasing in our country, it's actually declining. And other factors may be involved, too — like people smoking a little bit less. But clearly, the adoption of these LDL-lowering statins is an important part of that.

Well, Torcetrapib raises the "good" cholesterol — the so-called high density lipoproteins — or *H*DL, which apparently helps remove the *L*DL...

OID: And, as I recall, makes it less likely that someone will suffer a cardiac event at any given level of LDL.

Lewis: Exactly. The studies show that people with high HDL have a lower incidence of cardiovascular disease. But that's not all...

One of the reasons why Lipitor is the preferred statin — one of the things that's made it such a great success — is that 10 milligrams of Lipitor can do what 40 milligrams of other statins can do, only better. And the lower the dose, other things being equal, the lower the odds of significant side effects.

As you might imagine, that's a major selling point for physicians who were still nervous about prescribing statins for their patients. And that's made it much easier for Pfizer to market Lipitor.

However, in a combination pill with Torcetrapib, Lipitor should be even better. And here's why I say that: Torcetrapib potentiates Lipitor. In other words, it's been shown to make a given amount of Lipitor work better — so that the dose of Lipitor can be even *less*.

OID: That sounds impressive, all right.

Lewis: So Torcetrapib's currently in Phase 3 testing.

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And Pfizer should be filing for FDA approval next year. Incidentally, I understand in order to get FDA approval, Pfizer not only has to show that Torcetrapib plus Lipitor does what Pfizer says it does and that it's safe, but they have to show it reduces plaque, too.

OID: So you save on dental floss, too!?

Lewis: Not that kind of plaque. But if Pfizer can show that the Torcetrapib/Lipitor combination reduces plaque in blood vessels and that there are no unacceptable side effects, instead of Pfizer's marquis cardiovascular franchise going away in 2011, its cash flow not only shouldn't decline, but it should keep growing nicely without missing a beat.

IF TORCETRAPIB WERE TO GET APPROVED,
WE'D BE TALKING ABOUT A DREAM SCENARIO.

OID: And Pfizer's most likely free cash flow and value if Torcetrapib's approved?

Lewis: Oh, God! That would be equivalent to extending Lipitor another decade or so. In that case, you'd have a tremendous and growing cash flow from that franchise in each of the intervening years. And using a 33% margin on their Human Health division — and a 13% growth rate — I came up with $3.75 of free cash flow in 2011 and $4.07 per share in 2012.

OID: Using your worst-case margin and growth rate.

Lewis: That's right. A true high scenario would be a 40%+ margin on that business — and it might grow faster than 13%.

OID: If there's one thing that I know something about, it's best-case scenarios. And I'm not letting you guys ever see your wives again until you tell us what it is.

Lewis: Well, if we just keep the 13% growth rate and give it a 44% margin, then it would be approaching $5.00 per share of free cash flow in 2011, and slightly over $5.00 in 2012.

Van Den Berg: Oh, yeah.

OID: Glory, glory, hallelujah. Was that so hard?

Van Den Berg: That's where it would be. But look, if a fraction of investors believed that, this discussion would be academic. If people expected $5 of free cash flow...

OID: Then Pfizer would be a helluva lot higher today.

Van Den Berg: It sure would.

Lewis: But those are remotely possible outcomes.

Van Den Berg: I wouldn't even mention those.

OID: Because you're in the humdrum field of investing, not the high stakes world of investment publishing.

Van Den Berg: As value investors, we want to put multiples on things that we can reasonably expect without court cases or approvals of new drugs or things like that. There are a lot of "if"s there. But the fact still remains that if somebody buys it in the mid-$20s, they can project a reasonable price of $40-50. And if Torcetrapib gets approved, well, then you've got a *real* winner. But those are dream scenarios. They're fun to think about, but...

Lewis: And if those extras come to pass and the stock's at $45, then we won't sell it.

Van Den Berg: Right. We wouldn't sell it at $45.

OID: In the scenarios that you ran where Torcetrapib got approved, how did you arrive at pricing for it?

Lewis: I just assumed that its value proposition in the market would be comparable to that of Lipitor.

OID: That sounds reasonable, if vague.

Lewis: I don't think we're being aggressive.

Van Den Berg: If it gets approved, then I think that our upper scenarios would be very much in the ballpark. And I think Tom's $5.00 wouldn't be out of the question — because If Torcetrapib winds up being approved and it extends Lipitor's economic life, then Pfizer's a no brainer — because we'd not only be talking about adding in the 85¢ from Torcetrapib, but adding back a growing contribution from Lipitor, too.

And at that point... Well, I think you can do the math better than we can.

OID: If that's true, it's only because I have practice using multiples above 14. But can't you humor a desperate editor?

Van Den Berg: If Pfizer were generating $5 per share in free cash flow, other things being equal, then I think it might be worth $80 or thereabouts.

AN AVERAGE S&P FREE CASH FLOW MULTIPLE?
IT'S AROUND 20. BUT PFIZER'S NOT AVERAGE.

OID: And if you were trying to assign a fair multiple of free cash flow — based on what it actually deserves — instead of lowballing us with 14-16 times...

Van Den Berg: Well, for S&P 500 companies, I'd say that the median valuation has probably been something around 15-16 times earnings, and 20 times free cash flow.

OID: So you think Pfizer's a below-average company?

Van Den Berg: No way. The average S&P 500 company has an EBITDA margin of 14-15%. Pfizer's is closer to 40%. And the average company in the S&P 500 probably has a net profit margin of around, say, 5-6%. Pfizer's net profit margin has averaged more like 22-25%.

[Editor's note: And it's been even higher since 2002 — averaging something north of 29%. And *Value Line* is assuming a net profit margin that's even higher still — north of 30% — in their 2009-11 projections.]

Van Den Berg: Also, Pfizer's return on capital is up around 20% — which is probably twice that of the average company in the S&P 500. And Pfizer's balance sheet is bulletproof — and its earnings are *all* free cash flow.

OID: And then some.

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Van Den Berg: That's right. So there's no way that anyone could confuse Pfizer with an average company.

OID: In other words, you think it's better.

Van Den Berg: Pfizer's not even in the same *league*. It's head and shoulders superior to the average member of the S&P 500 — even if it winds up not growing quite as fast.

OID: Well, in that case, wouldn't an intrinsic value of 14-16 times free cash flow probably be a tad low?

Van Den Berg: Yeah. To be fair, I think 20-25 times free cash flow would probably be a *very* reasonable multiple — especially given the current interest rate environment and our view of what interest rates are likely to be in the next three to five years. As we said at our conference, we believe we're in an unusually favorable environment for financial assets — with low inflation and low interest rates.

So considering the current interest rate environment, today's level of inflation and the production of products worldwide and relatively restrained money supply growth very likely *keeping* inflation down, we could easily argue that free cash flow multiples should be even *higher*. [He pauses.]

But we really don't need to get into that — because you can easily justify these multiples *without* that thesis. Believe it or not, the S&P has sold at an average of about *30* times free cash flow at peaks, and 20 times earnings — because, of course, not 100% of earnings are free cash flow.

OID: Well, with apologies in advance for asking, wouldn't a 25 multiple on $3.50 to $5 of free cash flow imply a stock price of more like $87.50 to $125?

Lewis: It would. But we don't even want to *go* there — because that's speculation.

OID: Because it relies on Torcetrapib getting approved and being a commercial success.

Van Den Berg: You've got it.

Lewis: And if Pfizer being a worthwhile investment depended on Torcetrapib being approved, then we wouldn't be buying it.

Van Den Berg: Exactly.

Lewis: Again, we understand the approval hurdle isn't just whether or not it raises HDL — it certainly appears to accomplish that — but whether or not it has an effect over and above what can be achieved with Lipitor and the other statins.

Van Den Berg: So Pfizer has a higher hurdle to jump in order for the FDA to approve that one.

Lewis: And I think it's a reasonably good bet that they'll succeed, but not good enough for us to rely on.

Van Den Berg: Please don't quote us on any of this...

OID: No, of course not. We'll keep it our little secret — just between us and our subscribers.

Van Den Berg: ...Because we're only looking for the lowest reasonable scenario we don't have a problem seeing. And for me, that's $40-45 based on $2.30 of free cash flow three to five years out. As long as it's good enough on that basis, we consider everything else gravy.

Lewis: That's right. If we're correct and Pfizer winds up with anything *near* $3.00 of free cash flow per share in the 2011 time frame, then today's price is cheap. I mean, the market ought to be willing to pay a multiple on that free cash flow *substantially* higher than it is today.

Van Den Berg: That's exactly right. I mean, even if we use a lowball figure for 2011 free cash flow of $3.00 and a similarly lowball multiple, we arrive at a value of $45-60.

I THINK PFIZER'S MAKING GREAT PROGRESS — AND THAT TORCETRAPIB'S POTENTIAL IS HUGE.

OID: Please believe me when I say that I understand you're not counting on Torcetrapib being approved. But might we trouble you to be just a little more specific about what you think the odds are?

Lewis: I think they're higher than I thought last fall. It's still a high hurdle. However, I make a point of listening carefully not only to what people say, but how they say it. It's very important to me that if I'm going to delude myself, that I do so on the side of being cautious.

OID: So much for a career in publishing...

Lewis: And I think I'm hearing a level of confidence from Pfizer's management I wasn't hearing before. I definitely get the impression that they're making great progress on their trials.

OID: Let me phrase my question somewhat differently: If you were forced into a corner by a sleep-deprived, deadline-hounded, totally desperate newsletter editor and forced to say how likely you think it is that Pfizer will get approval for Torcetrapib, what would you say?

Lewis: Well, I've heard that it has the effect it's supposed to have — and that it potentiates the Lipitor. That means it makes however much Lipitor someone takes have more of an effect. That's something that they weren't saying before. They've also tested it for safety. And they've confirmed that it does raise good cholesterol — the so-called HDL.

So all told, last August, I might have guessed that the odds of Torcetrapib being approved were just over 50%. Today, I think I'd say 70%.

OID: Sounds good.

Lewis: But what remains at this point is for them to see if it actually reduces plaque better than Lipitor alone. And there hasn't been data forthcoming yet in that regard. However, they were willing to speak more recently with a level of detail and enthusiasm that I wasn't hearing before.

OID: But if Torcetrapib raises the good cholesterol and potentiates Lipitor, why wouldn't that be enough to get it approved?

Lewis: I don't know. That's just what they told me. Presumably, that's the hurdle the FDA's set for approval. Maybe it's because they concluded that the level of plaque is the most important indicator of how healthy people are.

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OID: If Torcetrapib gets approved, what are the odds that it'll be a commercial success?

Lewis: Huge. After all, cardiovascular disease is the biggest disease in the Western world. It's been estimated that only about one third of the people in the United States who would benefit from lower LDL are getting treatment. And who knows what the market could be globally?

OID: Price controls, counterfeiting and other intellectual property piracy aside.

Lewis: Even then. But in my projections, I simply assume that Pfizer's revenues combined from Lipitor and Torcetrapib grow about 14.9% during the first year after Torcetrapib's approval, which is 2008, 13.1% in 2009, 7.6% in 2010 and 2011 and 6.2% in 2012.

BUT THE ONLY CERTAINTY IS PATENT EXPIRATION.
APPROVAL AND MARKET ACCEPTANCE ARE UNKNOWNS.

OID: That doesn't sound wild-eyed. But what's to say there's not something out there about to be approved that's better?

Lewis: If there was something like that out there, I think that I would've heard about it. That said, however, some people say that niacin works just as well. But I have to go to an arcane bulletin board on the internet to read about it. I suppose that there could be something...

One of the things I had to overcome with this idea... I'm not really into alternative health. However, I am taking a couple of things that I didn't take before — like fish oil.

[Editor's note: We told Lewis how we'd read that statins deplete the body's supply of Coenzyme Q-10 — which we understand is important, if not critical, for proper heart function. So, we told him, we were surprised to learn that a review of 97 clinical trials published between 1965 and 2003, pooling results of 275,000 people in the April 11th Archives of Internal Medicine had concluded statin drugs reduce mortality and cardiac death by 13% and 22%, respectively; although the same review also concluded that those taking fish oil reduced mortality and cardiac death even more — by 23% and 32%, respectively.]

Lewis: I don't want to leave you with the impression that I take the fish oil for my cardiovascular health. I just take it because my eye doctor told me it's good for my eyes. And Jim Brilliant, our director of research, mentioned that it's supposed to help brain function, too.

OID: Yeah. It's supposed to be great for your memory. That's why I take it. And it absolutely works wonders. ...Now, what were we talking about?

Lewis: Natural healthcare alternatives.

OID: Oh, yeah. I haven't read all of the studies. However, I suspect that if people were fully informed about health and natural alternatives, the usage of pharmaceuticals might decline by 80-90%.

Lewis: Which wouldn't be a good thing for Pfizer or any of the other drug companies.

OID: You wouldn't think so.

Lewis: Well, let me address that issue this way: Near the top of my list of things that I'm *not* worried about would be an outbreak of well-being and common sense — of everybody starting to eat right, get the right amount of exercise and so forth.

OID: It's hard to disagree with you there. On the other hand, isn't there a rapidly growing awareness about alternative medicine, the importance of things like avoiding pesticides, eating organic food, etc.?

Lewis: Just about anything's possible. However, nothing that I see in our lifestyles suggests that there's likely to be an outbreak of really good health so that people won't need to be medicated as much.

Until I see obesity rates decline for two years in a row, it's not something I'm going to worry about. I think that a decline in obesity would be our early warning signal there.

[Editor's note: And of course, on the flipside of that equation, besides rapidly growing obesity is the spread of what have heretofore been regarded as Western diseases around the globe, rising standards of living leading Americans and others to spend an ever increasing share of their income on so-called "health"care, and the continuously expanding list of ailments and conditions for which drugs are routinely prescribed.]

Lewis: That said, as I mentioned earlier, we got a good illustration of just how uncertain the prospects for any drug can be when Warner-Lambert almost killed Lipitor rather than making it the fourth statin to come to market. There was a very good business case not to put any more money into Lipitor. However, despite that, they gave it one more go in the lab, got the indication that it was as efficacious as it was, and kept going. So Warner-Lambert came awfully close to actually pulling the plug on what ultimately wound up becoming the biggest drug in history.

OID: That story really puts it in perspective.

Lewis: Right now, we know for certain the exact day that Norvasc and Lipitor and Zoloft are going off patent. And we know exactly how much revenue each of those drugs are generating today.

By contrast, although Lyrica has been one of the fastest ramp ups ever, we don't know whether it's going to turn out to be a $1 billion drug, a $5 billion drug or something much more or much less. You don't know until you get there. As Pfizer's management described it, they're balancing the certainty of their expiring patents against the uncertainty of their new drugs in the pipeline.

And of *course* people are uncomfortable with that. Investors *hate* uncertainty. I'm not crazy about it either — but I've learned to live with it.

OID: So you never know if your products are going to get outmoded shortly or become a standard element of accepted therapy for decades to come.

Van Den Berg: Yep. But one thing that you *do* know is that Pfizer has nearly 20 drugs in its pipeline up for approval in the next few years. I think it's highly unlikely that *some* of those aren't going to get approved. And the

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revenues of those new drugs will start to add up. Meanwhile, by 2008, most of these patent expirations that everybody seems to be so fixated on will have occurred.

So Pfizer will begin to have revenue growth again — possibly as soon as 2007, and almost certainly by 2008 — based on what's in their pipeline.

WE EXPECT *TREMENDOUS* PRICING PRESSURE ON DRUG PRICES FOR A VARIETY OF REASONS.

OID: On the other hand, couldn't Pfizer also wind up getting FDA approval on Torcetrapib and any number of other drugs and still wind up not getting much of an economic benefit from 'em for political reasons?

Van Den Berg: They could. But that said, the company's response to that — and I think it's a good one — is that the cost of the drug is the wrong place to focus.

OID: Just what I say about our publication schedule. How exactly do they misdirect?

Lewis: They say that when people take their drugs, they wind up spending a whole lot less in total — when you include outlays on surgery and hospitalization — than they would otherwise. They say that it's generally the most cost-effective alternative.

[Editor's note: Just what Oakmark's Bill Nygren says.]

OID: But couldn't political pressure, along with the increasing bargaining power of benefits managers, HMOs, etc. and competition from biotech firms dramatically impair the pricing and profit dynamic that you expect?

Lewis: We're expecting *tremendous* pricing pressure on pharmaceutical prices for a variety of reasons — not the least of which is the increasing clout of the big HMOs, the other benefits managers and so forth.

[Editor's note: Asked about rumors of "much more significant price concessions [from drug] manufacturers related to Medicare Part D" in their latest conference call, Pfizer U.S. Pharmaceuticals V.P. Pat Kelly actually spoke optimistically about its impact: "We *very* aggressively want to insure the presence of Pfizer's great medicines in *all* managed Medicare formularies in the Part D program. And in fact, we successfully concluded negotiations with 82 of the almost 100 plans that are out there on a national or regional basis.

"Those negotiations were successful in terms of providing us with formulary access at a Tier 2 level for our medicines at a level greater than any of our competitors in various therapeutic categories. We secured that position by very effectively and aggressively contracting. And that has continued to this date.

"As we continue discussions with each of those plans, they've been uniformly pretty pleased with the progress they've seen with Pfizer medicines in their formularies and pleased with the negotiations that we had and that we continue to have. So we don't foresee really anything but continued strong performance in the Medicare world for Pfizer medicines."

Outgoing Vice Chairman Karen Katen then added: "Even more important, I think, is the overwhelming strength of the Medicare Part D program itself — where almost 23 million people are now enrolled. And the research so far shows that the enrollees are very satisfied with the benefit — and it is a real benefit. So that's a source of future volume."

Of course, assuming that Kelly and Katen are correct, any such positive impact ~~could~~ will reverse quickly ~~if~~ when a change in the political climate results in the pharmas getting squeezed harder.]

Lewis: However, Pfizer's already had some experience dealing with those pressures in Germany. And in that experience, they learned that patients and doctors don't want to make that switch — because they like being able to get the therapeutic benefit putting only *10* milligrams of a statin in their body as opposed to *40* milligrams. It's that much more efficacious.

And if I try really hard, I think I can remember a time when that *wasn't* a problem. But it's been an issue now for years. I can't predict a change in the political climate.

Van Den Berg: But all of your points are valid.

OID: Wow. There really is a first time for everything.

Lewis: They are. Those are just some of the risks that come with the territory — including a change in the political climate. However, all things considered, we just decided that given what this company brings to the table — not only for people in the Western world, but for literally hundreds of millions of others who aspire to have those benefits, too — we were prepared to live with 'em.

OID: There you go again sneaking in a free promo...

Lewis: But it's *true*. And given the level of benefits these companies bring to consumers in the U.S. and around the world, it's not going away.

OID: Although a situation where U.S. consumers are the ones paying for the vast majority of those benefits doesn't seem like a good prescription for stability.

Lewis: I agree that the pharmaceutical business will *never* be as attractive as it used to be.

Van Den Berg: That's right.

Lewis: These companies started working on statins something like 30 years ago. In this business, you work on developing a new compound for 10 years before you even begin to think you *might* have something. And then you spend hundreds of millions of dollars just to try to get it through the approval process.

And then, after all of that, you're counting on the political climate allowing you to reap a sufficient reward for your efforts during a finite window to make it worth decades of time, effort, and expense. So it's definitely not as good a bet as it was 20 years ago.

OID: But still one that you think is worth making.

Van Den Berg: At 15 times free cash flow, certainly. If it was selling at 20-30 times free cash flow, then I'd worry about all of the negatives you're pointing out. However,

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down around 15 times free cash flow, it's a bet that we're happy to make. In fact, we'd love to have a portfolio full of bets just like it.

PHARMA FACES LOTS OF HUGE CHALLENGES, BUT THEY'RE ALL *IN* THERE — IN THE PRICE.

OID: Speaking of the business not being as good a bet as it once was, you don't worry that, as some suggest, the biotech firms are utilizing a superior technology?

Van Den Berg: I remember when we were buying old-guard technology firms in 1990. We were early. And not being knowledgeable about the tech stocks, we learned an important lesson — which was that when you buy technology, you can't just do it based on the normal value system that we use elsewhere. You've also got to know whether the technology's obsolete or not.

OID: I'll show you my scars if you'll show me yours.

Van Den Berg: So we were early — and we bought the wrong stocks. The ones we bought didn't turn out to be the technology leaders. However, we ended up making a lot of money on 'em. So one of the things we learned from that experience was that even if you bought a Digital Equipment and a Burroughs — which you wouldn't exactly consider to be the right technology — you could still make money on 'em if you bought 'em at the right *price*.

So even if the biotech firms wind up making the business somewhat less profitable for Pfizer, we believe its stock price more than reflects that lower profitability. And we can't necessarily say that for the biotech firms.

OID: Another challenge facing big pharma firms and biotech companies alike is the fact that countries seem to structure their laws to their best advantage and to the disadvantage of U.S. patent holders. China, of course, is notorious for disregarding intellectual property rights — at least as long as they don't involve Chinese intellectual property.

Lewis: I think that's a fair statement.

OID: And Pfizer Chairman Hank McKinnell has said,

(continued in next column)

as I recall, that Europe has structured its intellectual property laws so Europeans, on average, pay around half as much for patented drugs as we do in the U.S. and four times as much for generics.

Lewis: That's my understanding, too.

OID: Until that changes, I'd have to imagine that the profit potential of their products globally is likely to remain a small fraction of what one might think it is. And I imagine that because U.S. consumers are footing the lion's share of the cost of new drug development worldwide, the risk of a political backlash against the pharmas is much higher than it would be otherwise.

Lewis: These companies know that they're getting ripped off in China. So they're not rolling out nearly as many new compounds as they are in the West where there is respect for intellectual property.

OID: And you don't worry about counterfeiting?

Lewis: We think pharmaceuticals as a product class are particularly well suited for RFID tags to cut down on counterfeit drugs. And I didn't know this last summer, but Pfizer is out in front in the use of RFID tags.

[Editor's note: RFID tags are radio frequency identification chips that are expected to eventually replace bar coding for purposes of tracking product shipments, monitoring inventory, and distinguishing between genuine and counterfeit merchandise.]

Lewis: So do I worry about intellectual property being defended? Sure. It *is* a problem, it's *been* a problem — and it's likely to *remain* a problem. But it strikes me as one that's more likely than not to diminish over time as the offending countries realize how much it's hurting them by discouraging activities requiring collaborative innovation.

[Editor's note: And it sounds like Pfizer Chairman Hank McKinnell would agree — and even suggest that China is more opportunity than threat. Here's some of what he said about the opportunity in China during the company's most recent conference call (which he directed, incidentally, *from* China):

"Many of you know first-hand the amazing development and potential of [China. It's] projected to be the world's fifth largest pharmaceutical market by 2010.

"But what you may not know is that Pfizer has been investing in China across three decades, and that we're already among the leading pharmaceutical companies in China today, the largest foreign company, and #2 overall — rapidly closing in on #1. We expect our business here to double and redouble again over the next six to seven years."]

OID: And drug reimportation?

Lewis: It's like the Prego Spaghetti Sauce commercial back in the 1980s. There was this classic Italian family sitting around the dinner table. And the mother in law would say, "But does it have fresh garlic in it?" And the son would say, "It's *in* there." And she would ask about fresh tomatoes and onions and so forth and so on. And the answer would always be the same: "It's *in* there."

Well, it's the same with Pfizer. It's already in there — it's in the *price*.

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OID: Even the prospect of Democrats in charge of Congress — and perhaps even a President who believes in a Canadian-style healthcare system, however difficult that might be to imagine today?

Lewis: That would certainly test our mettle. Suffice it to say that it wouldn't be a good thing for the stock.

Van Den Berg: No, it wouldn't. And I can't think of anything more disastrous to our healthcare system than to have Hillary in there mucking it up. But what do you think the free cash flow multiples of the pharma stocks were when they sold down in 1993-94 as a result of fears about the Clinton Health Care Plan?

OID: I'll bite. What were they?

Van Den Berg: They were roughly what they are for Pfizer *today*. At that time, the pharma stocks got down to 12-15 times free cash flow. And Pfizer is selling at something around 15 times free cash flow today. So when Tom says it's in there, he means it's *in* there.

It's been going sideways or down — and mostly down — for eight years. So there's enough disgust in the price to account for every negative you've mentioned and more. If it weren't facing these negatives, this thing wouldn't be selling at 15 times free cash flow. It would be selling at closer to *30* times free cash flow.

[Editor's note: Their estimate for 2006 free cash flow is $1.82. And lest you wonder why *Value Line*'s figures suggest it should be higher, Lewis informs us that he believes *Value Line*'s estimate for 2006 operating cash flow is nearly 70¢ per share too high.

(Pfizer's financials are somewhat muddier than usual for several reasons — including the fact that the smoke has yet to clear entirely from their recent acquisition activity.)]

THIS BUSINESS WILL NEVER BE AS GOOD AS IT WAS, BUT IT'S NOT GOING TO BE CHOPPED LIVER EITHER.

OID: You say that you don't expect this business to ever be as good as it used to be.

Lewis: That's right.

OID: Might you give us a sense of what kind of returns you expect Pfizer to earn?

Lewis: Let me put it this way. *Value Line* is showing them earning a return on equity just north of 20%. We're pretty comfortable with that. And at today's price, we'd be fine if it were a little less.

Van Den Berg: Like Tom said, it's already *in* there. Pfizer used to have a return on capital of 36-41%. And now it's down to 20%. That's quite a ways down already.

Lewis: One more thing — the last three years, they've been buying back stock at a pretty aggressive rate.

OID: Although, some might say, not aggressive enough.

Lewis: As I recall, they just completed a $5 billion share buyback program. And the reason I bring that up is that the only way that they would ever get back to an ROE anywhere near what it used to be, I think, would be if they were to really step up their share repurchases in a way that shrunk their book value.

OID: And absent that, I gather that you're thinking that they're likely to generate a return on capital of something around 20%.

Lewis: That's right.

Van Den Berg: But as I mentioned earlier, the average company generates a return on equity of 14% — with a net profit margin of 5-6%. Pfizer generates a return on equity of 20%...

OID: Without the use of financial leverage.

Van Den Berg: That's right. Also, this company has a net profit margin that's approaching 30% — which is nearly five times that of the average company. But again, their return on equity today is only 20%, which I think is low — both relative to what it's been in the past and what it *could* be.

OID: So if Pfizer generates free cash flow equivalent to your most likely case margin scenario, even if Torcetrapib winds up being a flop, you should do fine. Even a 20 multiple on $3.30 of free cash flow...

Van Den Berg: We're not looking for Pfizer to go back to earning a 40% return on capital. Those days are over. However, is their net profit margin likely to decline to 6%? Given the business they're in, we don't think so. I mean, if a metal bender can do that, this company should do better.

OID: Despite the politics, the possible price controls, the counterfeiting, etc.?

Van Den Berg: Anything's possible. The cloud hanging over Pfizer does remind me of the cloud that's been hanging over the tobacco companies for many years. But when all is said and done, we *still* think it's a bargain.

OID: Because it's in there.

Van Den Berg: That's right. We think the politics and so forth are only likely to go so far.

[Editor's note: It's interesting that Van Den Berg draws this comparison — because Semper Vic Partners' Tom Russo does, too. Russo, who bullseyed Altria and the legal issues surrounding it in our August 11, 2003 edition, tells us that he believes the drug companies are at risk of the same kind of legal attack that's had limited success against the tobacco companies — a process that he says begins with their vilification in the press.

Notwithstanding our respect for Russo's judgement and expertise (and despite the vilification process of the drug companies already underway) we're inclined to agree with Van Den Berg that it's only likely to go so far with the drug companies — at least over the next few decades.]

Van Den Berg: We obviously have our concerns, just as you do, which is why we did those cash flow projections that basically assumed disaster for Pfizer — with it losing its patents for Lipitor, its revenues slowing, margins crashing, and so forth. We don't know how you could get any worse than some of the scenarios we ran...

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OID: Short of a huge legal or regulatory disaster.

Van Den Berg: Always. And no matter what we did, we couldn't come up with a scenario where Pfizer was worth less than the low $20s. That's the bottom line.

So let's say that our worst case is that we're sitting here a year or two from now and this stock is $22 or $23, and we've collected a 3.5% dividend. Well, if that's the worst thing that we ever do, we'll take it.

HERE'S A BACK-OF-THE-ENVELOPE PROOF
THAT WE'RE ON THE RIGHT TRACK....

Van Den Berg: I went to bed thinking about our conversation. And I woke up at 5:30 this morning...

OID: I give you nightmares, too?

Van Den Berg: No. I had a major breakthrough. And it's so simple that you aren't going to believe it.

OID: Don't tell me that you're doing what Buffett did after I called him — and getting an unlisted number?

Van Den Berg: Not yet, although it's a good thought. I figured out a way to double-check our analysis.

OID: Fire away.

Van Den Berg: Let's assume that we're right and that Pfizer's base business excluding Lipitor and their drugs that are coming off patent in the next few years do have free cash flow of $1.13 — let's call it $1.15 — per share.

OID: Consider it assumed.

Van Den Berg: And let's assume that we're right about it growing 13% per year. Over the next five years, that would total a little over $7.00 of free cash flow.

OID: More like $7.34, but who's counting?

Van Den Berg: Add to that the free cash flow that's going to be generated by Lipitor. It's growing a little bit. So let's just say that after five years, it totals about $5.00. If you're interested, we're assuming the free cash flow progression by year will be 85¢ this year, 85¢ in 2007, $1.10 in 2008, $1.15 in 2009 and $1.15 in 2010.

OID: Factoring in nothing for Torcetrapib.

Van Den Berg: That's right. So if you add it all up, you get $5.00.

OID: I'm coming up with $5.10. But it's close enough for government work...

Van Den Berg: And finally, Pfizer's ahead of schedule in their plan to cut costs by $4 billion per year by 2008. And that should add another $1.50 or so of free cash flow to their bottom line during the same five-year period.

So over the next five years, based on our projections, after paying out a hefty dividend — perhaps something in the neighborhood of $5.75 per share — Pfizer's likely to add about $8.00 per share to its stated book value.

OID: Before you factor in the exercise of options, share repurchases and so forth.

Van Den Berg: That's right. Meanwhile, the company's return on equity has been between 19.5% and 47.9% every year during the past 14 years.

OID: Yep. According to Value Line, during the period, their average return on equity's been just under 31%.

Van Den Berg: That sounds about right. So I don't think it's a bad bet to assume that they'll be able to earn a 20% return on equity in the *next* five years.

OID: Probably not — especially when you consider that those returns are on stated book. And according to a footnote in Value Line, Pfizer's book value includes $7.63 per share of goodwill (as a result of their acquisitions). So on tangible book, its returns are already higher.

Van Den Berg: That's right. So if you assume that they can earn 20% on their incremental $8.00 per share of book value, their earnings and free cash flow five years from now should be something like $1.60 above what they are today.

OID: And that would be on beginning of year equity. On average equity, it would add more like $1.75.

Van Den Berg: Correct. So if we're right that Pfizer will generate free cash flow of about $1.80 per share in 2006, and they can just manage a return on equity of 20%, looking out five years, they ought to be able to generate free cash flow of a little over $3.50 per share.

OID: So your back-of-the-envelope analysis suggests that your projections haven't been so wild-eyed.

Van Den Berg: Exactly. And by the way, that's not fully factoring in the impact of the capital compounding during that period. So my figures somewhat understate the incremental capital and the implied impact on earnings and free cash flow.

[Editor's note: Although, to be fair, neither do they factor in the impact on book value of share repurchases at a multiple of book.]

Van Den Berg: But here's what's interesting to me. In effect, I went about the analysis from a completely different direction than Tom. I just woke up this morning with the idea of doing it this way.

And Tom didn't want to show you this... Actually he wanted to show you, but truth be told, I wouldn't *let* him — because we try not to be aggressive in our assumptions. I said, "Tom, of your seven primary scenarios, let's just show Henry the first one." And only because of your persistence, we wound up showing you three.

OID: If I ever apply for a job as an interrogator, maybe I can give you as a reference.

[Editor's note: Portions of this interview were deleted in order to maintain our PG rating.]

Van Den Berg: We showed you the real low case — which was $2.30; we showed you the mid-case — which was $3.30. And finally, we showed you his dream case — which was $5.00. Again, that last one's ridiculous —

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because you can't count on it.

OID: Oh?

Van Den Berg: It's certainly possible. But I truly believe that this scenario — where 5 years out, they're generating $3.50 of free cash flow — is a real good, probable case. In fact, in my opinion, it's the *most* probable case. I'd even go so far as to say it's a *very* probable case.

OID: We won't tell anyone.

Van Den Berg: And again, Pfizer's accrued equity will be compounding over the next five years, but I didn't factor the impact of that compounding into my analysis. So there's a little margin of safety.

OID: As long as it's little...

Van Den Berg: So I think Pfizer's a good idea. I feel very comfortable with our analysis. And quite frankly, looking out five years, I actually feel like its value is likely to be higher than $45.

OID: About 13 times your estimate of free cash flow?! Wow! But don't worry — we'll keep it our little secret.

Van Den Berg: And that's all you need to know. Again, I feel comfortable with the $45 — even $55 — value after doing this exercise. And I hope it does it for you, too.

OID: It does. And don't worry — we'll tell no one you assumed a double-digit multiple of free cash flow...

Van Den Berg: So again, I think that we're using a very conservative model — and I'm *very* comfortable with it.

OID: All's well that ends well.

But as long as you've been drinking, would you care to admit what you think Pfizer might be worth if Torcetrapib gets approved?

Van Den Berg: If Torcetrapib gets approved and it winds up extending the Lipitor franchise, then I'd think that Pfizer would probably be worth *$100* or more.

OID: Whether it ever gets that kind of valuation in the market or not.

Van Den Berg: Exactly — which is one of the reasons why I don't even want to *talk* about that kind of scenario. I'm just talking about what it's probably *worth*. What it's going to sell at is up to others to determine.

But I think we've shown that Pfizer is dramatically misperceived and, in effect, hidden in plain view. However, despite everything we've said, we know that we can spend a lot of time analyzing a single holding and still be dead wrong. Any single stock in our portfolio can be a loser. That's why we try to avoid talking about any single one. We know that some of 'em are going to be big winners, some will be mediocre and some will be losers.

OID: Let's just skip the latter...

Van Den Berg: We just don't know which ones. That's what happens to many investors. They don't get the returns that they should because they think they know which stock is going to win.

OID: I strongly resemble that remark.

Van Den Berg: If you're wrong and it's one holding within a 20-stock portfolio, then you'll still be fine. However, if you got all excited about something and put 10% or more of your portfolio into it, you might *not* be.

OID: Well, if it'll make you feel better, please feel free to briefly tell us about one or two more. I won't even try to shoot holes in 'em — very hard....

THE BEST INDICATOR IN THE WORLD
IS MAKING A GREAT CASE FOR WAL-MART.

Van Den Berg: By the way, I'm not saying that Pfizer is our best idea. I think what's a great case is Wal-Mart. It's certainly a classic case of misperception. And I say that because Wal-Mart is being so maligned by the unions.

OID: And their comrades in arms in the media.

Van Den Berg: The union propaganda is so powerful — it's almost like they control the press. I mean, every *day* you're reading something about Wal-Mart. It's like they were criminals.

OID: Absolutely. Semper Vic Partners' Tom Russo and I were struck how it's that way in spades with the tobacco companies. And now it seems to be that way with Big Pharma — especially Merck and Pfizer.

Van Den Berg: The press behaves like a pack. When something's up, they can't say enough good things about it. When it's down, they can't find enough bad things to say. And one journalist tries to outdo the other.

During the tech bubble, one guy would come out and say a stock was going to $400. Then the next guy would want to outdo him, so he would say that it's going to $600. And before you know it, somebody had a target of $1,000.

OID: But it makes for very entertaining programming.

Of course, I find that kind of behavior despicable — except when we do it...

Van Den Berg: And I think that's the way it is on the downside, too. People want to outdo each other with their scary predictions and sensational headlines — because that's what gets people's attention. It sells newspapers and attracts eyeballs.

OID: Yep. Living legend John Templeton used to say that if newspapers and TV shows didn't focus on the bad news, they were pretty much guaranteed to quickly go out of business — because people would tune 'em out. And "If it bleeds, it leads" was allegedly Mouth of the South Ted Turner's credo.

Van Den Berg: I couldn't agree more.

OID: However, it seems like the tendency is to give the union view and the plaintiffs' view in a far more favorable light than the viewpoint of the companies — which, more often than not, seem to be treated like

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they're guilty until proven otherwise. And even then...

Van Den Berg: That's certainly what they're doing with Wal-Mart. I'm keeping a file on Wal-Mart. And I find myself continually amazed at what unions get away with in terms of propaganda about Wal-Mart.

In fact, I even saw an article where they interviewed a union representative — and he said, "I believe that our publicity at this point is really starting to hurt Wal-Mart." Just think about it. In that one statement, he said it all. He's trying to hurt a company employing a million and a half people just because they're a non-union company.

OID: It's not irrational from his perspective. What's wild is the degree to which most journalists seem to slant their reporting like they're on the union team.

Van Den Berg: They really do. And the result is that investor sentiment winds up being manipulated.

We've got clients that are just furious that we own Wal-Mart. They are so mad at them. You should *hear* some of these people. And I tell them, "How bad could it be? They employ 1.3 million people in the U.S. — and 1.8 million worldwide. They pay double the average industry wage. And nobody pays health insurance for part-time people." I go through the whole thing.

And they say, "But they take jobs away." You ought to hear the arguments.

OID: I'm sure.

Van Den Berg: And you know that the union is doing it all.

OID: With the assistance of their allies in the media. But is Wal-Mart the holding that you're getting the most grief about?

Van Den Berg: Oh, we get grief about Pfizer, too. But frankly, we get grief about *all* of our stocks — because they're all out of favor. But do you know how we can tell when we *really* have a winner?

OID: When our LEAPS have expired?

Van Den Berg: Nope. It's the ultimate bellwether.

OID: BusinessWeek, The New York Times, yours truly...

Van Den Berg: It's even better than those. It's when our clients get really *angry* — when they're so mad that they make us sell it. We've had five clients make us sell Wal-Mart. They didn't even want to *talk* about it. They just didn't want it in their portfolio. That's the bellwether — because nothing reflects investor sentiment better.

We're amused by it. It's so ridiculous. The way people feel about Wal-Mart is so classic.

We told one client — and she got a little peeved at us — "You know what? If we were to measure the amount of good that Wal-Mart did versus the amount of good done by Mother Theresa, it wouldn't be *close*. If it were up to me, I'd give Sam Walton the Nobel Peace Prize."

OID: Nice thought, but I don't think you're eligible unless you're rabidly anti-American.

Van Den Berg: She almost gasped. And we said, "Look. Sam Walton's enabled poor people to get 25% more for their money than anybody else. Where else can tens of millions of lower income people around the world get 25% more for their money?"

We said, "Look, Wal-Mart employs 1.3 million people in the U.S. If these people are so unhappy, why don't they just leave and get a better job?"

OID: But if they hate Wal-Mart, chances are they think the world's worst terrorist is in the White House, and there are no jobs — outside of fast food, of course.

Van Den Berg: You may be kidding, but you're *right*. They all say, "Well, they probably *can't*." I say, "If they can't get a better job than the one they have at Wal-Mart, isn't it a good deal?" It's like kindergarten reasoning — you know, it's the emotional thing. They're just engaged in a very cursory, but very broad-based way of thinking.

And yet I imagine that some pension funds have sold their Wal-Mart stock to avoid taking heat for owning it.

OID: No doubt.

WHAT A DIFFERENCE SIX YEARS MAKES —
YOU GET OVER THREE TIMES THE VALUE TODAY.

Van Den Berg: However, from a valuation standpoint, look at what Wal-Mart was generating in sales and earnings per share in 1999 when its stock was at $70. Then look at those figures now. It's truly amazing.

OID: You think a little over 15 times earnings and 50% of sales is more attractive than 55 times earnings and 186% of sales?

Van Den Berg: Isn't that something? That's what *really* got our attention. It has doubled its earnings and sales per share since late 1999/early 2000. Everything has doubled — right across the board. Yet here the stock is at $44 or $45.

OID: That's some contrast. But the last time I looked, over $12 billion of Wal-Mart's $16 or so billion of operating cash flow was getting eaten up by their capital expenditures. If so, the company's still selling at around 40 times free cash flow.

Van Den Berg: Well, yeah. But that's the point. Here's the way I look at the free cash: If the company's getting a great return on their free cash, why *wouldn't* you want 'em to invest it? Why would you *want* the free cash? After all, the company is earning a higher return on their free cash than I'm getting on mine.

OID: Great answer. And when they build a new store, do they still effectively own the real estate?

Van Den Berg: You've got it.

OID: Well, that's a very interesting aspect. You might be able to persuade me, after all.

Van Den Berg: Just think what their free cash flow would be if they were to stop building stores.

OID: Sure. But when a retailer stops building stores,

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isn't it usually because their concept's become outmoded? And at that point, isn't its stock more likely to sell based on its asset value?

Van Den Berg: I'm not saying that they *will* stop building new stores. I'm saying that if they did, you would get a look at their true free cash flow.

OID: I understand. But aren't retailers like sharks — if they don't move forward, they atrophy and die.

Van Den Berg: With the profitability that this company has, they can make a nice living at $300 billion in sales. But since they're looking beyond the U.S. as they go into China, India, and the rest of the world, there's no reason to assume they can't continue to open up new stores.

In fact, Wal-Mart's management recently announced that they expect that their company's Chinese operation could be as big as their U.S. business within 20 years.

OID: As big in terms of number of stores, revenues, earnings or what?

Van Den Berg: I believe they were talking stores. And they have a 3,700 store operation in the U.S. But if they have the same number of stores in China, they should have the same revenues and earnings there, too.

OID: To what degree does the way they're financing those stores expose them to expropriation of their assets whenever China feels like it?

Van Den Berg: In the past, that was certainly more of a consideration than it is today. Because of the fact that China wants to become a bigger part of the world's business community, it's getting more likely that something like that will not happen. If that's a risk to Wal-Mart, then it's also a risk to every American business that opens a shop in China.

OID: I certainly agree with you there. But aren't they much more exposed to that kind of thing than, say, a Coca-Cola, an Altria Group, or even a Pfizer — where the capital requirements are much lower and, presumably, the returns on capital are much higher?

Van Den Berg: I think the bigger risk is counterfeiting rather than expropriation — and it's kind of hard to counterfeit a retail store.

THEIR EXPANSION OPPORTUNITIES ARE EXCITING
— ESPECIALLY THE ONES CLOSEST TO HOME.

OID: And you're not worried about the category killers like Home Depot, Bed, Bath & Beyond, and Best Buy — and online players like Amazon, Google, and Yahoo — taking too big a bite out of Wal-Mart's business?

Van Den Berg: I've never been a believer in Amazon. I went through that argument with E-Toys. When you look at the distribution costs that E-Toys had, it's amazing. They spent more on advertising than most retailers spend on setting up retail boxes.

OID: But haven't both groups been taking share away from Wal-Mart for years?

Van Den Berg: We used to argue this subject back and forth during the Tech Bubble. And my argument was, "Look, if it's all that wonderful, [his voice crackling with laughter] how come they never make any *money*?

OID: Whether the various online competitors are a good investment or not, if they keep taking share, isn't that a negative — and potentially a serious one?

Van Den Berg: It does raise a question. But the question it raises in my mind is when the day of reckoning will be for the online players.

OID: And the category killers?

Van Den Berg: Actually, Wal-Mart's been expanding their presence in bedding, electronics, and groceries. And they don't have to go quite as in-depth and offer all the products the category killers do to make an impact.

OID: So you view it as more opportunity than threat.

Van Den Berg: Exactly. Look at what happened with Toys "R" Us. Toys "R" Us was the category killer. But then Wal-Mart decided to get into the toy business. And it wasn't too long after they started to expand their toy lines that they became the largest seller of toys in the U.S.

Now the same thing is happening in the grocery business. Even though that's a relatively new area for Wal-Mart, they've already become one of the biggest grocery chains in the U.S. And now they're making a move into the organic segment, including grocery.

OID: Which seems like a fantastic way to increase their presence among more upscale consumers.

Van Den Berg: That may be true, but I don't think it's material.

[Editor's note: Speaking of material, Van Den Berg pointed us to an article by Marc Gunther in the August 7th edition of *Fortune* from which the following was excerpted:

"Wal-Mart's campaign [to go green] has ... turned the small world of organic cotton upside down, thanks in part to Coral Rose, a ladies' apparel buyer for Sam's Club. In ... 2004 [she] ordered a yoga outfit made of organic cotton for Sam's Club.... The 190,000 units sold out in 10 weeks....

"The organic cotton industry had found its best customer. Five years ago, global production of organic cotton [totaled] about 6,400 metric tons, and some farmers who['d] converted to organic methods, which can cost more, couldn't find buyers willing to pay a premium.

"In 2006, Wal-Mart and Sam's Club alone will use 6,800 metric tons, and they've made a verbal commitment to buy organic cotton for five years, giving farmers an assurance that there will be a market for their crops...."

And we're inclined to disagree with Van Den Berg on this point. We believe Wal-Mart's initiative to increase its presence among more upscale customers is *very* material — and understand it's going better than expected to date.]

Van Den Berg: Of course, Whole Foods is the category killer there. But does that mean Wal-Mart and Whole Foods can't co-exist? No. Both will get their share.

Wal-Mart's going after the low-hanging fruit. And because of their buying power, they can offer a wide variety

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of merchandise and still offer greater savings than the category killers. At the end of the day, there's enough room for Wal-Mart and the category killers to co-exist.

OID: And market share figures bear that out?

Van Den Berg: I don't know if the market share figures bear this out, but I do know that they successfully co-exist. But what's most important to us, frankly, is a new store location strategy that Wal-Mart got from Walgreen. Basically, Wal-Mart used to put one store at one end of town and another at the other end and none in-between to avoid having one store cannibalize another.

But they discovered that while the incremental stores do cannibalize one another a little, they nonetheless result in a lot more sales over the long run.

OID: Plus, I imagine that they get certain economies of scale associated with distribution and advertising.

Van Den Berg: Exactly. So they've been testing this. And their test results have been so successful that now they can add stores in a majority of their existing markets — which lets them squeeze their competition even more.

OID: And because of the aforementioned economies, that's probably very profitable incremental volume. That does sound like a big deal.

Van Den Berg: Exactly. It's *huge*. And that's what matters to us most about Wal-Mart, not its expansion in China, India and the like.

WE NEED TO PROTECT OUR TRACK RECORD
LIKE COCA-COLA PROTECTS ITS FORMULA.

OID: Thanks, again, for taking time to talk with us and sharing some of your ideas.

Van Den Berg: It's been my pleasure. I only wish that our director of research, Jim Brilliant, had been able to join us. One of our associates recently recalculated our relative outperformance on a moving average basis. And according to his estimates, over the last 16 years, our margin of outperformance above our benchmark was 7.6%; over the past seven years, it was 16.2%; and over the last five years, it was 10.2%. Jim has been a big part of that.

OID: Somebody's doing something right. I gather that your business has been growing like a weed.

Van Den Berg: It has — and that's despite the fact that we've been turning away some business. For example, we've turned away $500 million from a well known investment bank and $200 million from a guy in Europe.

OID: May I ask why?

Van Den Berg: There are a couple of reasons why. But ultimately, it's very simple. We don't want to sacrifice our performance. We want to keep our shop small enough... The big-cap stocks are going to be a bonanza for us. And we could put *$20* billion to work in them today. But when the big caps take off, the small caps will get creamed. And We want to have a shop that's small enough so when the small-cap stocks get creamed, we can take advantage of the situation and have them add to our performance.

Having a lot more money under management wouldn't affect our performance right away, but it would be a serious drag on our performance over three years or more.

OID: That's forward thinking. I have trouble thinking past our next edition... Well, come to think of it, maybe our time frames aren't all that different...

Van Den Berg: That's what we feel like we have to do in order to maintain the reputation of the firm.

OID: Whether it's the right thing to do or not, I suspect that most people would find a way to rationalize taking the money — one way or another.

Van Den Berg: We've heard all of the rationalizations — because we have a marketing department. But here's the way we look at it: It's not all humanitarian — it's business, too. It's like Buffett's analogy about a good business being protected by a moat. We thought, "What is it that protects our business more than anything else?" And the answer is our reputation and our track record.

So we said, "We've got a better moat than Coca-Cola — because you can't go over to China and create a 31-year track record in less than 31 years."

OID: I certainly can't argue with you there.

Van Den Berg: So we've got a 31-year head start on competitors in China and India and everywhere else. Therefore, if we protect that, we have one of the best moats any business can have. However, if we let it deteriorate like so many managers do, it's easy to become an also ran. And if you become an also ran, who wants to talk with you — and who wants to do business with you?

Therefore, for the long-term future of this company and our 35 associates, I believe we need to be as serious about protecting our track record as Coca-Cola is about protecting its formula. That's why we turned it away.

OID: Well, we sure appreciate you not turning us away. Thanks, as always, for the ongoing education.

Van Den Berg: Our pleasure.

—OID

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selected from comments by McKinnell and his answers to the analyst questions which followed at Goldman Sachs' 27th Global Healthcare Conference which took place on June 13th. Where applicable, we've also inserted excerpts from comments by McKinnell and some of his associates and their answers to questions by analysts during Pfizer's most recent conference call which was held July 20th.

At both of Century Management's client conferences, Arnie Van Den Berg recommended his clients subscribe to *BusinessWeek* — since, he observed, it's one of the best contrary indicators to be found anywhere. If that's true, you might get a chuckle or two from reading some of what *BusinessWeek* had to say in its recent issues about Pfizer (for example, in its July 17th and August 14th editions) after reading some of the comments by Van Den Berg and Lewis, and McKinnell and associates. In any case, we hope you find their comments as enlightening as we do.

MCKINNELL: WE'RE IN A TOUGH PERIOD TODAY. BUT I THINK THE FUTURE LOOKS MUCH BETTER.

First of all, the cycles in this industry are very long.

Henry McKinnell: I wanted to give you my perspective about how you might think about Pfizer as an investment. One thing's crystal clear — you can't look at these companies through the lens of quarterly earnings or even annual earnings. The cycles in our business are just too long.

One of the products I'm sure you'll ask me about is Lipitor plus Torcetrapib. The discovery program that led to Torcetrapib started in 1990. So we quite realistically are working with 15 to 20 year cycles. Everything invented in our laboratories this year, no matter how wonderful it might be and how it might impact shareholder value, won't actually get to patients for something like 12 to 15 years on average. So the cycles are very long.

The regulatory and business environment today is lousy.

McKinnell: So how do you think about these businesses, and Pfizer specifically, in this environment? Well, I think you have to think two-dimensionally.... And one of the axes on this matrix I'm going to describe is the environment in which we do business — the regulatory authorities and the payers — and how friendly they are towards the pharmaceutical business.

And that axis ranges all the way from very unfriendly to very friendly. Clearly, over the last five years, that environment has worsened for those of us who have to get products approved and then used in the market place. And I'll talk a little bit in a minute here about what I think it's going to be in the future.

The other axis is the new product cycle. Our business clearly is based on the invention and development and [market introduction of] important new medicines. And on that framework, the industry has not fared very well over the last five years. Clearly, the product coming to market — even over *10* years — in spite of increased spending, has not significantly increased.

And we knew that our patent expirations were coming.

McKinnell: ...The axis that talks to the environment in which we do business got worse for *every*body — and that certainly affected Pfizer. The axis that talks about the medicines we're marketing *also* got worse for Pfizer over the last five years. We knew in the late 1990s — and I knew when I became chairman and CEO — that it was my destiny to lead the company during a period in which we were going to lose one third of our revenue and 50% of our profits in the years 2005, 2006 and 2007 from the expiration of the patents on the medicines we invented in the 1980s and introduced so successfully during the 1990s — a period when our share price went up 16 times. I knew it was unlikely that we were going to repeat that record.

So not surprisingly, in this more adverse environment, and as our product portfolio weakened because of the loss of patents, our share price went down.

I expect the business/regulatory environment to improve.

McKinnell: But you're in the business of investing in the future, not the past. So what can I say about this matrix going forward? The FDA is more risk-averse, certainly, but there is a pendulum that swings back and forth over many years. In one period, more emphasis is placed on safety; and then a few years later, it's on [reducing the long lags in new drug introductions]. And with Andrew von Eschenbach as the FDA commissioner, and public sentiments switching a little bit because of the new news around new treatments for cancer and diabetes, among others, I think that the regulatory sentiment is going to improve.

And although I can't point to any evidence that the payer environment is improving, what is clear to me is that the environment is *so* bad and everybody's being *so* unsuccessful that there is now a willingness to try something different. So the experiments we've run in Medicaid in Haringey north of London demonstrate a better way.

And I do think, in Pfizer's case, if we're successful in demonstrating for the payers ... that there is a better way to manage healthcare costs, this environment will significantly improve.

Expirations will end and we'll launch lots of new products.

McKinnell: One of the things about patent expirations is that when a patent expires, like the Zithromax patent last year, it doesn't expire again next year. So at some point, we'll come *through* this period. Then our success will be driven by the *new* products we're launching. And there, the news is very good.

Our goal is to have 20 products in registration by the end of 2006. We're almost there. We have 19 in registration or approved. And we haven't given up on the one that we need in order to allow us to declare victory on our five-year goal of 20 new medicines by the end of 2006.

I expect the environment and our portfolio to improve.

McKinnell: Lyrica is clearly one of the most successful launches this decade. This is an historic week for us.... I came from the launch of Eraxis in Florida. We'll be back in California in two weeks for the launch of Chantix. And we'll be back in three weeks for the launch of Exubera.

So we're in the midst of launching three new medicines

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in this six-week period.

[Editor's note: And that makes five new medicines in the last 10 months according to McKinnell during their latest conference call].

McKinnell: And we're not done yet. There's more to come in the rest of the year, and more new filings.

So once the patent expirations get behind us, if people can get beyond this six-month horizon that everybody seems to have, over the long-term, I think that you'll see in this matrix I'm suggesting — and I do mean five years or so — that both our product portfolio and the environment in which we do business improves. I think somewhere along here, there'll be a catalyst — a spark — that ignites that, and that we'll see a significant change in [analysts'] attitude towards our future.

IT'S NOT HARD TO PROJECT OUR CASH FLOW. IT'S HARDER TO SAY EXACTLY HOW WE'LL USE IT.

Here's some perspective on our cash flow and usage....

Analyst: Could we talk a little bit about your use of cash, what your priorities are, and how you think about allocating that cash?

McKinnell: Well, let me help you with the math: This year we will generate something like $16 billion in cash flow. And that probably rises to $19 billion or so in three years time.

If you look at how we *use* that cash, the first [use] is dividends — which, following the significant increase we implemented at the beginning of this year, is the 39th straight year in which we've increased our dividend (although we've never increased it by 26% before.) However, it's not notable that we increased our dividends for the 39th year; nor will it be notable when we increase it for the *40th* year. However, dividends account for about $7 billion of our cash flow at current rates, and capital expenditure about $2-1/2 billion.

Our major use of cash is in our research infrastructure.

McKinnell: We have completed, over the last decade, a massive investment program in research infrastructure. We've also built a large number of new, modern pharmaceutical manufacturing plants which, by the way, are *clearly* the class act in the pharmaceutical business. Regulators *do* turn to us for expertise in manufacturing. We're not the company with the consent decrees and the manufacturing problems you see in the case of so many of our competitors. So we've always felt that manufacturing was important, and it's always been one of our key

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competitive advantages.

We are continuing to invest — partly because our product portfolio is shifting from tablets and capsules to large molecules. And we are constructing — well, actually reconstructing — one biologics plant; and we'll be announcing a new biologics plant here shortly, to add to capacity to support our growing "biotech business".

[Editor's note: Which we understand they're in the process of beefing up — product-wise and capability-wise — with acquisitions.]

McKinnell: Secondly, as we rationalize the system from almost 100 manufacturing sites down to 65, we have to invest in the 65 in order to transfer the production from the others. So that's our *major* use of cash.

[Editor's note: In their latest conference call, they said that they expect that number to decline to 63 by 2008. And Vice Chairman David Shedlarz added: "Obviously, we will continue to make investments that support our new product potential. But what must also be taken into consideration is the very robust program to enhance [our] productivity — of which you'll see a little over $2 billion in 2006. However, that's not the end of the game — because we [expect] those investments to peak at about $4 billion by 2008."]

The rest of our cash goes to acquisitions and buybacks.

McKinnell: That leaves us with $6 or $7 billion a year for other stuff. And the priorities there are acquisitions of intellectual property and products, and share repurchases. So being somewhat mathematically inclined, we said approximately half will go to share repurchase and half will go to intellectual property and product acquisitions.

Where it gets a little tricky is it's almost impossible for us to predict our business development needs — because a negotiation that starts off as a partnership with a $20-30 million up-front payment suddenly turns into a billion dollar acquisition when the other side decides that they'd rather sell than complete our partnership agreement.

[Editor's note: And they've apparently been very active in that area. In their July 20th conference call, outgoing Vice Chairman Karen Katen added: "We have intensely concentrated on licensing and partnering ... complet[ing] an average of one deal per month during the last six months — a rate we believe is unprecedented in the industry."]

McKinnell: So my expectation — and it's based on nothing other than our history — is that we'll be doing two to three of these kinds of small acquisitions focused on near-term product opportunities (Vicuron was a good example) in the, I'm guessing, $1-4 billion range. So I think $2-3 billion is probably a reasonable estimate of what we'll need for business development. In that case, the other $2-3 billion will go to share repurchases.

[Editor's note: On June 26, Pfizer announced its agreement to sell its Consumer Healthcare business to Johnson & Johnson for $16.6 billion in cash — resulting in after-tax proceeds of about $13.5 billion.

In that same press release, the company announced:

(1) that net proceeds from that sale plus the company's projected cash flow from ongoing operations over the next 30 months, net of capital expenditures and dividends, were expected to total approximately $34 billion,

(2) that Pfizer's share repurchase authorization had

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been increased from $5 billion to $18 billion; and

(3) the company was now expecting to purchase up to $17 billion of their common stock during 2006 and 2007 — up to $7 billion in 2006 (the $2 billion they repurchased in the first six months, plus $5 billion in the second half) and up to $10 billion in 2007.]

OUR GROWTH IS HIDDEN BY PATENT EXPIRATIONS.
BUT BY THE END OF '07, THEY SHOULD BE BEHIND US.

Our growth is being masked by our patent expirations.

Analyst: Looking out into the 2011 time frame, you noted how about a third of sales and half of profits are going away. The numbers are slightly lower depending upon how the models look when Lipitor goes off patent. But will that period be substantially different, or will we know the answer to that in the next 18 to 24 months?

McKinnell: Well, up 'til 2011, it's looking pretty *good* — because the big patent expirations are behind us at the end of '07. And that period through the rest of this decade looks very strong — because we'll be launching new products [whose revenue won't be] offset by the old.

Last year and this year, the base business is growing almost 10% or more, depending on the year. Of course that's being masked by the loss of some big, important products. However, that will be behind us by the end of '07.

We think Lipitor plus Torcetrapib can replace *all* statins.

McKinnell: In 2011, we get to do it again — when we *do* lose the exclusivity on Lipitor, which you think will be a $10 billion problem. (We think it'll be significantly bigger than that.) And Plan A is clearly to replace that business and more with Lipitor plus Torcetrapib — which further reduces LDL cholesterol beyond what Lipitor can achieve and significantly raises HDL or good cholesterol.

If that works the way we *think* it does from epidemiological studies in unique populations, that's a replacement not just for Lipitor, but a replacement therapy for every patient on a statin of any kind — because they obviously have high cardiovascular risk. You can address about a third of that cardiovascular risk with statins. It looks to us like the *other* two thirds are amenable to treatment with an agent that safely and effectively raises HDL. So that's the first answer.

But we're not putting all our eggs in the Torcetrapib basket.

McKinnell: If that doesn't work — we think it will, but if it doesn't — we do have another five years to solve that puzzle. We're spending $7.5 or $8 billion on research. We're expecting three or four new products every year coming out of that. We have time to resolve that issue.

And we have other CETP inhibitors in development. We have other approaches to cardiovascular disease in development. So time helps in our business in a way in that we'd have time to accelerate some of those programs to bring them forward. But our money clearly is on Lipitor plus Torcetrapib being successful.

AS LEADERS IN EVERY THERAPEUTIC AREA,
WE BENEFIT FROM THE TREND TO SPECIALIZATION.

We're the leader or big players in every therapeutic area.

Analyst: Some other companies thought about becoming more specialized, whereas Pfizer didn't. How is that creating opportunities, where there's probably going to be a smaller number — there'll probably be one — inside the primary care space?

McKinnell: Well, you're [asking about] our ability, given our size, to effectively be all things to all patients. We're competing in 11 or 17 different therapeutic categories depending on how you define them. There are a couple of holes — gastrointestinal disease being one of them. However, we're basically market leaders or a major competitor in every therapeutic area. So we can both do *specialty* ophthalmology, oncology, etc. — where we're either leading or will be leading in this period — and offer products used by general practitioners.

Specializing by other firms opens up opportunities for us.

McKinnell: A number of other companies have concluded that they can't compete at that level. So they *are* focusing. I think two things are being missed about that. First, by focusing, they're leaving some big areas. And you will see an announcement today or tomorrow about us acquiring [another company's] decade-long research effort in one of these general-practitioner-type areas they're leaving. So those decisions by others are opening up opportunities for us.

But as the universe of companies that are able to compete in these major leagues diminishes, we go from being the partner of choice to smaller companies to one of a small number of potential partners — and we clearly have the lead. So I think for a couple of reasons this apparent strategic shift by a number of companies to more specialized, noncompeting broadly helps us....

[Editor's note: In their most recent conference call, McKinnell elaborated: "The recent acquisition of the metabolic program from Bayer signals a strategic change in the marketplace. As numerous companies, including Bayer, focus more narrowly..., it's a real opportunity for Pfizer and others like Pfizer to pick up very good programs in broader therapeutic areas that require promotion more broadly to primary care physicians. And I think you're going to see more of that as the year unfolds here."

John LaMattina, SVP, Pfizer Global Pharmaceuticals, added: "Yeah, I think people are surprised when we talk about how active we've been in this area recently. In the last 22 months, we've done 15 deals of various sizes ... across 10 of our 11 different therapeutic areas.]

Analysts won't always be focused on the crisis de jour.

Analyst: In one classical sense of how the analysts look at the pharmaceutical business, there is this sense that sales concentration is your friend — that the great operating leverage that one gets from a *very* large product is really what drives the extraordinary growth in earnings. With Pfizer now going into a lot other areas, is it the case that diversity is no longer the enemy of leverage?

McKinnell: Well, we are diversified, but in a way that

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I think a lot of the analysts are missing — because Lipitor is so big that everybody [seems to have] tunnel vision. That's all they want to talk about. But we have five or six $1 billion products that are growing 20% or more: like Geodon, Relpax, and Aricept. These are really big products — not adding as much as Lipitor to total revenues, but doing a great job at adding to our growth.

[Editor's note: And in their latest conference call, outgoing Vice Chairman Karen Katen added that they had eight in-line medicines with worldwide double-digit growth in the second quarter.]

McKinnell: So once we get through the crisis de jour — it was the patents last year, it's generic simvastatin this year — I'm hoping that the analysts kind of lift their heads out of this eyes-down position and look more broadly at the operating flexibility we have....

IN CARDIOVASCULAR, ROUND ONE WAS ABOUT COST. FORTUNATELY, ROUND TWO WILL BE ABOUT EFFICACY.

Lipitor's market share loss has stabilized.

Analyst: Is it time to pull in your short-term guidance for Lipitor, or are market volume increases kind of saving the day?

McKinnell: Lipitor is losing more share than we would have expected. But [those losses are declining] quite dramatically. In fact, last week we actually *gained* share, but I think that may be an anomaly — it was a short week. But the share we're losing has been coming down quite dramatically. And I think that it's fair to say that we've stabilized share loss.

We have a program in the field of recapturing the Zocor business. Clearly, what happened early in the year is that managed care pushed hard to get new patients onto Zocor because a *therapeutic* substitution on June 23, or whatever the magic date is, is really *hard* — you've got to get new prescriptions, patients back into the office and there's additional lab tests that have to be done — whereas a generic substitution is automatic. So June 23rd [when Zocor goes off patent] kind of happened already. Therefore, I don't think that's any kind of magic date anymore. And we have stabilized share.

We're seeing much more market growth than we expected.

McKinnell: And the one thing that *is* happening — which is much more positive than we expected — is the market growth is solidly into double digits now. So I think that the key to understanding this is not to rely on static analysis in a very dynamic market. And what clearly has happened is that more patients have come into the market, and more than the fair share have gone to Zocor, which will go generic later this month.

Round 1 was about cost. Round 2 will be about efficacy.

McKinnell: But there will be a round two here — which will be our sales force going back to those doctors asking, "Well okay, how did those patients you put on simvastatin do? What are their lipid levels?"

And we know two things: First, guidelines are moving down to 70 [for LDL] for those of us with two risk factors — which is unfortunately almost all of us in this room. And second, there's no way to get to 70 with generic simvastatins.

So I think round two will be as more and more people get on statin therapy, which is a good thing, the next question is, "Are they getting to goal?" And yes, it's true that plans are concerned about drug costs. And clearly, you save money versus Lipitor with generic simvastatin. However, they're also concerned about their scores — in other words, how many people are getting to goal. And they're also concerned about total cost.

And efficacy is Lipitor's strength....

McKinnell: So I do think that the second round is going to be a conversion of those patients who were brought in on what will be a low-cost statin to more effective therapy — which not only lowers LDL, but significantly lowers the risk of heart attacks and strokes. And what we've seen from the IDEAL data is that of the patients who start on simvastatin, we can prevent one out of every six heart attacks and strokes by having those patients on Lipitor. And that *more* than covers the cost of the Lipitor therapy versus simvastatin.

So this isn't over in round one here. This is a very dynamic market.

[Editor's note: In Pfizer's most recent conference call, executives elaborated. First, outgoing Pfizer Vice Chairman Karen Katen mentioned the SPARCL study as "another source of new business [for Pfizer] that happened in the second quarter" and asked Michael Berelowitz, Pfizer VP of Worldwide Medical and Outcomes Research, to talk about it. Here's some of what Berelowitz had to say:

"SPARCL is a study with an acronym that stands for Stroke Prevention by Aggressive Reduction in Cholesterol Levels. It highlights at least three unique characteristics of the clinical program around Lipitor. First, this program has been developed around patient populations with a huge unmet medical need. A large number of patients suffer a stroke — estimated at 15 million people worldwide. And around 10 million of those remain disabled thereafter. Stroke patients are an area of huge medical necessity.

"Of the people who get a stroke, many of them — up to 40% of them — will have another. SPARCL was a study using Lipitor 80 mg. in people who'd had a previous stroke or ischemic event, to demonstrate in nearly 5,000 patients the ability of Lipitor to reduce by 16% the occurrence of a subsequent stroke, and, just as you would have expected, ... to reduce cardiovascular events."

According to a Pfizer press release dated August 9th, "[I]n the trial, Lipitor was shown to reduce ... major coronary events such as heart attack, cardiac death or resuscitated cardiac arrest, by 35% compared to placebo." But the press release did mention an increase in the incidence of hemorrhagic stroke — the less frequent type of stroke in which "a blood vessel in the brain leaks or bursts" — from 1.4% in those taking placebo to 2.3%.

Berelowitz (again, from their latest conference call) continued: "Then I think the third element is that it really puts into perspective the remarkable data that Lipitor has shown in stroke. Stroke happens in people with high blood

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pressure. We studied that in ASCOT, and demonstrated that 10 mg. of Lipitor decreases stroke.

"It happens in people with diabetes. We studied the effect of 10 mg. of Lipitor in CARDS — and it demonstrated a 50% reduction in stroke. And it happens in people with atherosclerosis. We studied 80 mg. of Lipitor in TNT — Treating to New Targets — and demonstrated that 80 mg. of Lipitor is more capable of reducing stroke than 10 mg. in that patient population.... The other highlight — and it does highlight the need to move to higher doses of Lipitor — was the tolerability of 80 mg. of Lipitor....

"So I think it highlights a number of issues around the safety of 80 mg. of Lipitor, the uniqueness of the study programs we prepared to innovate and invest in, and the unmet medical needs that we're addressing with Lipitor to highlight the need for this medication."

McKinnell concluded: "I think you should conclude from this that those physicians and patients who know the data will use Lipitor. I think we're also going to see quite a profound change of thinking later this year, or early next, as the guidelines officially go from 100 mg. LDL to 70 — because you just can't get there with generic simvastatin. That's going to change this market in quite a profound way in our direction."]

THE CATEGORY'S GROWING VERY RAPIDLY — AND WE EXPECT THAT GROWTH TO CONTINUE.

Extraneous events dramatically impact primary demand.

McKinnell: Again, the good news is [that the category is] growing very rapidly again. We didn't expect quite this market snapback. And I do think there's going to be a very interesting event towards the end of this year or next year.

We saw, for example, a real pop in the market when Bill Clinton had a heart attack. That suddenly woke everybody up to: "Oh, gee, maybe I should worry about a heart attack myself. If somebody as disciplined and fit as Bill Clinton could have a heart attack, maybe it could happen to me too."...

And I expect *very* interesting data late this year/early next.

McKinnell: And by the end of 2006 or early in 2007, I believe that we're going to see some *very* interesting data around the remodeling of the arteries by high-dose Lipitor treatment. It'll come out of the Lipitor/Torcetrapib studies — and not just one, but three of them. So we'll see the benefits of Lipitor — and the benefit of Lipitor/Torcetrapib.

[Editor's note: This time frame was confirmed by John LaMattina, SVP, Pfizer Global Pharmaceuticals, during the company's most recent conference call. Asked when they were expecting to present the IVUS data for the Phase 3 program on Torcetrapib, here's what he said:

"The data everybody's waiting for is the imaging data, which we plan to present — not just the IVUS data, but also the carotid artery work — at the American College of Cardiology meeting in March.... We'll also have some presentations at the Heart Association meeting in November — which hopefully will be impressive until the other studies we're doing outside of imaging [are complete and available]. But the ones that everybody is waiting for will be presented in March 2007."]

McKinnell: But the piece *I'm* talking about, which will be immediate, is: "Oh, man, if you can reverse heart disease like that, maybe *I* should be on this drug."

I think this market will grow, and we'll do just fine in it.

McKinnell: So I don't think that by any means what we've seen during the first six months of this year is terribly predictive of where it's going to go. That's probably where your forecast differs so significantly from ours — because we do know we have the agent that is unsurpassed in lowering cholesterol. It's also unsurpassed — and *superior* — in preventing heart attacks and strokes. And ultimately, that's what this is all about.

So I think this market will grow, and we'll do just fine in it — even though in the first half of this year we have seen more of a loss of market share than we expected. We thought that would occur during the second half — it appears to have occurred in the first half in anticipation of the [Zocor] patent expiring. So, in a nutshell, no — we haven't given up on our Lipitor forecast.

[Editor's note: They're targeting Lipitor sales of about $13 billion this year. And so far, so good. Pfizer reported that Lipitor's worldwide revenue was up 9% to $3.1 billion in the second quarter — and that U.S. sales of Lipitor were up a robust 11% over the same period last year (although we understand that 8% or so of that latter figure was the positive impact of price increases and changes in rebates.]

MCO'S DO WANT TO MAXIMIZE DISCOUNTS, BUT THEY ALSO WANT TO ATTRACT CLIENTS.

MCOs want discounts, but they also want patients....

Analyst: I think in the past, you've talked about your full basket of products as a competitive advantage for contracting with MCOs [managed care organizations]. Do you still believe that's the case? And more specifically, on the Wellpoint deal you announced, I believe it was, a three-year deal on Lipitor. Was that deal solely for Lipitor or was that on the full basket?

McKinnell: Well, we negotiate with customers mainly around benefit to patients. That really is the Lipitor story — which is why the IDEAL results are so important to us. MCOs do have an interest in maximizing discounts, but they also have an interest in attracting clients and patients to their plans. So mainly the discussions are around benefit to patients.

Zocor without patent protection still isn't better....

McKinnell: We do negotiate for discounts. And the battle, obviously, is over Tier 2. We're never going to be Tier 1 — that'll be generic simvastatin. Privastatin and Lescol are just going to get obliterated. So Tier 1 will be generic simvastatin. The battle really is for Tier 2. And Tier 3 is where you go to die.

[Editor's note: Different drugs, of course, are assessed different co-payments depending on the tier in which they're placed. Tier 1 drugs are generally generic medications —

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HENRY MCKINNELL
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and are covered at the lowest co-payment. Tier 2 drugs are the preferred brand name and higher-cost generic medications — and are covered at the middle co-payment. Tier 3 drugs are the *non*-preferred medications on the formulary — and are covered at the highest co-payment.]

McKinnell: So we have excellent formulary position in Tier 2. We're on over 80% of the private plans and over 85% of the Medicare plans — which is better then any other statin. And over half of those contracts run for two to three years from now. So there's no magic change on the 23rd of June. Zocor without patent protection is still no better than Lipitor. It's still simvastatin.

RUMORS OF BIG PHARMA'S DEMISE ARE PREMATURE.
NEW PRODUCTS WILL GREATLY IMPROVE SENTIMENT.

New products will change public and investor sentiment.

Analyst: One of the interesting things that *we* picked up from the ASCO [American Society of Clinical Oncology] meeting and also, I think, through some of the conversations that we've had is that large-cap pharma is now a more interesting presence inside the new oncology agents. I'd be interested in your thoughts on Sutent and where it's going — and the halo effect that it may be having on some of your other products and categories.

McKinnell: I do think part of this improvement in the environment is going to come from the new medicines in diabetes and cancer and heart disease that you'll see coming to market — and not just from ours, but in general from the traditional large-cap pharmaceutical companies. There haven't been too many of those in the last five years. But that is changing.

I think that will lead to a change in public sentiment and investor sentiment. In fact, we're seeing it already in the attitude tracking numbers. We're now back to where we were five years ago in terms of "Do you think the industry is doing a good job?" Now research productivity is part of that, but there are some other pieces as well. However, that's very positive in a political environment.

[Editor's note: In Pfizer's latest conference call, outgoing Vice Chairman Karen Katen discussed the company's increased research productivity. Here's an

(continued in next column)

excerpt: "We're also benefiting from increased efficiency across Human Health. For example, in research, we've substantially lowered [pipeline] attrition rates."

As Legg Mason's Bill Miller pointed out at a recent CFA Financial Analysts Seminar, if this is true, the implications are quite significant. (See page 2.)]

Distinctions between biotechs and pharma are blurring.

McKinnell: I do think that the traditional strength of large pharma has been chemistry. We like to do with small molecules what the biotechs historically have done with large molecules, which means they're injectable. You're starting to see that in the new targeted cancer treatments that are proving so helpful to patients.

[Editor's note: Presumably, McKinnell was referring to Sutent — Pfizer's cancer therapy, which was recently approved in the European Union, after having been approved earlier this year for use in the U.S.]

McKinnell: Now having said that, we're already the eighth largest biotech company, if you define biotech as large molecules — and by 2010, we expect to be fourth. So we have a melanoma product which is a monoclonal in Phase 3, which could very well be on the marketplace in a year or two. And that would be large molecule.

So this historic distinction between the biotechs and large pharma, if it ever meant *anything*, it certainly means nothing today. The distinctions are blurring. In fact, some of the bigger biotechs are trying very hard to figure out how to get into the *small* molecule business.

SMOKING CESSATION IS A BIG MARKET —
AND NOT JUST IN THE UNITED STATES....

Quitting smoking's tough; so managing expectations is key.

Analyst: Would you talk a little bit about Chantix, and what you need to do there to get the launch right to make sure we don't have the things that went wrong for this marketplace with earlier therapies.

McKinnell: Yeah, we've gone to school on the smoking cessation market. And we understand several things: One is that it is a medical addiction. This is not a behavioral problem. People are addicted to nicotine. In fact, it's as powerful an addiction as heroin. Therefore, telling people to just stop smoking *obviously* doesn't work. Over 90% of smokers *try* to quit, but only 5% who try actually succeed. We can increase that number to 30-50%, but most people who try to stop smoking will not succeed.

So the key to this marketplace first of all, is managing expectations. We clearly could drive big revenue for the first six months and then have such disappointment that it didn't work all the time, that sales would go down again and that would be the end of it.

Therefore, in the launch, we're not out to maximize revenue in the first six-month period.

So we're trying to stack the deck....

McKinnell: We're targeting patients who are serious about quitting. In fact, they're *so* serious, they're prepared to go through a couple of failures before they finally succeed in quitting. And it's not just the medicine itself which improves the quit rate from 5% to over 40%. With it,

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we include a major behavior modification program.

And in addition to patients, we're also targeting physicians — because the majority of physicians have had very bad experiences with smokers. It's just a field littered with failure. When they've tried to convince a patient to quit smoking, the first thing is that they don't *want* to quit smoking. Secondly, they try, and they fail, and fail, and fail. So these are fields that most physicians just don't want to talk about.

Therefore, we're targeting the 25% or 30% of physicians who are serious about helping people stop smoking, who understand how difficult it is, and the 25-30% of smokers who are serious about quitting smoking, and are prepared to go through multiple attempts.

And that motivated group of both physicians and patients, with a major behavior modification program — a disease management program — we think, will start to build a positive reputation that yes, it's a tough addiction, but this is an approach that works. [What we don't want to do is create] unrealistic expectations and then have everybody disappointed, so the medicine gets a bad rap — because it's not that the *medicine* isn't effective, it's that the addiction is so strong.

Our timing (for talking about reimbursement) is wonderful.

McKinnell: So it's rolling out starting in July. About 25% of smokers have insurance coverage. We're trying to expand that.

[Editor's note: And based on executives' comments during their most recent conference call, they're apparently quite optimistic that they'll be successful in doing so — both in the U.S. and abroad. Here's an excerpt from what SVP, Pfizer Global Pharmaceuticals, Peter Brandt had to say about it:

"[I]t's predominantly been a cash market historically — [without] much reimbursement for smoking cessation products or programs in the past. One of the advantages we have is that society's putting a *huge* amount of pressure on payers. And payers themselves, led by *their* customers, the employers, are changing even without any introduction of a novel, innovative product such as Chantix.

"So our timing is wonderful, in terms of going into some of these conversations with the payers and those that represent them in terms of why it's important to begin to reimburse at higher levels than they have previously for smoking cessation products.

"We still don't expect it to come anywhere *near* the type of reimbursement or formulary level you see with a product like Lipitor. But it's going to be higher, we think, than we've seen previously...."]

It's a big market — and not just in the United States.

McKinnell: In fact, after this conference, I'm going directly to Japan where over the last three or four years we've convinced the Japanese government that contrary to their law... The law in Japan says they will not reimburse prevention products. But we said, "The most important thing you can do to control healthcare costs is to stop people smoking — because you're responsible for their healthcare costs for the rest of their lives." And they've just changed the law.

Now Champix is a few years away. It's actually Chantix in the U.S., Champix outside the U.S. — another FDA foible. So in Japan, we've changed the law, and the market is now ready for a targeted smoking cessation product.

[Editor's note: In their most recent conference call, outgoing Vice Chairman Karen Katen talked about some of those developments outside the U.S.:

"There's a very interesting confluence of circumstances around the world. Governments are recommending smoking cessation. And we're seeing an increasing willingness to treat smoking as an addiction — which, of course, it is. In places like Norway and Japan and Taiwan, they've already agreed to reimburse for Chantix — which is a breakthrough for us. And many employers in the U.S. have begun covering smoking cessation in their health programs. All of these things, I think, create a trend. And we'll be there with it knowing Chantix will benefit from it."

McKinnell added: "Just as confirmation of that, in China, there are 350 million smokers. And our discussions this week with representatives of the Chinese government have been very positive on the importance of Chantix and the behavioral modification programs that go along with it."]

McKinnell: This is actually the first targeted therapy for cessation of smoking. And it's going to be a big success. If you look at it as a traditional new product in this market, you won't get very excited. But if you realize that 90%+ of smokers want to quit and here we have a way to *help* them quit — well, that's a big market.

[Editor's note: In their July 20th conference call, McKinnell elaborated: "The newly released Cancer Atlas says that upwards of one billion people will die this century due to smoking-related illnesses."]

EXUBERA: BETTER COMPLIANCE = BETTER RESULTS — AND THE MARKET'S FAR LARGER THAN IT APPEARS.

A terrible epidemic with a paradigm of treatment failure....

Analyst: As you think about Exubera, and where it's going, would you be willing to give us sort of a ratio of how many people will use it instead of [injectable] insulin versus those who use it earlier in the paradigm of use?

McKinnell: Well, there's an epidemic of diabetes. And I don't remember the numbers, but they're enormous. This is one of the pandemics we need to deal with — and it's here and now. Fifty percent of children born this year, if we don't change things, will go on to develop adult onset diabetes, and blindness and amputation and heart disease. So it's a problem that we need to deal with.

Diabetes treatment is a paradigm of treatment failure. You start with diet and exercise, you go to one oral agent, you go to another oral agent, maybe you add a third, and eventually you go to insulin in Type II diabetes.

Inhaled insulin means better compliance and better results.

McKinnell: And there are two opportunities here. The one people think of is, "This is a more convenient form of insulin. So instead of injecting yourself, you use the inhaled formulation." And the data we presented at ADA

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last week does show that with the inhaled form of insulin — and insulin *is* the gold standard in diabetes treatment, because that's how our bodies work — you do wind up with better compliance, much better blood sugar control, and half the weight gain you get with injectable insulin. So there's a value proposition for patients and physicians and payers.

The opportunity here is bigger than it may appear....

McKinnell: However, the far *bigger* opportunity — maybe five times bigger — are those patients who are failing oral therapy, who *should* go to insulin, but because of the impact on their quality of life or fear of injections, they don't want to go to insulin. So this really is a new treatment option for those patients, and, eventually, for all Type II diabetics, who should be on insulin, but are unwilling to go to the injectable form of insulin.

And there's an enormous backlog of people who are getting poor blood sugar control — running enormous risks of blindness, amputation and heart disease — that *should* be going to insulin but aren't. They are our immediate market for Exubera. And of course, every year, that population grows and grows. So I do think that the opportunity here is far bigger than anybody *thinks* it is who just looks at the injectable insulin market.

Let's face it — if patients are compliant, they're pretty well controlled. Exubera is actually better, to our surprise. However, the real opportunity here is those failing two or three oral agents who should be going to insulin and won't.

Exubera costs more short term, but it costs less long term.

Analyst: Can you comment at all at this time about any of the formulary discussions in the United States?

McKinnell: It's too early. Everybody loves the idea, but they haven't gotten around to talking about price yet. However, again, we have a value proposition here. There's clearly a benefit to Exubera in this patient population. And heart disease and amputation are big ticket items. So there's clearly an economic rationale here.

Again, this is kind of at the heart of what we believe on the environment is that rather than looking at Exubera as additional cost — clearly, it's more expensive than injectable insulin, but rather than thinking that way — think of it in terms of health outcomes and long-term costs. By the way, that's the reason why we're going to prevail in the U.K. — because that's just a stupid policy to say, "It would add to costs." That ignores the whole point. After all, you're spending the money *any*way. You're just spending it on patients who are in failure as opposed to spending it early on prevention....

[Editor's note: When they were asked how they expect Exubera to be reimbursed by managed care, Peter Brandt, SVP of Pfizer Global Pharmaceuticals, responded that they expected "very good levels of reimbursement". And he went on to mention another class of products with very high forumlary acceptance and suggest that Exubera's benefits relative to it were, as he put it, "quite profound".

When asked for specifics, he continued: "Most of the managed-care organizations put new products on their formulary for six to twelve months, until they have their normally scheduled PNT committees. And we are seeing some — albeit only a handful so far — that have been scheduled almost on an emergency basis.

"And that's because they really do see two things: (1) the total *cost* of diabetes — which is not only an *extremely* large number, but it's one that is growing astronomically. And (2), the benefits of Exubera.

"So there are a number of formularies that have already gone favorably towards Exubera — meaning Tier 2. But again, most of these discussions are going to play out over the next six months on this product."

Brandt also mentioned that the second phase of Pfizer's rollout of Exubera would begin in September — when, he said, he expected initial supplies to be available at pharmacies nationwide.]

WE'RE GOING TO DO WELL IN JAPAN — OUR DIFFICULT PERIOD THERE IS BEHIND US.

We've done very well in Japan — and plan to do better.

Analyst: ...I'd be interested in your thoughts on the growth in the Japanese business. What sort of numbers of products do you think you'll be launching there over the next couple of years? And how do you expect it to go over?

McKinnell: Well, Japan is the second biggest pharmaceutical market in the world — the largest outside the United States. That growth's been depressed by the [increased demand from their] aging of the population being offset by the government's policy of reducing price. So there's been very little market growth.

We've done very well *within* that marketplace by gaining share with the products we're marketing.... We're by *far* the biggest *foreign* company, but we're not there to be the biggest foreign company. We're probably tied with Takeda at this point for number one.

Despite the long delays, we have 10 launches planned....

McKinnell: Over the next three or four years, we're launching 10 or more products. Japan has these enormously long regulatory delays. And in almost every therapeutic area, you start with a discussion like I've just described with Chantix: "Well, what do we need *that* for?" You know, "People pay for their cigarettes. We're not going to pay for their smoking cessation product". So it takes a few years to get through that.

We went through that with depression, where the Japanese government felt there *was* no depression in Japan. There were high suicide rates, but no depression. So we had to overcome that.

We're going to do well in Japan.

McKinnell: There are so *many* new products being launched there. So let me give you a list of what we're planning to launch:

In 2006, we plan to launch Zybox MRSA, Zoloft — whose patent expires in the U.S. this year, but we're just launching in Japan — and Detrol. In 2007, we plan to launch Celebrex, Inspra Neurontin — its patent has expired in the U.S. — Somavert. In 2008, we plan to launch Champix and Sutent. In 2009-11, we plan to launch

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Caduet, Macugen, Lyrica, Zmax and Torcetrip/atorvastatin. We're going to do well in Japan.

We didn't factor in the lifetime employment thing in Japan.

Analyst: On the other hand, the Japanese government basically blocked your restructuring efforts. Could you talk a little bit about that and the impact that it's having on your overall restructuring?

McKinnell: Yeah, it wasn't the government.... But what the questioner's referring to is that as part of our Adapting to Scale initiative, we're taking 10-15% out of our cost base and staffing. And in Japan, for *any* company to reduce employment is a really big deal. There is a social contract with those who join you for lifetime employment. In Japan, a lot of the part-timers and temporary workers are expendable, but the full-time employees are not.

That's why I've never felt mergers in Japan would be very successful. Japanese companies' idea of a merger is that you take two businesses and put a holding company over them and everything stays the same. It's really hard.

Now there are a couple of companies that have done things a little smarter. But it's really hard to do the kind of integration and mergers that you do in the United States.

But our difficulties in Japan are now behind us.

McKinnell: We did have non-Japanese management in Japan who didn't quite understand the importance of this social contract. And we did have the beginnings of discontent within the organization with respect to how we were managing that.

But we've removed some senior management there, we've appointed a new Japanese manager — somebody I worked with when I joined Pfizer 35 years ago.... I started my career in Japan. I always knew he would be the country manager; I just didn't think it would be this way. But he is now our country manager, he's doing a great job, and they've found a way to realize the savings other than reducing permanent employees and employment. And we're going to do really great in Japan.

So we did go through a bit of a difficult period earlier this year, but that's completely behind us at this point.

TORCEPTRAPIB'S PHASE 2 SIDE EFFECTS? IF THEY EXIST, ITS BENEFITS SHOULD DWARF 'EM.

Putting Torcetrapib's Phase 2 side effects in perspective....

Analyst: I have a question on Torceptrapib and blood pressure elevation. Torceptrapib is perhaps one of the most comprehensive and expensive Phase 3 programs in the industry. I'm interested in your thinking about it relative to the risks of [elevated] blood pressure....

I understand that in the aggregate data, 3-5% of patients had a greater than *10* mm rise in blood pressure. Might I ask how you got comfortable with going ahead with it knowing that you had compounds behind it that perhaps *didn't* have that side effect?

McKinnell: If we see what we saw in Phase 2 trials in Phase 3, what is the implication? First of all, it's not certain that we will — because we have all kinds of history of weird things happening in Phase 2, because patients are so intensively monitored, that we never see again. And many of the Phase 2 studies lock in the antihypertensive treatment — because most of these patients are obviously hypertensive. So there's no flexibility in dosing of the hypertensive agent.

By contrast, in the Phase 3 study and the real world, physicians will treat to the gold standard on hypertension. So you may never see this blood-pressure effect again. What you might see is a slightly more aggressive use of medicines to control blood pressure.

We're not talking emergency hypertension or liver damage.

McKinnell: Now it is true there will be some outliers. But this is not emergency hypertension or liver damage that we're talking about. It's something that's routinely measured with blood pressure tests, it's very easy for a physician to pick up a more significant increase, and it does disappear with discontinuation of the therapy.

Therefore, for those 2-3% of patients that may get the 10-15 mm increase, which would be a concern clinically, the answer is either to treat them more aggressively with the blood pressure medicine or discontinue therapy. So we'd lose 3% of the patients.

And what it's ultimately about is the *net* effect....

McKinnell: Now the *net* answer to this is going to be what we're really after is effect on the cardiovasculature and morbidity/mortality risk. And what we demonstrate in the Phase 3 morbidity/mortality studies will be a net — it will be the benefit of the HDL elevation and the LDL lowering offset by what we know to be a an increased risk from higher blood pressure.

So if there is this small increase in blood pressure, then it will bring with it a small increase in risk. But if that's offset by a *dramatic* reduction in risk from the HDL and the LDL, who cares? It's something to be aware of, and it'll be in the package insert, but it's certainly nothing that caused us great heartburn in making this decision.

Remember that we picked the 60 mg. dose. We would have gone higher absent this blood-pressure effect. But the 60 mg. of Torceptrapib gets us the 50-60% increase in HDL, which is more than you can do with anything else. And we think [that the very small blood pressure elevation] will be manageable in the real world clinical setting.

And the benefits should dwarf those effects, if they exist.

McKinnell: So I think this focus on blood pressure is really a red herring, but it does come out of Phase 2. And we have no Phase 3 data. So you can have your opinion and I can have mine.... When we get the Phase 3 data, towards the end of this year, we will have the answer to this question. And my guess is that you *won't* see the increase in blood pressure.

But if it *is* there, and it's being treated more aggressively, then it will get folded into the whole equation of risk-benefit of Lipitor/Torceptrapib. And if it's as good as we think it is, it will put this 2 milligrams of mercury into complete insignificance even if it's there — which, again, it may not be.

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OAKMARK FUNDS'
BILL NYGREN
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he's been early and that many of his clients have once again lost patience. But he's just as confident he's right.

The excerpts which follow were selected from Nygren's comments and the questions and answers which followed from his two latest conference calls, which were held on April 19th and July 20th, and the 2006 Morningstar Conference, held on June 30th, at which Nygren delivered the keynote address. As always, we found his comments to be as valuable and on the mark as ever and hope that you'll agree.

AN UNUSUAL INVESTMENT OPPORTUNITY CONTINUES — HIGH QUALITY BUSINESSES ARE (STILL) CHEAP.

For me, it feels like déjà vu all over again.

Bill Nygren: Regarding our thoughts on the market, frankly, I feel a little bit like the little boy who cried wolf. It's been almost three years now that we've been saying that high quality businesses appear attractively priced relative to lower quality, more cyclical companies — and also that stocks were more attractive than bonds or cash. We still believe that both of those views are appropriate.

However, knowing that many have grown tired of hearing us say high quality is the place to be, it reminds me a little bit of the late 1990s. At that time, we were a broken record saying that we thought tech was overvalued.

If we had been smarter about understanding how some of the large tech companies had developed franchises with enduring competitive advantages, we might have owned them earlier in the mid-'90s, and thus wouldn't have cried wolf for quite so long. It wouldn't have necessarily meant that we would have owned them in '98 and '99. But maybe our audience wouldn't have grown quite so tired of our message that tech was overvalued. Unfortunately, by the time our message was important and accurate, much of our audience had lost patience with us.

Today, investors have an unusual opportunity.

Nygren: Today may not be similar in terms of the magnitude of the opportunity, but there is a great similarity with our belief that competitive advantage and brands that are possessed by above average businesses will win out versus commodity businesses over the long run. And today, investors have an unusual opportunity to purchase those companies without paying a premium.

In general, we don't believe that small companies deserve the P/E premiums that they've achieved. And on the quality side, we don't believe that names like Dell and Wal-Mart deserve to sell at lower P/Es than electric utilities.

Schering's once again selling well below its business value.

Nygren: Our portfolio changes during the second quarter were minor. In the Oakmark Fund, we sold our Coca-Cola Enterprises to buy Coca-Cola. This was primarily in response to the decline in the multiple premium required to trade up to Coca-Cola.

We also added Schering-Plough. As we said in our quarterly, we believe Schering-Plough's business has outperformed the stock the last couple of years — to the point where it's once again selling well below its business value. And we think Schering can further improve its earnings — largely through cost saves.

We also believe that it would make a *very* attractive acquisition candidate. So to the extent they don't improve on their earnings enough to get the stock price higher, we think there's the potential that somebody else in the industry could be interested in getting it higher for 'em.

Strong content producers *benefit* from new platforms.

Nygren: In Oakmark Select, our portfolio changes were driven by spin-off activities. The split of Liberty Media into Liberty Interactive and Liberty Capital took place in the second quarter. And that split followed on the heels of the first quarter's spin-off where Viacom spun off shares of CBS to its shareholders.

This gave us the opportunity to shift our ownership to the pieces of these companies we believe are most attractive. Our decision to go with Viacom's cable TV assets — which are comprised mostly of Nickelodeon and MTV — rather than CBS's distribution assets, was based on our view that strong content producers are beneficiaries of the new delivery platforms, whereas existing delivery platforms could potentially be harmed by platform splintering.

We believe QVC and its virtues are underappreciated.

Nygren: Our decision to add to Liberty Interactive instead of Liberty Capital reflects our belief that their primary asset, QVC, is underappreciated. I believe that investors who view QVC as just another form of retailing are missing an important connection that the company's built up between QVC's hosts and their viewers. QVC provides value retailing, entertainment and trusted endorsement in a combination that proves *very* powerful.

Incidentally, we thought the consensus would reflect our belief that QVC was the really exciting asset there — and that Liberty Interactive would sell much closer to what we saw as its fair value. And we thought that the market might be frustrated with the hodgepodge of securities that ended up in Liberty Capital and put a bigger discount on it. So I went into that spin-off thinking we'd be selling off Liberty Interactive to buy Liberty Capital. Therefore, I was somewhat surprised at the pricing when both pieces came out looking undervalued, but Liberty Interactive seemed *more* undervalued to us than Liberty Capital.

We consider both Liberty Interactive and Viacom to be far-above-average businesses that are priced similar to average businesses. And that theme continues to prevail *throughout* our portfolio....

IT *MAY* BE DIFFERENT THIS TIME, BUT THAT'S NOT THE WAY TO BET.

Given today's prices, superior stocks should do fine.

Nygren: Since this theme has dominated our portfolio changes for about the last three years, and *hurt* our performance over that time, I think it's important for us to consider how we might be wrong. However, I can only think of a couple of ways that we can lose money by buying

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superior businesses at average prices.

First, we could be correctly identifying these businesses as superior and still lose money, only lose less than the market loses. But given how superior long-term stock market returns have been relative to the returns of other asset classes, and given that the current market P/E is only about 15 times earnings — which is the average of what P/Es have been over the last couple of generations — it seems to me that betting against the market at this level would result in you having a low probability of being right.

It may be different this time, but it's not the way to bet.

Nygren: Assuming that an average business is going to have decent performance from this level, our bigger risk is that the businesses we're identifying as superior — those that have had very strong performance over the last decade — won't continue to achieve above-average growth, and therefore, won't deserve to sell at superior multiples. In other words, maybe they *deserve* the average multiples they're getting today.

For that to happen, I believe we would need to not only see a continuation of the commodity price increases that we've recently experienced, but also a continuation of above-average growth for industrial companies. That growth would have to outpace the earnings growth being experienced by strong consumer-branded companies, category-killer retailers, world-class technology companies, and strong, worldwide financial institutions. That would require an epic form of the "it's different this time" theory — not impossible, but we *certainly* don't see that as likely.

We won't be dissuaded by short-term stock prices.

Nygren: Therefore, our bottom-up stock selection continues to produce a portfolio light on commodity and industrial exposure and heavy in consumer, retail, media, and financials. Our holdings look more like growth businesses than they usually do. However, like always, we've been buying these positions from frustrated sellers who've endured disappointing stock price performance and are now growing tired and throwing in the towel.

And although we can certainly be wrong on our analytic work — errors that anybody could make there — we won't change our position just because short-term stock prices haven't yet rewarded our conviction....

PEOPLE ARE TOO FOCUSED ON INTEL'S *RECENT* PAST.
THEY'VE HAD SOME PRETTY BIG SUCCESSES, TOO.

We think AMD's victory over Intel will be short lived.

Shareholder: Intel just gave *horrible* guidance. What do you think about the idea of Intel bringing in an outsider to turn that company around like Hewlett-Packard did?

Nygren: We have a different point of view on Intel than some of the more frustrated investors who've owned it for awhile. We think of AMD's victory, if you will, in being able to gain some market share with the last product cycle as more like a hit movie — where it happens once in awhile but you have to be really careful extrapolating that.

And actually, Intel's earnings numbers came in a couple of pennies better than what was expected....

Shareholder: Yeah. But the guidance...

Nygren: The sales guidance for the rest of *this* year was below expectations.

If Intel's problems persist, we'll ask tough questions, too.

Shareholder: And their gross margins were lower, too — *significantly* lower.

Nygren: But remember, this is a transition period for Intel. They're just entering a new product cycle. And the price/performance ratio of their new chips looks superior to that of the ones they're replacing.

Now if this is something that they're still dealing with in the second half of *next* year, then we'll be asking that kind of question, too. Is there something wrong with their management? Is there something wrong with their product positioning? But it's too early at this point to extrapolate the problems they've had with their most recent product cycle.

Intel management wasn't responsible for the Tech Bubble.

Shareholder: Is it really? This management has been in place with little or no new blood for awhile. And I can't think of anything they've done right the last six years. What have they done to give you confidence that they can turn around what's essentially an 800-pound gorilla?

Nygren: Well, for us, the biggest thing is that this 800-pound gorilla you talk about was their own creation. Ten years ago, Intel had about a third of the sales level that it does today. And their stock price has actually been a good performer over the past decade.

We don't hold management responsible for the fact that five or six years ago, their stock price zoomed up to a crazy level that didn't make any sense to us.

Intel's recent past's been lousy, their long-term past great.

Shareholder: But putting their stock price aside, haven't they made mistake after mistake operationally? For example, the Titanium was a disaster. It came out a year late. And they mismanaged their inventory. In 2003, they had too little — and then they had too much. This management has made one colossal mistake after another.

Nygren: But you're picking the time period.... Their earnings are more than 10 times what they were 15 years ago despite those mistakes. So yeah, they do make mistakes, but they've had some pretty big successes over that 15-year period, too. And we just think that people are overly focused on their mistakes right now.

Shareholder: [Laughs.] Maybe. But for seven years, I don't think that they've done *any*thing right.

Nygren: It's been a tough macro environment over the last six years for everybody. The very things you're complaining about — that these guys have been there for 15 years or more — is part of what gives us comfort here. This company has become an institution — and I mean that in the *positive* sense of that word. They've developed a leading market position that is going to be very difficult for anyone to displace. Over a long time period, they've grown their business substantially and made their shareholders a

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lot of money. And we think people are overly focused on their recent past results.

Intel's negatives are *more* than reflected in its price.

Nygren: Incidentally, we've received a lot of shareholder communication on Intel.... It's been in the press almost daily about how Advanced Micro Devices has been gaining market share in the server market. Lots of shareholders e-mailed us about that — commenting on what a great job AMD has done, and what a lousy job Intel has done. We think that's part of the reason why Intel's become as inexpensive as it has.

So we think that issue is pretty well incorporated in its price....

And long term, we like this business a *lot*.

Nygren: We think that Intel is a *very* good business. We think that their R&D money has not been spent in vain and that you'll start seeing new products come out in the second half of 2006. And we think that over the long term, this company is *very* well positioned to continue being the leader in the semiconductor business. So it's a name that we like a lot long-term....

IS GROWTH OVER AT WAL-MART? HARDLY.
WE THINK ITS GROWTH OPPORTUNITIES ARE GREAT.

Even if saturation *were* a reality, growth would be OK.

Attendee: I have a question about Wal-Mart. Are you concerned at all about the absolute size of the business and market saturation and cannibalization of additional stores? Could part of the reason why the stock's gotten so cheap be that their growth is behind them and there's really not an opportunity for their growth to continue?

Nygren: I think there's a *lot* of growth opportunity ahead for Wal-Mart. That company's done a great job of changing the mass merchandising business and basically forcing companies like Kmart and many other regionals into bankruptcy. They achieve tremendous economies of scale, and then they use those economies of scale to return even *lower* prices to their customers at prices that their competitors can't match. But if that were their only business, the saturation concern would be a real one.

However, even if we believed that, the cash flow that Wal-Mart generates before their outlays for expanding their store base is very significant relative to their market cap. And we've recently seen them start repurchasing shares. So I think that they could achieve an average growth rate just from *that*....

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But we think Wal-Mart's growth opportunities are great.

Nygren: But you still have opportunities to see margin improvement at Sam's. And they have *tremendous* opportunities for taking share in the grocery business where they have a labor cost advantage over the incumbents like Safeway and Kroger.

And only recently, we've seen Wal-Mart start to make international investing a significant part of their growth plan. I think that there are opportunities outside the U.S. in the basic merchandising business that are similar to those that they achieved inside the U.S. So we think that their growth opportunities are great....

WE UNDERSTAND FRUSTRATION WITH HOME DEPOT,
BUT NARDELLI'S BEEN DELIVERING THE GOODS.

I don't think management's responsible for the stock price.

Shareholder: You've spoken repeatedly of investing in companies that treat their shareholders like partners. Yet the behavior of Home Depot's management and board seems to fly in the face of that. Have you had *any* second thoughts about it?

Nygren: We've not had second thoughts at *all* about our investment in Home Depot. I think most of the shareholder frustration on this issue has come from the large pay package that the CEO, Bob Nardelli, has earned in the five or six years that he's been in charge — which has made for great press, because it came at a time when Home Depot shareholders were losing money. But I don't think management is responsible for the stock price.

I think that, fundamentally, Nardelli's done a terrific job.

Nygren: I think management *is* responsible for the fundamental performance of the business. And over the time period that Nardelli's been in charge of Home Depot, its earnings per share have nearly tripled. Its growth rate has been far above average. It's an *enormous* growth number.

And Nardelli's established an infrastructure for Home Depot that was much needed for a company its size. So I think that, fundamentally, he's done a terrific job.

I agree that his compensation package is very high. But I don't think we'd have been better off as a shareholder if they had paid some random person *half* as much money as Nardelli got. I think that he has definitely helped grow the fundamental value of this company very significantly over the time period he's been there.

And same store sales *isn't* the right yardstick for 'em today.

Nygren: I think the other reason Home Depot started to take flak was they have a strong belief that as they are moving their business from a pure retail business to a supply chain management business for remodelers and builders, the traditional same store sales numbers that the retail industry looks at are not providing an accurate reflection of their business. That's frustrated a lot of retail analysts on Wall Street because that's a number they use to compare one retailer to another.

But I don't think he's trying to be an annoyance there. I think he's trying to get people to focus on the fact that he's changing Home Depot from being a pure retailer to a supply chain management company. So even though he caught a lot of flak at the shareholder meeting for not presenting

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their same store sales numbers anymore, I believe that Mr. Nardelli was correctly telling the shareholders that that was not the important measure and redirecting them to a more appropriate way to evaluate Home Depot.

We don't think they're anti-shareholder at *all*....

Nygren: One of the other things that we look for to identify shareholder-oriented managements is whether they're willing to invest excess cash flow and excess capital on the balance sheet into their own stock via repurchases rather than in ways that grow the top line of the business and might grow the importance of the CEO's job. And there, Home Depot's been one of our most aggressive companies in shrinking their equity base.

So we don't consider Home Depot's management to be anti-shareholder. In fact, we've been quite pleased with the job that they've done.

Shareholder: Sounds reasonable. But what about the board just not even attending the shareholder meeting?

Nygren: [After a long pause] I don't *have* much of a comment on that. [He sighs.] I don't know — maybe that was a mistake.

[Editor's note: We understand that Nardelli has acknowledged as much, apologized profusely for it, and said quite emphatically that it won't happen again.]

We think Home Depot *and* Lowe's will be successful.

Nygren: Anyway, Home Depot continues to be a large holding of the Oakmark Fund. It's selling at a discount to the market multiple. And we think there's a lot of room for two successful players in that market. Home Depot and Lowe's have taken pretty different courses. Home Depot is trying to appeal more to a professional builder, Lowe's to more of a do-it-yourself remodeler. We think *both* companies will be successful.

And we think the multiple that Home Depot is at now should allow the stock to perform in line with or better than Lowe's given its business fundamentals.

OUR INVESTMENT IN KNIGHT RIDDER WORKED OUT, BUT THE NEWSPAPER INDUSTRY'S ANOTHER STORY.

Final outcome for us in Knight Ridder was very positive.

Nygren: One of the three criteria that we use for deciding whether or not a security is appropriate for us to hold is the quality of management. But when we've made a misassessment of management, occasionally, we've been put in the position of having to oppose them publicly.

For example, there's Knight Ridder, which was resolved in the first quarter. Those of you who have been on the call before know we had become frustrated with the job that the management at Knight Ridder was doing. We thought there could be improvement in their operations, and we saw an opportunity to take advantage of a gap between the public and private valuations.

The price at which Knight Ridder agreed to be sold — I believe it equated to $67.50 of cash and stock per share from McClatchy — was a very positive outcome relative to where the stock traded when we started our activism.

But we can't say that for the newspaper industry.

Nygren: On the other hand, it was not as high a multiple as we'd hoped for the newspaper business. And as a result, we've reduced the target multiples we're using for other newspaper businesses.

The reduction was not enough to make Gannett stock a sale. So we continue to own it in Oakmark. Nonetheless, it reflects a meaningful reduction from the kind of acquisition multiples that we had previously seen for newspaper companies. And we think our adjustment appropriately reflects the fundamentals and the problem newspapers are having capturing younger readers.

THERE'S NOT ENOUGH FOCUS ON THE P/E AT PULTE AND TOO MUCH FOCUS ON THE PAST AT DELL.

We expect a housing slowdown, not a housing crash.

Shareholder: Given the apparent slowdown in the housing market, could you give us your current outlook on Pulte Homes? Also, Dell looks like it's fallen off a little. Could I get your current outlook on it, as well?

Nygren: Sure. Both stocks were lousy performers last quarter — and we purchased more of both. So both are names that we still like a lot.

Starting with Pulte, we continue to believe that the housing market is going to slow, not crash, and that we will see a significant decrease in the rate of housing price appreciation. However, we don't think that we're going to see a significant decrease in home prices. In that environment, we expect Pulte's earnings to come down, but for them to remain substantially positive.

We think there's too little focus on Pulte's multiple.

Nygren: One of the reasons that we like Pulte is that we think there's way too much focus to the right of the decimal point on what the company is likely to earn, and way too little focus on what the appropriate multiple for this company is. The last paragraph you read in most research reports says: "So we think Pulte will earn $4.00. And if you slap a multiple of 8 on that — because that was the average in the last decade — it gets you to a $32 target."

Well, we think that's the wrong approach to valuing this company. We think that more thought has to go into determining the appropriate P/E multiple. I think that the homebuilding industry has evolved a lot over the last couple of decades. During that time, it's basically gone from being a real estate conversion business to one that makes money building homes and that has developed significant competitive advantages in the homebuilding process.

And when analysts and investors focus on the significant competitive advantages that the large builders have developed, we think a multiple that's closer to the market multiple than what these companies have historically gotten will be appropriate.

At Dell, there's still a lot to like....

Nygren: In the case of Dell, you're right. That, too,

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has been a disappointing performer since we bought it in the first quarter. But over the last six years, Dell's stock has fallen by 50% while earnings have more than doubled. Dell is priced at about a market multiple today despite reduced earnings expectations. And adjusting for Dell's large cash position, it is now priced at a lower P/E than the average company. I think investors are mistakenly letting a rear-view mirror view of the stock price color their thinking about the quality of Dell's business.

Dell has a cash-heavy balance sheet. It generates large amounts of excess cash not needed for reinvestment in its business. And that excess cash is now being used for share repurchase.

It's the low-cost producer and the market share leader in an industry with moderate-to-above-average top-line growth potential.

The odds are *tremendously* in favor of the Dell shareholder.

Nygren: If you look at anything besides stock price, an analysis of Dell would lead you to conclude that it's a better-than-average business. But the current valuation does not reflect those advantages at all.

Six years ago, Dell's stock was priced so highly that their 18% annualized compound earnings growth since 1999 was not adequate to make it a good investment. Today, if Dell merely matches S&P earnings growth, its relative P/E ought to increase. So we think that the odds have shifted *tremendously* in favor of the Dell shareowner.

We think Dell will *continue* to be the market leader....

Nygren: Some have argued that Dell's cost advantage has been declining, but nobody has argued that it's gone. We think it's still significant, and that Dell will continue to be the market leader in the retailing of PCs. And we think that the worldwide PC market will continue to grow at an above-average rate.

So Dell should have at least average top-line growth. It should continue to be a strong excess cash generator. And we applaud their program of taking advantage of stock price weakness by increasing their share repurchases....

YOU CAN LEARN A LOT ABOUT MANAGEMENT BY WATCHING WHAT THEY DO WITH THEIR CASH.

Criticism of companies' capital structure has changed....

Shareholder: You mentioned the high level of cash on Dell's balance sheet. I was just wondering whether you think companies generally are being responsible in terms of utilizing that cash, maximizing their return on capital, and thus enhancing shareholder value?

Nygren: I think most companies have reasonably appropriate capital structures. A couple of years ago, people got bent out of shape because they thought that debt levels were too high. And I think that you're hearing a little bit of the opposite criticism today. Some argue that cash levels are too high.

I think that people probably overreacted a couple of years ago — and I'm not sure the criticism of holding too much cash is deserved today....

Share repurchases can tell us a lot about a management....

Nygren: We like it when a management shows a willingness to grow their per share value not only by growing their net income, but also by shrinking their shares outstanding. To us, that's a clear indication that they're willing to take steps ... that grow shareholder value whether or not they grow the importance of their job. So we *very* much applaud managements that are willing to use their excess cash flow to repurchase shares.

For example, Dell is repurchasing a *very* significant percentage of their shares outstanding every quarter. And they're doing it with excess cash flow. Well, we view that as the behavior of a very good fiduciary. They're increasing the value of their own holdings as well as ours — and we applaud it.

And it's not just Dell....

Nygren: One underreported point of this compression in valuations that we've experienced is how what used to be considered the high quality, large-cap growth companies are starting to behave like value managers relative to their own stock. Companies like Wal-Mart, Intel and Dell are all involved in *very* aggressive share repurchase programs — because they believe that that's the best way they can utilize their cash flow.

The analysis of those companies today is very consistent with how we used to think about consumer product companies a decade or so ago, when you'd say, "Well, maybe their revenue growth has become mediocre, but there's so much excess cash generation. And they're willing to utilize their excess cash in a way that adds to their per share value. So you get a magnification of their top-line growth by the time you get down to their bottom-line per share value growth."

AT H&R BLOCK, THERE'S MUCH SOUND AND FURY, BUT IT SIGNIFIES NOTHING. IT'S A *GREAT* BUSINESS.

One way or another, the main source of share loss will end.

Shareholder: H&R Block came out with some news about restating their financials, and their stock price took a slight hit. Could you talk about your evaluation of that?

Nygren: Sure. On the real fundamental side, there have been a couple of issues at H&R Block — the biggest of which has been inroads that their competitors have made. Generally, the way they've made those inroads has been by offering earlier access to refunds for the tax prep customer, including this last year — loans that their competitor, Jackson Hewitt, was offering where they would do

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PORTFOLIO REPORTS estimates the following were Oakmark Select Fund's largest equity purchases during the 3 months ended 6/30/06:

1. LIBERTY INTERACTIVE CL A
2. VIACOM INC CL B
3. PULTE HOMES INC
4. INTEL CORP
5. DELL INC

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somebody's tax return based on their year-end pay stub and give them almost one month earlier access to their refund than they had the prior year or that H&R Block was willing to offer.

I think that's a *real* issue. H&R Block has to decide how competitive they want to be in that business. The cost of giving people early access to refunds is quite high — and it's a lightning rod for consumer advocacy groups. Yet for the low-income customer, that seems to be a real driver in who they choose for their tax preparation services.

By next year, I think either Jackson Hewitt will have decided that it's not worth the political heat for offering their pay stub loans, or H&R Block will have come out with a competitive product. So one way or another, I think that H&R Block is going to put an end to their market share losses there.

The tax return snafu makes a good story, but it's "noise".

Nygren: Then, on what I consider the "noise" side, like a lot of companies, H&R Block has made minor restatements in their results. Those restatements haven't been big enough to affect their underlying fundamentals. However, in an environment where the press has been anxious to report negative news on companies, I think when a tax preparation firm has to admit that they got their own taxes wrong, it creates an awfully good story. [Ed. note: Indeed, it does.]

And it's the kind of thing that you wish wasn't there. You wish you didn't have to deal with it in the newspapers. But it doesn't really change business value.

And we think the Spitzer thing is much ado about nothing.

Nygren: Also in the "noise" category is the Spitzer suit or investigation — I'm not exactly sure what stage that's at — where they're accusing H&R Block of being misleading on an IRA product they were selling to their customers. Basically, the annual maintenance fee on their IRAs was sometimes more than the 1% or 2% their customers were earning in their cash accounts.

However, I think that's noise, too — more a reflection of a standard fee structure being applied during a time when interest rates were so low that returns were very low in *any*body's accounts. And being the largest factor in the tax preparation business, H&R Block was in the position of having to take most of the political heat associated with offering that product.

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However, it was something that I don't think they made *any* money on. If they did, it certainly wasn't significant. So the absence of that product would not change our estimate of H&R Block's business value.

Noise aside, it's a business that we still like a lot.

Nygren: Our story for owning H&R Block is pretty simple. We think the tax preparation business is a *great* business. It's a very strong cash generator. It doesn't take much in the way of capital expenditures. The demand for the service grows almost every year. And the valuation that the market is putting on it is well beneath what it puts on the average company.

Meanwhile, the company's been consistently shrinking their equity base. And despite the shortcomings in their tax business, their top line has continued to grow. So we think that they'll continue growing earnings at an above-average rate. It's a business that we still like a lot.

PORTFOLIO REPORTS estimates the following were Oakmark Fund's largest equity purchases during the 3 months ended 6/30/06:

1. SCHERING-PLOUGH CORP
2. COCA-COLA CO
3. VIACOM INC CL B
4. INTEL CORP
5. DELL INC
6. PULTE HOMES INC
7. HEINZ HJ CO

LIMITED, GAP AND MATTEL ARE TURNAROUNDS.
BUT WE'LL BE FINE WHETHER THEY TURN OR NOT.

We think Xerox has a great technology and a great CEO.

Shareholder: I look at the portfolio from time to time — and I always question why certain things are in here. You have some high quality businesses that are selling for market multiples, or below market multiples. But for the life of me, I can't figure out the appeal of certain holdings — like Limited Brands, Gap, Mattel, and Xerox. Presumably, Xerox is supposed to be a turnaround. I've read some things about their CEO.

Nygren: We think Anne Mulcahy is a superior CEO. We think that Xerox has a great technology in printing. And that stock was priced like it was going bankrupt several years ago — and we didn't think that it would. They also have good market share in color laser technology.

At Limited, we're not relying on a turnaround....

Shareholder: What's your rationale for the others — Limited, Mattel, and Gap?

Nygren: Very simple. Limited's two biggest assets are the Victoria's Secret and Bath & Body Works chains — both of which are very high return, consistent growers. We think of Victoria's Secret as the dominant retail chain in its category. And Limited's also got a third chain that tries to sell mainstream apparel that's been losing money. We believe they'll either succeed in turning that around or kill it in a relatively short time.

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And if they were to just close that division and break even on the disposition of its assets — and we think they can do *better* than that — we think that the stock is selling at a discount to what Victoria's Secret and Bath & Body are worth.

In Gap's turnaround, we think there's more to come.

Nygren: We bought Gap several years ago as a turnaround. And as you quite often see in turnarounds, the cost side gets done relatively quickly and easily — the better management of assets, improved cash generation, etc. And Gap's stock did well during that time period.

But that was followed by disappointingly slow results on turning around the merchandising inside of both Gap and Old Navy. We think that turnaround's still in progress.

Based on what they're earning right now, the stock is trading at a pretty normal P/E. So the reason why we want to own Gap is that we think that as they get their merchandising act together, they ought to be able to significantly increase their margins.

At Mattel, we don't expect Barbie to fade into the sunset.

Nygren: Mattel has also been a long-time holding. Again, CEO Bob Eckert has done a *very* good job on the cost side. However, their Barbie line has gone through a couple of very difficult years — largely at the expense of Bratz, which is a line of edgier dolls, as opposed to the more wholesome image that Barbie is trying to convey.

A lot of people take the negative market share trends of the recent past and extrapolate them into the future. We think they're more likely to reverse — at least partially — than to just continue to deteriorate. And if *we're* right, Mattel is at a pretty low multiple of sustainable earnings for a branded consumer company.

WE LOOK FOR MISPLACED FRUSTRATION, BUT SOMETIMES IT'S WELL DESERVED.

If higher quality names get cheap enough, we'll be gone.

Nygren: By the way, on something like a Mattel or a Gap, or any of these names that are part turnaround, if the expected return gets down around what we expect to earn in very high quality companies like, say, Home Depot or Wal-Mart, it does make us do more careful analysis. Even if we haven't lost any confidence in the company's ability to implement its turnaround, if the companies where things are working smoothly become cheap enough, then it's not worth being in the turnaround. We haven't made that transition, but I would say from current price levels, it's getting to be a close call.

Sometimes frustration with a company is well deserved.

Shareholder: One reason I brought those names up was that I think another risk is that these stocks could become value traps — you know, where they're continually in turnaround mode. Meanwhile, the clock's ticking. And you're losing the opportunity cost.... In other words, do we own some value traps?

Nygren: Yes, we do. I only wish I knew which ones they are. That's just the nature of value investing. Generally, a value investor buys something after bad news — where other people have gotten frustrated. And so they're extrapolating that bad news into the future, whereas the value investor thinks it's temporary. So our mistakes tend to be situations where those other people were right — and it either lasted longer or it was permanent.

But I don't think the companies that you mentioned — Mattel, Gap, Xerox and Limited — have a significantly higher probability of turning out to be value traps relative to the other names that we own in the portfolio.

Gap reminds us a bit of Toys "R" Us....

Shareholder: Well, in fairness to you, some of them, especially the retail names, feel a little bit like Toys "R" Us. And I know we did well, eventually, on that one.

Nygren: Yeah, although Toys "R" Us was kind of a hollow victory at the end. I thought we would make money on Toys "R" Us because I thought they could turn around the toy business. But there was a real estate value that kind of gave us a backstop. And the company benefited from a big increase in real estate value.

However, what I viewed as our backstop ended up being the reason we made twice our money in the stock after owning it for five or six years.

I think Gap has some of that characteristic of having real estate as an important backstop in case we're wrong on their ability to turn around the company. I don't think Limited does. But there, we have the strength of the Victoria's Secret and Bath & Body names that I think makes it a misunderstood company.

Nygren's value investor equivalent of the 80/20 rule....

Nygren: And one of the things that I really *like* is when there's a version of the old 80/20 rule we all learned in business school — that 80% of the value comes from 20% of the company. I think the analytic equivalent of that for a value investor is that if 80% of what's written about a company is on something that only represents 20% of the value, there's an opportunity for you to do better analysis.

With Limited, 80% of what's written on it talks about whether or not they can turn around their apparel chain. But again, if they can't, they can probably get out of it for a couple of bucks a share. And if they can turn it around, maybe it's worth $7-8 a share.

But meanwhile, nobody is paying attention to the resurgence in growth at Victoria's Secret which is probably worth *$20* a share. And they're not paying attention to the same-store sales growth they're getting at Bath & Body that's worth *another* $10 a share. When that much effort is being placed on something that we believe represents the smaller part of the value, for us that's a reason to take a more careful look at almost *any* stock....

THE REASONS WAMU'S OUR BIGGEST HOLDING APPEAR TO BE VALID AND STILL IN PLACE.

We like the retail banking area a lot....

Attendee: Within the financial stocks, where do you see the best opportunities?

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BILL NYGREN
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Nygren: Well, our biggest investment among the financial services companies is in U.S. retail banking — about 80% of which by value is in WaMu, a big part in JPMorgan (which just reported a really good number), and a little less in Citigroup. We like the retail banking business a lot.

We think that changes that have occurred with securitization and derivatives have allowed the retail banks to strengthen their relationship with their customers — because they can now separate the decision of serving the customer from the decision of keeping the asset on their balance sheet.

So if a Washington Mutual thinks terms have gotten too easy on mortgages, they can still serve their customer, but now just securitize the mortgage and get it off their own balance sheet. In the past, they had to break the relationship with the customer and give somebody else a chance to interact with their customer.

The retail banking business has had great long-term growth. It sells at a discount multiple. And we think it will continue to have good cash generating characteristics. So we like that sector a lot.

WaMu didn't retain their aggressive mortgages....

Shareholder: Obviously, the housing situation affects so much of our economy. And I keep reading about all these adjustable-rate mortgages that are going to be ratcheting upwards during the next six to nine months. Does that at all give you pause about Washington Mutual?

Nygren: There are a few things that give us comfort there. First of all, to the extent WaMu participated in writing the most aggressive mortgages — the nothing-down, negative-amortization-type mortgages — they were generally sold rather than put on their balance sheet. So even if Washington Mutual wrote some bad mortgages, they're somebody *else*'s problem at this point, not theirs.

WaMu's portfolio statistics suggest they're in good shape.

Nygren: As for the classic adjustable-rate mortgages that Washington Mutual keeps on its balance sheet, the credit statistics that the company provides indicate that the company's equity cushion relative to the loan amount is larger than it's been at almost any point in their history. So in order for them to really create a problem, there would have to be a significant decline in housing prices.

To the extent that some of the homeowners can't pay the higher mortgage payment, there's enough equity in the house that I don't think it necessarily means that Washington Mutual would lose anything on the mortgage.

If you wanted to try to lay out the nightmare scenario for the whole economy, it's that consumers are unable to afford higher payments, the resulting sales and foreclosures create a decline in housing prices, and that effect then filters through to the rest of the economy and destroys the consumer sector. But I don't see that as a reasonable fear right now because I think the cushion we're starting with is significant enough to provide pretty good protection against that.

All of the reasons we've liked WaMu appear to continue....

Nygren: And Washington Mutual just reported a number that was consistent with *our* expectations and, it looks like, consistent with Street expectations. They continued their string of increasing their dividend every quarter — which brings their streak to something like 10 years in a row during which their dividend's gone up every quarter — and increasing the size of their share repurchase plan.

And the company continues to show a *really* favorable business mix shift with more of their income coming from retail banking and credit cards and less from mortgages. So on a fundamental basis, this company continues to execute the way that we had *hoped* they would. In fact, WaMu being at a 15% weighting simply reflects my belief that it deserves to be our largest holding. So all the reasons we've liked WaMu appear to continue....

WE EXPECT DEMONIZATION OF PHARMAS TO DECLINE AND DEMAND FOR PHARMACEUTICALS TO GROW.

Politics aside, drugs are a cost-effective alternative.

Attendee: Pharmaceutical companies are currently being demonized. How do you view their future?

Nygren: We're a fan of pharmaceutical companies. They get demonized, I think, because of politicization of health care costs. Most individuals pay a significant part of their pharmaceutical bill, while they don't pay anything for their hospital stays. But the reality is that if you can successfully treat a disease with a pill, you dramatically reduce the system-wide cost of treating that disease — although that doesn't stop the individual users of that pill from complaining about how much they have to pay for it. [Ed. note: Or politicians from demagoguing the issue.]

But as a more serious look is taken at the issue, and drug coverage begins to more closely resemble other medical coverage — so the disincentive to treat disease with pills declines — the economics will make pharmaceuticals a preferred treatment method. And, therefore, the demand for pharmaceuticals should continue to grow significantly.

And they're great businesses that deserve premium prices.

Nygren: They're great cash generating businesses. We think they deserve to sell at premiums. We currently own Bristol-Myers and Abbott. And in Oakmark Select, we own IMS — which is a provider of data to the pharmaceutical companies.

We have not wanted to be involved in bigger names like Merck and Pfizer because of potential litigation risk. We think the undervaluations of those other names is just as significant without the litigation concern.

IF WE BELIEVED TODAY'S OIL PRICES, WE COULD FIND *LOTS* TO DO THERE.

In oil, it looks like déjà vu all over again.

Attendee: In the energy area, do you have any outlook for oil prices? And where are the risks there?

Nygren: Over the last three or four years, we've seen

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BILL NYGREN
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the price of oil spike from around $25 to more than $70. It's very reminiscent of what happened right about the time I was getting into the investment business in the early '80s. At the time, oil had spiked up to around $35 a barrel. And one of the great investments back then was a company called Tokheim — because they made gasoline pumps, and everybody had to change their pumps to accommodate three digit prices. (All the old pumps were 99¢ maximum.)

And I remember reading all of these papers written by industry experts explaining why prices had gone permanently higher because we were running out of energy — only to see the price of oil right back down at $7 or $8 four years later.

[Editor's note: As we recall, some were talking about $100 per barrel oil even then.]

Commodity prices tend to correct — and for good reasons.

Nygren: I think the situation today is very similar. The experts are giving different reasons why it's different this time — China being the largest one. However, those China reasons made sense back when oil was selling at $25, too. It's not necessarily that prices need to go up from *$70*.

We think the history of commodities is that much more frequently, as users and producers of a commodity react to those price changes, spikes reverse. And we think that we haven't seen that full reaction yet. We aren't yet seeing companies make investments that only make sense if oil stays above $60. We haven't seen consumers make those adjustments. In fact, we haven't even seen the energy companies themselves significantly accelerate what they're spending to develop properties.

And as those adjustments happen, we think that prices will come back down. In ballpark terms, I'd say that something like half of the move up is likely to be retraced over time.

We're not finding bargains today in energy.

Shareholder: Have you found any even remotely attractive names in the energy area?

Nygren: The easy answer to the question is no. There have been a couple of names that have not been at our sell targets.... The energy names that you've seen in our portfolio recently just continued to trade between our buy and sell targets. But we have not found recent examples of energy names trading beneath our buy targets.

And that's because we give future oil prices a hair cut....

Nygren: Now a big part of the reason why is that we're unwilling to step up our estimate of long-term replacement cost economics which drives our valuation. We've not been willing to step it up to the high $50s or $60s level per barrel for oil that the long-term futures are trading at.

So again, our position, and our buy and sell targets, are a reflection of our belief — which is formed from talking to both energy users and energy producers — that the current market price does not represent a sustainable, long-term, market clearing price. If we're wrong on that... If we marked oil up to $70 a barrel, then we could find *lots* of attractive energy stocks. We just don't believe that that's the right thing to do....

I *ALWAYS* THINK U.S. STOCKS ARE MORE ATTRACTIVE. WHAT'S UNUSUAL IS THAT DAVID (HERRO) AGREES.

We consider some international stocks to be fair game.

Attendee: Would you invest part of your portfolio overseas if you could?

Nygren: We do own Diageo in the Oakmark Fund — and Inbev, which is a European based brewer. But our thought process is that if we're talking about an international leader which happens to be headquartered outside the United States — say, a Gucci versus a Tiffany, where their businesses are basically very similar, or a Nestlé versus a General Mills — that's fine. We think of that as fair game....

We think KFC's growth in China is underappreciated.

Nygren: Take YUM Brands. It reported a quarter that showed the return of growth in China, as had been expected — and perhaps a little *more* growth there than expected. And therefore they increased their guidance by a couple of pennies. So that one continues to be a stock whose fundamental story we very much like.

And although the position of KFC in China is acknowledged in most of the research reports, we think the strength of that growth opportunity is underappreciated based on its multiple....

For non-U.S. stocks, we leave the driving to David Herro.

Nygren: But when you talk about non-U.S.-based companies whose business is all non-U.S.-based, there we defer to our international team. Led by David Herro, they have a great long-term record. And we think our shareholders have ample opportunity to achieve that diversification through them. And, quite frankly, we think they get a better result doing it that way than if we started to own some of those same names in the Oakmark Fund.

David and I agree — U.S. stocks are more attractive today.

Attendee: Do you have an opinion about whether U.S. or international stocks are more attractive today?

Nygren: I've always got a bias. I almost always think U.S. names are more attractive than international names. But speaking for David Herro, he's recently said the same thing — and that's unusual for him.

So whatever your normal allocation would be, I would shift it a little bit more toward the U.S. And I think rebalancers *are* doing that today, and rear-view mirror investors are moving more of their money internationally.

—OID

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"[I]nvestors continue to chase commodities and the stocks of companies that produce them. Even though oil, gold, silver, copper, and so on, have generated virtually no inflation-adjusted returns in over 100 years, large pension funds and other institutions have committed billions of dollars to them. None apparently had the slightest interest at half the price or less a few years ago. It is claimed that these inert assets, when blended in a broadly diversified portfolio, will dampen volatility and boost returns, since their fluctuations theoretically won't correlate with those of domestic stocks and bonds. Loosely translated, this means no matter which way your other investments go, commodities won't necessarily follow suit. The point escapes us. Why expose yourself to losses — and, over time, there'll be plenty... — just to avoid volatility, when it has nothing to do with risk in the first place? ...As far as enhancing returns is concerned, the history of commodities clearly points to the likelihood of an opposite outcome. In spite of this reality, their current popularity is just what we would have expected, and a telling contra-indicator, given the tendency of institutions to load up on assets that have already risen sharply in price, and sell those that have either done nothing or gone down.

"Unfortunately, a lot of the funding for this activity has come from the sale of high quality, large capitalization domestic stocks of the type held in our Fund. This has effectively kept a lid on their values, perhaps giving the impression [that] something's wrong with them. Nothing could be further from the truth. A similar pattern surfaced in 1998, when investors piled into vastly inflated tech/telecom and dot.com stocks, while nearly everything else went begging. Just as that cycle reversed, this one will too. At that point, money should flow back to the safety and liquidity of high quality growth companies, bolstering their long-sagging valuations.

"So how have domestic stocks performed compared to these alternatives? The answer is 'great' but ... you have to stay with them a long time to prove it. (That means no jumping in and out of the market on hunches about its direction, no hedging, and no portfolio rebalancing. These strategies may seem promising in retrospect or on paper, but over time they'll cost you money.) A look back will help put things in perspective. Charles Dow's Industrial Average debuted May 27, 1896. The original list contained just 12 stocks, grew to 20 in 1916, and then 30 in 1928. At the turn of the 19th century, the Index stood at 65.73, and now, over 100 years later, hovers around 11,000. That works out to 5.3% compounded annually. Adding dividends, the return averaged 9.9%. Tellingly, the Index's price gain over this long period directly matched the growth in earnings of American businesses, supporting a point we've made for years: rising earnings alone cause stocks to appreciate. Despite the financial industry's efforts to convince us otherwise, investors, as a group, cannot outperform what the economy delivers. Had there been no growth or additions to the list, the Dow would still be at 65.73.

"[I]nflation's taken a major toll on stock returns, slashing the century-long nominal 9.9% rate to 6.3% in constant dollars. It has punished commodities even more. Since introduction of the CPI in 1921, gold has made only 1.5% annually, and that's after a 150% advance over the last several years. [S]ilver has risen less than 0.5% per year since 1792, and copper has dropped from $4.50 a pound in 1855 to around $3.50 today. ...Since 1869, oil's averaged $19 a barrel in 2005 dollars, yet sold as low as $10 in 1998. Oil's history is one of booms and busts, not compounding earnings and free cash flow. Comparable measures of emerging and developing markets cannot be taken due to their relatively short histories, and the same can be said for hedge and private equity funds. [I]nvestors should approach these 'opportunities' with caution. The long-term record of domestic stocks clearly bears no resemblance to what the public came to expect in the 1990s, when the S&P 500 compounded at 18.3% for 10 years (its second best showing ever) and 28.5% for the last five. [T]he same thing happened during the decades of the 1920s and 1950s, when returns averaged 15% and 19%, respectively. Who could have guessed that each of those booms would be followed by 20 years of single-digit returns? History is now repeating itself....

"Though it may seem otherwise, none of this should concern us. The time to worry was six years ago, not today. The market's performance since early 2000 has been a correction of vast speculative excesses, nothing else. The economy is strong, employment robust, and earnings have grown from $360 billion to $890 billion, cutting the market's P/E ratio from 37 to about 15, and a projected 13.5 next year. That number is below average dating back to 1871. With this backdrop, it's ironic, yet no surprise, that investors, so eager to buy stocks when valuations were 2-1/2 times higher, now reject them.... We've been living in one of the most discouraging periods on record for investors and, at this point, a lot of people probably believe things will never get better. But they always do, most often when least expected. Sooner or later, it doesn't matter which, optimism will return, most likely triggered by good news now waiting in the shadows around the corner. When that happens, everyone will be talking about how cheap stocks are, yet only perceptions will have changed. Five years from now, today's concerns will be long forgotten, and the market should be a lot higher. While we think it's always a good time to buy quality stocks at reasonable prices, opportunities seem particularly promising today."

Letter to Shareholders — August 1, 2006

Outstanding Investor Digest is published bimonthly, more or less (usually less) by Outstanding Investor Digest, Inc.
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