Outstanding Investor Digest

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

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LEGG MASON VALUE TRUST'S BILL MILLER
"LET ME EXPLAIN THIS CONTRARIAN THING — IF YOU *DON'T* LIKE IT, THAT'S EVIDENCE I'M RIGHT."

Legg Mason Value Trust's Bill Miller is best known for his fund's 15-year streak of beating the S&P 500 in each and every year since 1991. For his part, Miller plays it down — and even points out that it's partially an accident of the calendar. He says if one were to take any 12-month period other than calendar years, there would be no streak.

But the numbers don't lie. During Miller's 15 years at the helm, Legg Mason's flagship fund has run circles around

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GREENLIGHT CAPITAL'S DAVID EINHORN
"HERE'S THE MOST ATTRACTIVE BARGAIN WE OWN — AND BY A CONSIDERABLE MARGIN, TOO."

David Einhorn's Greenlight Capital describes itself as "a value-oriented investment management firm" that "seeks to maximize partners' capital by buying securities [substantially below] their intrinsic values" and "selling short securities [substantially above them]".

Well, so far, so good. Since its inception in May 1996, Greenlight's first fund — Greenlight Capital, L.P. — has earned a compound return of 27.4% per year net of all fees

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LONGLEAF PARTNERS' MASON HAWKINS ET AL.
"WE'RE BACK IN THE EQUITY INVESTING BUSINESS AND VERY EXCITED ABOUT OUR IMPLIED RETURNS."

Longleaf Partners Fund advisor Southeastern Asset Mgm't could find so little to buy during the 18-month period through year end 2004 that the fund's cash built and built until it comprised fully 26.4% of the fund's assets. However, what a difference a year makes. At December 31, 2005, the fund reported holding *zero* percent cash.

If holding so much cash penalized the fund's returns,

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BERKSHIRE HATHAWAY'S
WARREN BUFFETT & CHARLIE MUNGER
"TODAY, WE'VE GOT MORE MONEY THAN BRAINS. BUT IT'S *EXTRAORDINARY* HOW FAST THAT CAN CHANGE."

We still find it hard to believe that a mere $10,000 invested in Buffett Partnership, Ltd. at its inception in 1956, reinvested in shares of Berkshire at the partnership's termination in 1969, would be worth over $350 million today. And mind you, that's *after all taxes, fees and expenses*. Incredibly, before fees and expenses (but after taxes) that $10,000 would've grown to something closer to *$600* million.

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the S&P 500 for any period you might want to choose. Most interesting, however, is just how steady the fund's margin of outperformance has been — 4.8%, 4.0%, 6.1% and 4.9% per year — over the trailing 3, 5, 10 and 15 calendar-year periods. And that steady margin of outperformance is more interesting still given Miller's penchant for being overweighted in tech and telecom — areas notorious for their volatility.

Incidentally, Legg Mason Value Trust's performance placed it among the top 1% and 2% of all funds followed by *Morningstar* within its category for the trailing 10 and 15-year periods ended December 31st. And lest you think that was a fluke, the only other fund managed by Miller for five years or more — Legg Mason Opportunity Trust — has done even better. Over the past five years, we estimate that mid-cap offering outperformed the S&P 500 and the *Morningstar* Mid-Cap Growth Index by 11.4% and 11.9%, respectively.

The following excerpts were selected from comments made by Miller and answers to attendee (and our) questions at three different events — all of which were held in Manhattan. The first was Miller's presentation at the Tomorrows Children's Fund/Ira W. Sohn Investment Research Conference, which occurred May 5th. Second was Legg Mason Asset Mgm't's Year-End Symposium, which took place on December 8th. And last, but not least, was a panel discussion chaired by Bruce Greenwald, the Robert Heilbrunn Professor of Finance and Asset Management and Director of the Heilbrunn Center for Graham & Dodd Investing at Columbia Business School, which took place on February 3rd. The panel, incidentally, was part of the Columbia Investment Management Conference — a joint production of CIMA (the student-run Columbia Investment Mgm't Association) and the Heilbrunn Center for Graham & Dodd Investing. And finally, we'd like to thank Miller and his associates for providing us with revised data and updates until very shortly before we went to press.

We find ourselves consistently educated and enlightened by what Miller has to say, and find his insights to be among the most sharp, thoughtful and original that we come across anywhere. We hope you agree — although, as he says, he's more likely to be right if you don't.

KEYNES: LET ME EXPLAIN THIS CONTRARIAN THING — IF YOU *DON'T* LIKE IT, THAT'S EVIDENCE I'M RIGHT.

My best recommendation — not to buy anything I like....

Bill Miller: When I got the call to come back to this event and make a recommendation or two, I thought about it — and realized that probably the best recommendation I could make is *not* to buy anything I'm going to talk about here today.

Not too long ago, my colleague David Nelson told me, "Bill, I've been watching you for about 20 years. And portfolio management must be a skill — because you have no evident skill in security analysis or in stock selection."

That reminds me of the time I went to see Peter Lynch about 20 years ago. We were talking about portfolios. And I said, "Peter, let's talk about what we own personally. What do you like right now?"

He said, "Well, I like something you never heard of called United Hearne."

And I said, "United Hearne, the Panamanian gold company?" He said, "You know about it?"

I said, "I *love* this company."

He said, "I love it, too. I've got it my mom's account." Well, it went from $18 to $1 in about six months. [Attendees laugh.]

The best indicator you're right? When others don't agree....

Miller: It reminds me of the line that Keynes used. Keynes was a great investor, but he had to put his ideas through the King's College endowment committee. And he recommended some Argentine bonds in the early or mid-1940s. And they said, "Well, you can't buy those — because the outlook isn't that good for them."

So he sent 'em a memo saying, "I want to again explain my investment philosophy. It's called contrarianism. And what that means is that the stuff I like is stuff that the average person, when they look at it, *won't* like, and indeed will think is imprudent. So the fact the committee doesn't like it is the best evidence for it being a good investment." But they still rejected it again....

I've got the grievous loss part down — but the equanimity....

Miller: The other great Keynes story is from 1937. Keynes was long on margin in his personal account, and he was long in his endowment, as well. And the market began to drop very rapidly — falling almost 50% in the first six months. And so he began to get these letters that said, "Don't you think that you should reduce your exposure as the market's falling?"

He finally got exasperated and sent a memo back saying, "I wouldn't consider it improper to own a few shares at the bottom of the market. Your apparent investment approach is that I should be liquidating as the market gets more attractive, and that I should be buying as it goes up." He then said what I thought was a great line: "I consider it the *duty* of every serious investor to suffer grievous losses with great equanimity."

So I have a lot of experience with the former — and I'm trying to cultivate the psychological state that he was recommending.

WE BUY ALL THE NORMAL VALUATION-DRIVEN STUFF — AND THE SECULARLY MISPRICED COMPANIES, TOO.

I just thought about things in a simple-minded way....

Miller: When I first got started in the business, I wasn't clever enough to realize what Will Danoff at Fidelity knows — which is that if you buy the new *high* list everyday, you get a much happier life than if you buy the new *low* list. [Audience laughs.]

I just thought about things in a simple-minded way — which is that the economy grows over long periods of time. And therefore, most of the time, GDP is at an all-time high, and corporate profits are at an all-time high. So other things being equal, the stock market should be at an all-time high.

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I figured if that set of hypotheses were true, by looking at companies on the new low list, you could probably figure out why they *weren't* at an all-time high. And those things either had to be temporary problems, or long-term ones. So you just forget about the latter and buy the former. And that's how we've developed our business over time....

We do all of the standard value stuff and more....

Miller: Today, we manage about $60 billion using a valuation-driven approach. We buy all the normal, low P/E, low price-to-book, low price-to-cash-flow stuff. Those are companies we believe are *cyclically* mispriced.

What I believe makes us somewhat different from other managers with valuation-driven approaches is that we also buy companies we believe are *secularly* mispriced. They tend to be companies that we believe have long-term, sustainable competitive advantages; they earn *well* above their cost of capital for as far as the eye can see; and they generate huge amounts of excess cash flow. And those would include names like Google, Yahoo! and Amazon.

U.S. EQUITY MARKET HAS LAGGED ALMOST EVERYBODY.
AND IT'S NO SECRET WHY — OIL PRICES AND THE FED.

My expectations for stocks? That they'll go up a lot.

Miller: Let me talk a little bit about what I think about the market.... I love these events — because they give me a chance to be publicly wrong about the markets. As someone said about me, I always have one of two views on stocks — either that they're going up, or they're going up a lot. Well, my view is that they're going up a lot.

The U.S. market lagged nearly every market in the world.

Miller: And if I think about the U.S. equity market in 2005, it's really been like the story of the prince who fell under an evil spell and turned into a frog — because effectively what's happened in the equity market in 2005 is that if you look around the world (and I think Bloomberg follows 55 or 60 equity markets), I think only about *three* have done worse than the U.S. equity market: China, maybe Taiwan, and Slovenia. And of course, China *always* goes down. And Taiwan is close to China — so it must have gotten the Chinese stock market flu. And then Slovenia just must not have gotten the message that all of those countries' markets are supposed to go up.

But the U.S. equity market is only up 3% to 4%, whereas almost every other market in the world is up double digits in 2005.

The first reason is oil prices. And we think they've peaked.

Miller: And if you think about it, it's not because we (continued in next column) don't have the largest, most transparent, most productive, and most profitable market in the world. It's because of two macro factors: oil prices and interest rates.

Oil prices, which peaked at $70.85 the day after Katrina made landfall, are now trading right around $60. It's very clear — at least it's clear to us — that oil prices have peaked for this cycle. The marginal cost of production of oil is about $40. So we have about a $20 premium in there for all of the stuff that you read about every day in the paper: lack of domestic refining capacity, supply disruptions, 30% shut-in in the Gulf, unstable regions in the world, Chinese growth — everything that's well documented and discounted in the overall market. We think that a $20 premium is sufficient — and that's what the market told you after Katrina.

And oil prices also had a greater effect in the U.S. than they did in other parts of the world. That's because our taxes on oil are among the lowest in the developed countries. Therefore, when price increases flow through, the consumer sees it. And of course, the U.S. is the biggest energy consumer in the world.

But we believe that oil has peaked — and that it's now trading in a band somewhere between $40 and $60 or $65.

The second reason is the Fed. And they're almost through.

Miller: The second issue — the other macro issue — has been 12 Fed tightenings in a row. [Ed. note: And now we're up to 14 and counting....] What we've had is the tightest central bank in the world. And that has depressed multiples in the U.S. equity market.

Two years ago, in 2004, earnings were up 23%, and the stock market was up 10% or 10-1/2%. So far in 2005, earnings are up 15% or 16%, and the market's only up about 4%. And that's due to these two macro factors.

And the market seems to have started realizing it.

Miller: But the latest Fed minutes indicated the Fed is getting close to at least changing their language.... So we believe that we're at 450, or maybe 475 basis points at the max, on the Fed tightening at the short end — and that we're within 3-4 months of the end of Fed tightening.

And the market looks forward and discounts things. That's why the market's begun to act better — it's discounting the end of Fed tightening.

WHEN THE MARKET BELIEVES THE FED IS DONE,
WE'LL GET A SIGNIFICANT RALLY IN STOCKS.

When the Fed is done, multiples will expand.

Miller: So what I think is going to happen is that when the Fed is done — or when the market *believes* that the Fed is done, or when we get a language change — we'll get a significant rally similar to what happened in '84-85 and 1995 when the Fed was done.

That will allow multiples in our stock market to expand again for the first time in several years. And we believe that just as multiples have compressed during the last two years, taking away the gains that earnings drove, what you'll have in 2006 is that whatever the growth rate of earnings is — and the consensus is, I think, 7% or 8% — you'll have somewhere between 1-1/2 and 2 times that gain on the overall stock market. So if earnings are up 5%,

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the market will be up 10%. And if earnings are up 8%, the market will be up 16% — through multiple expansion.

And they'll expand most where they *compressed* the most.

Miller: Where will that multiple expansion be the greatest? Well, it'll be where the multiple *compression* has been the greatest — in the so-called mega-cap growth stocks in the top 100-150 names in the S&P 500. They're the most attractively valued that we've seen them since 1995 — the best values in 10 years. I think in 1999, the top 50 names of the S&P 500 traded, on a simple P/E basis, at *170%* of the bottom 450. Now, they trade at a slight *discount* to the bottom 450 in terms of simple price-earnings ratios. So at the margin, that's where we're going with our capital.

And you can kind of go right down the list from JPMorgan, Citigroup — all of those names. Tyco is a big holding for us. All these companies have great balance sheets, they're buying back stock, they're raising their dividends, and their multiples are very low compared to historic norms.

The two most attractive sectors — financials and tech.

Miller: And the two sectors that we think are probably the most attractive — financials and technology — are where we think the multiple expansion will be the greatest. So we've been increasing our weightings in certain technology names over the last couple of months. And we already have a big weighting in financials.

So I would say we have quite an optimistic outlook on the overall U.S. equity market for the next 12 months....

THERE ARE SOME NO-BRAINERS OUT THERE
— BUT NONE MORE THAN DELL, DUDE.

Dell's as easy as it gets. Just ask the company's founder....

Miller: Right now, I think that there are some very no-brainer ideas out there. Dell, I think, is as easy as it gets. The stock's $28-29. It was down 20% or 30% in 2005. It's down a little bit this year. In December, [Founder & Chairman] Michael Dell exercised 8 *million* options — and held them. I don't think Michael has ever done that before.

They took out about 5% of their shares all of last year when their stock dropped below $30. And for the quarter that ends this month, they'll have bought in about 2-1/2% of their outstanding shares. So their buybacks have been accelerating to the point that they're shrinking their outstanding shares at an annualized rate of 10%.

Dell's free cash flow total return is something around 20%.

Miller: Dell trades at about 15 times this year's free cash flow. And free cash flow will grow, conservatively, 12-15% a year. The way we tend to eyeball rates of return is to look at free cash flow yield — which, in Dell's case, is about 6.5% to 7%. And to that, we add their free cash flow growth rate — which is 12-15%. Therefore, Dell's got a free cash flow total return of 19-20%.

You'd have to ask Michael Dell specifically what it is that's motivating their recent stock repurchases. But I'd say with some confidence that if you asked him, he'd say, "It's because our stock is trading at a big discount. And therefore, we can buy back stock and increase the value." So with the company buying back stock, we think that's a very easy one....

A vote of confidence from an unlikely source....

Miller: By the way, [very highly regarded short seller] Jim Chanos is here. I think that Jim and I have been in the business about the same amount of time. And I think that for that entire period, everything that he's been short, I've been long. I don't understand how we've both been able to survive in the business. [Audience laughs.]...

Jim Chanos: [Trying not to laugh] At different times, Bill — at different times.... [Audience laughs again.]

But I'm really going to stun Bill by telling him that in our very small Opportunities Fund — which is less than 1% of our assets under management — we are *long* Dell against a couple of PC stocks that we think are actually in trouble. So it may be rare in your view or mine, but we agree on it. In fact, I think Dell's a screaming value.

PORTFOLIO REPORTS estimates the following were Legg Mason Value Trust's largest equity purchases during the 3 months ended 12/31/05:

1. DELL INC
2. PULTE HOMES INC
3. BEAZER HOMES USA INC
4. RYLAND GROUP INC
5. CENTEX CORP
6. HEWLETT-PACKARD CO
7. COMPUTER ASSOCIATES INTL
8. TYCO INTL LTD
9. CISCO SYSTEMS INC
10. MASCO CORP

[Editor's note: As we were going to press, we had the opportunity to speak with Chanos. He informed us that the PC stocks he was shorting against Dell had, in fact, collapsed. So he closed out the entire position — both the shorts and the long position in Dell.

And Chanos added, "I still think Dell's pretty cheap. But our business is not generally to own unhedged, cheap value stocks. As good a business model as I think that is, that's not our business. But it reflects — and reflected — my opinion accurately."]

INTERNET COMPANIES ARE UNUSUAL BEASTS —
AND ONES WITH WHICH WE HAVE SOME EXPERIENCE.

Internet market share ratios have their own distribution.

Attendee: You talked about how you look at cyclical companies with low P/Es, and low price-to-cash-flows. Bill, could you talk a little bit about secular companies like Google — what you look for in terms of your valuations?

Miller: Well, we have a lot of experience in those new business models. And Michael Mauboussin, who teaches at Columbia, has been one of the leading figures in this whole area. So if you take Michael's class, you might learn

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a little bit more about that.

The way we kind of think about those things is that there's a different aspect to major businesses on the internet — and that is that the market shares follow a power law distribution — or at least they have historically. And there's no reason to think that they won't continue to do so. What that means is that there's a fixed relationship between the size of the #1 company, the #2 company, and the #3 company. And that almost never changes — for all kinds of different reasons having to do with the economics of technology.

Something else unusual — huge amounts of free cash flow.

Miller: And the core part of all of those businesses — and by "all of those", I mean Google, Yahoo!, Amazon, eBay, and to a lesser extent, IAC/InterActive — is that they require very little marginal capital in order to generate huge amounts of free cash flow. And their ongoing business models can sustain, at the margin, returns on capital north of 100%. So if you just look at that and you size their markets, the biggest issue with those companies is how they're going to allocate their capital over time.

Google's kind of an interesting one — because it dropped 10% the other day on a so-called "miss" — which actually wasn't a miss except in the sense that they didn't beat expectations....

Dell's stock has been volatile....

Miller: Dell was one of the first companies that we began to think about on a long-term, secular basis back in the early-to-mid-1990s. And if you look at it, for example, you see that there were 23 times when its stock dropped more than 10% in response to an event, or in response to their quarterly results, since January 1st, 1990. And Dell's gone up on average, on a geometric-return basis, 0.15% per *day* for the last 15-16 years.

But if more big drops mean higher returns, we'll take it.

Miller: Speaking of weird facts the quant guys figure out, if you take Microsoft, Cisco, Dell and a few others, what you'll find is that there's also a relationship between the number of times the stock has dropped more than 5% or 10% on a given day, and the geometric rate of return per

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day since January 1, 1990. So the more times that they've dropped, the higher their rate of return.

So that's a long-winded way of saying that when we think about those businesses, what we're really thinking about is the critical issue of how long they can earn above their cost of capital and where they'll allocate that capital.

Recently, it's become stylish to hold lots of cash....

Miller: Incidentally, I want to take off on a previous question about too much cash on the balance sheets. I happen to believe that we've gone from when there was too much debt a couple of years ago, to now, where companies are, generally speaking, *over*-capitalized in my personal opinion. Many companies carry way too much cash because of their having perhaps too much debt in the past. And secondarily, they also do it because other companies have a lot of cash and they want to be like everyone else.

There's a lot of interesting buyback activity by the techs.

Miller: And what's interesting is that the worst abusers in the misallocation of capital have been the tech companies. But, actually, they're the ones that are taking the lead now.

For example, Intel's got like a 17% share repurchase going — which was a bold move and a good move. Again, Dell's buying 2.5% of their stock this *quarter* — and actually took shares out at a 5% clip in the last 12 months. And look at what IBM did back in the early 1990s, shrinking their cap significantly before their turnaround was clear.

So I think that there's a lot of interesting activity going on in the tech space....

Amazon is a company that people love to hate right now.

Attendee: What's your thinking on Amazon?

Miller: We're the biggest shareholder of Amazon, and one of the biggest of eBay. These are companies that people love to hate right now. Amazon's got the same economic model as Dell — roughly speaking — the same negative working capital, the same long-term operating margins, the same long-term returns on capital, the same triple-digit return on operating assets in the business.

Amazon should have about $8.5 billion of revenue in 2005, and $10 billion next year. And remember that this is a company that people thought was going to be out of business in a few years. This year, for 2005, they should have around $550 million of free cash flow — in 2006, $860 million of free cash flow. Earnings this year should be $1.40, and $1.80 next year. Both of those are untaxed — and they both exclude stock compensation. Even if you tax the earnings, Amazon still has a lower P/E multiple than Whole Foods — and so does eBay for that matter. Now Whole Foods is a good company, but it's a grocery store.

So when we look at what Amazon's doing, we've got a 5% free cash flow yield — and free cash flow has grown 25% a year.

[Editor's note: Miller made those comments in May before Amazon's free cash flow growth began to slow. Shortly before we went to press, Miller told us that Amazon's 2005 free cash flow had come in at $530 million and that their estimate for Amazon's 2006 free cash flow had fallen all the way to $460 million. And therefore, the company's free cash flow yield for 2006 had declined to

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something below 3%. (He also informed us that their updated earnings estimates for 2006 and 2007 had been revised to $1.21 and $1.29, respectively.)

It appears to us that some of Amazon's shortfall was due to declining margins, but that it was primarily a result of their skyrocketing capital expenditures. (The company's operating cash flow was up 29-1/2% in 2005, but its capital expenditures more than doubled.) And reportedly, Amazon CFO Thomas Szkutak has said that he expects the higher capex spend to continue as it pursues opportunities in three areas: developing digital content opportunities, web services, and search capabilities.

However, when we asked Miller whether he thought Amazon's capital expenditures were temporarily elevated or the new baseline, he told us that he thought it was the former — and that he thought capex was probably as high a percentage of total revenues as it ever will be. Either way, the merits of Amazon as an investment, or the lack thereof, would appear to boil down to what kind of return you expect the company to earn on those outlays.]

Miller: We think that Amazon's worth about $50 right now — and it's trading in the $30s.

[Editor's note: Lest you wonder, we believe this figure is after giving their valuation a 20%+ haircut. As we recall, Miller referenced a valuation for Amazon in the mid-$60s in late 2004.]

OVER THE LONG TERM, WE PREFER NEW MEDIA. BUT OLD MEDIA VALUATIONS ARE INTRIGUING.

We chose new media over old, content over distribution.

Attendee: Obviously, one of the things that captures the imagination of people in our business is the collision of all the different media firms, old and new — with the technology companies getting into the media business, and the media businesses getting into the technology business.

What's the best way for you to play the collision of things like newspapers with the on-line classified services, Google transforming ad markets, and all of that? And could you talk about that both conceptually and also put some names on it?

Miller: We don't own any newspaper stocks right now — or, to be more explicit, let's just say that we didn't own any as of our last public filing. Within the old media space, we own Time Warner — where we think content's getting more valuable and distribution, at the margin, less so.

We sold our Comcast in 2005 when it was around $33-34 and swapped into Yahoo! at the same price. I think that Comcast is now maybe $27-$28, and that Yahoo! is around $40-41.

Over the *very* long term, value's migrating to new media.

Miller: Basically, we have about 20% of our assets in "net" sort of names — which are the new media companies. And part of our thinking on this is that if you add up all of the values of the old media — and I'm including all of the newspapers, all of the radio stations, and all of the media conglomerates like News Corp and Time Warner — and then you add up the big, dominant new media names like eBay, Amazon, Yahoo!, Google, and IAC/InterActive, the value is migrating in favor of new media.

I don't want to overemphasize the next 6-12 months in my comments — because we're talking, really, about a *very*, very long-term trend.

But it's really a question of valuation — e.g., newspapers....

Miller: So it's really a question of valuation. I've been very intrigued with the newspaper stocks which have come down a lot in the last year or so. Newspapers are clearly not going away — and they generate a lot of cash. So that old media area is an area of increasing interest....

eBAY AND MICROSOFT HAVE EERY SIMILARITIES. I LEARNED THE *HARD* WAY WHAT THAT CAN MEAN.

Do these numbers sound familiar?

Attendee: Can you give us a little of your rationale on eBay?

Miller: eBay's really interesting — because, as some of you may know, I wrote this really stupid article 15 or so years ago about how Microsoft was overvalued in 1991 and 1992 when it had a market cap of about $20 billion. Well, it only went up about 12 times over the next 12 years. So that was not a great call on my part.

It's interesting to compare eBay today with Microsoft in 1992. Here are some numbers: In calendar year '04, eBay had $3.2 billion of revenues. In calendar year '92, Microsoft had $3.2 billion of revenues. eBay's gross margin was 85.7%; Microsoft's gross margin was 83.1%. eBay's EBITDA margin was 47.9%; Microsoft's was 39.7%. eBay's operating margin was 40.1%; Microsoft's was 35.7%. eBay's net margin was 23.8%; Microsoft's was 23.7%. eBay's sales growth year over year was 51%; Microsoft's was 42.4%.

And so far, eBay's stock has appreciated *faster*....

Miller: So if you look at that, you see that eBay has a business model which looks identical to Microsoft's. And all you have to do is think about eBay's sales growth rate, which is slowing — it's not going to be 50% — but which is going to comfortably exceed anything we're likely to see elsewhere. And again, eBay has a P/E multiple well below Whole Foods. So we think it's reasonably attractive here.

From the day Microsoft went public until this week, it averaged about a 0.5% a *week* rate of return. eBay so far, same terms, is averaging about 1% per week rate of return. So we think eBay is quite attractive.

CABLE GETS DOUBLE THE VALUATION OF WIRELESS. BUT WE BELIEVE THAT VALUATION GAP WILL SHRINK.

Consolidation will change the economics of wireless.

Attendee: Sprint Nextel is currently your top holding. What's the story there?

Miller: What we find interesting about this company is that the wireless business has gone from having six or seven competitors down to where three will control about 75% of the business. So that will change the economic

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incentives in terms of pricing, and in terms of growth — just as it does in any industry when it consolidates.

What's fascinating about the Sprint Nextel deal is that it marries a consumer company and an enterprise company. And maybe most importantly, when you look at the numbers on this thing, you're going to have a company which, by the end of 2006, will effectively be debt free.

This one's easy. We expect the valuation gap to shrink....

Miller: When you adjust for the value of the spin-off — assets that they'll probably spin-off: the ILEC [Incumbent Local Exchange Carrier] assets and probably the long distance — you've got a company that's trading at about 5 times enterprise value to EBITDA, with about $4-1/2 billion dollars of free cash flow in 2005.

[Editor's note: Just before we went to press, Miller informed us that their latest estimates for Sprint Nextel's free cash flow in 2006 and 2007 were $5.6 billion and $6.7 billion, respectively — in which case, the company's 2006 free cash flow yield would be up around 8%.]

Miller: Also interesting, when you back out their ILEC business and do all of the numbers, that's only $1,300-1,400 per subscriber. And we're talking about a subscription business — like cable, like magazines, and like newspapers. Only cable is *$3,500* a subscriber.

Why is it that Gannett pays 10 times enterprise value to EBITDA for community newspapers that don't grow — but here you have a wireless business like Nextel's that's selling at 5 times EBITDA, that *is* going to be growing 500,000 subscribers a quarter, with no debt, and a lot of flexibility? So we think this one is pretty easy over the next couple of years as people begin to revalue its assets. We think Sprint Nextel is very cheap at $25.

[Editor's note: While we're not necessarily thrilled with the business, if *Value Line*'s 2008-2010 projection is in Sprint Nextel's future, we would have to agree. They're projecting cash flow and free cash flow at that time of $6.50 per share and $4.55 per share, respectively — which would be more than double the free cash flow that Miller tells us he expects the company to generate in 2007.]

WE DON'T CARE SO MUCH ABOUT CEO REPUTATION. COMPETITIVE ADVANTAGE, ON THE OTHER HAND...

It's not about CEO reputation, but competitive analysis.

Attendee: One of the trends recently seems to be a lot of interest in CEO reputation. How important is that to you in your investment evaluation?

And secondly, you're talking about a lot of companies that form the new core of U.S. investing. Can you comment on the outlook for what used to be those companies — like IBM, GM, and GE?

Miller: Each one's different. We own IBM — which is competitive across almost all its product lines now that it's gotten out of the PC business. And GE, I believe, is *quite* attractive here. [Chairman/CEO] Jeff Immelt is buying stock — and the company has stepped up its repurchasing of stock. We don't tend to divide the world into old economy/new economy stocks. We just try to do the competitive analysis on a company-by-company basis.

And in terms of CEO reputation, the quality of the management is an important issue, but I would say that CEO reputation, per se, is not something that we would consider to be terribly, terribly important.

It's hard to see how you lose money in GM bonds.

Miller: On GM, I think the GM benchmark bonds are kind of interesting here — because I *don't* think that it's going to go bankrupt soon, and you get paid a lot to wait. And if it *does* go bankrupt in 3 or 4 years, we think that although those bonds may touch the 40s for awhile, they'll probably trade in the 50s or 60s, because they immediately become zero-coupon bonds. And then you're going to get a nice recovery as they start shedding all of their liabilities and you get equity for 'em. It's hard to see how you lose in that.

Also, I like to be senior to Kirk Kerkorian. And he has a big position in GM stock. So if Kerkorian makes money, we're home free.

[Editor's note: It appears that Kerkorian isn't alone. Based on SEC filings, it looks like managers we follow — Capital Research, Brandes Investment Partners and Longleaf Funds' advisor Southeastern Asset Management and Kerkorian's Tracinda Corp. — were four of the five largest shareholders of GM common as of December 31st, owning, in aggregate, around 40% of its shares.

And Brandes and Capital Research were reportedly the two largest purchasers of GM during that same quarter — reportedly accounting for as many shares purchased as the next eight largest purchasers combined.

Of course, some very highly regarded short sellers have said that they're taking the *other* side of that bet.]

SO FEW COMPANIES UNDERSTAND FINANCE 101. INTELLIGENT CAPITAL ALLOCATION IS QUITE RARE.

It's amazing that so few managements get it....

Attendee: Some people will see companies buying back stock and assume that they're admitting that they don't have any better place to put their money.

Miller: Sure. But most people don't know anything about investing. [He laughs.] I believe that [Smith Barney Aggressive Growth Fund's] Richie Freeman mentioned UnitedHealth Group — which I think he said is one of his biggest holdings. And it's one of our biggest holdings, too.

I had dinner with Bill McGuire, UnitedHealth Group's CEO, the other night. And we talked about share repurchases versus dividends. And I said, "Bill, you know it's amazing that so few companies understand Basic Finance 101 — which is whether you buy back stock, pay a dividend, buy another company, invest in new product development, or what have you, you're allocating capital."

One question should determine if you buy back stock....

Miller: So the question is always, "What's the best use of my capital? What gives me the highest, risk-adjusted rate of return long term?" And it might be new products.

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It might be share buybacks. It might be distributing it out in dividends. But that's the only question.

So the idea that somehow or other, if you buy back your stock, it's an admission of failure... If your stock has a very high implied rate of return, then buybacks are what you *should* be doing. If your stock has a relatively low implied rate of return, then you shouldn't be doing that.

In our view, every other reason or rationale is idiotic.

Miller: Now there are a lot of reasons that people give for buying back stock which make no sense — such as propping up the stock price, or showing confidence in their future. And that makes no sense either — because, again, it should be all about the implied rate of return.

From our view, buying back stock on a regular basis to offset option dilution is idiotic. That makes no sense. The question is just, "What's the business worth?" and, "How do we earn the highest, risk-adjusted, rate of return long term?"

Buffett and Lampert are good role models there....

Attendee: You mentioned that you liked the way that Eddie Lampert was allocating capital at Sears Holdings. What exactly is he doing that you like?

Miller: He's basically allocating it rationally. And Eddie's doing exactly what Buffett does. So if you read Buffett's stuff — or if you read Eddie's stuff, for that matter (however Buffett's had a much longer time to write about it than Eddie has)... But Buffett says his managers' job is to do the best job running their companies that they can — give the best value to their customers, build the best long-term value, etc. And whatever excess cash that they generate, they dividend up to him. And he then determines how to allocate it.

Well, Eddie has the same deal with his managers. There's a certain amount of capital that it takes to make Sears and K-Mart as good as they can be given their respective positions. And that happens to be less capital than they actually generate. So therefore, he will take that capital and buy back stock if it's trading cheaply enough, or he'll buy other companies if the opportunities are right — he'll do whatever he believes is sensible.

They don't feel the need to participate in the latest fad.

Miller: My point is he's making a judgement based on the situation at Sears and K-Mart at each point in time. For example, he just offered to buy Sears Canada. He just sold Orchard Supply. All of those decisions are based on trying to allocate capital sensibly — not, "Well, Federated spends X% on new capital expenditures. So I will, too."

(continued in next column)

He's just trying to look at what the needs of Sears and K-Mart are, not what Federated or May or Bloomingdale's spends. And that really drives most people crazy — because they think the average of what other people do is what *they* ought to do.

And the same principle should be applied to R&D.

Attendee: But on the investor side of it, don't you wish that they were doing more to support innovation, in terms of R&D, and create new products? As an economist, say, isn't that what you'd *want* them to do?

Miller: It's very hard to generalize and say, "Companies should spend more on R&D." Barry Schwartz wrote a book entitled, *The Paradox of Choice*. Should Procter & Gamble spend a lot more on R&D to get another flavor of toothpaste? Does that really add much to the world's welfare? I don't know. It *might*. The point is that you have to look at it on a company-by-company basis.

I would say that intelligent spending on R&D is a really good thing. Unintelligent spending — and a lot of companies do this — is saying something like, "We'll spend 6% of sales on R&D."

My question to those companies is, "Why? What's the relationship between sales and the new products that you're going to develop?" Well, the answer is that there's no relationship at *all*. But they have this budgeting thing. You should spend on R&D when it's an intelligent thing to do. Some companies should spend more and some less.

WE HAD A PROBLEM WITH OPTIONS ACCOUNTING, BUT NOT ACCOUNTING FOR RESTRICTED STOCK.

We've always been in favor of restricted stock....

Attendee: I have a question for you about Google. That company uses quite a lot of restricted stock. And yet they don't fully account for it.

Miller: What exactly do you mean when you say, "They don't fully account for it?"

Attendee: They only expense 25% of the amount they issue in any given year. It's restricted, so they don't *have* to. And other companies do it the same way. But they're older companies — so they have older restricted stock that comes up.

Miller: Google doesn't have a choice in their accounting treatment of restricted stock. There's not a wide degree of latitude in terms of how companies can account for restricted stock.

Attendee: But doesn't that inflate their earnings?

Miller: No, because they expense the amount of restricted stock that basically vests in any given year.

Attendee: Right — but only 25%.

Miller: Yeah. But up until this year, companies expensed *zero* percent of the options that they gave. So we've always been in favor of restricted stock — because companies had to account for it honestly.

And, again, the restricted stock that Google issues will

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be expensed as it vests.

Attendee: In the future, yes. But for now, it makes them look like they're earning more than they really are — because 75% of it is *not* being expensed.

Miller: I didn't take the other side of the option argument. But I will take the other side of *this* argument: Let's say that I give you 1,000 shares of restricted stock — and 250 of those shares are vested right away. I expense 250 shares.

"But wait a minute," you say, "that still leaves 750 shares not accounted for." Well, what happens if you leave my company?

Attendee: Yeah, but who's leaving Google? No one's going to leave Google shares on the table.

Miller: But when they actually become an expense to the owner, they're accounted for on the income statement.

Attendee: Right, they're not doing anything illegal. But until then, Google's earnings get artificially boosted.

Miller: Not any more than if I buy a tractor. I mean, if I'm Google and I buy a tractor to mow the grass, that doesn't go on my income statement. It just goes on my balance sheet, gets capitalized as an asset and depreciated over its economic life. You can say, "Oh, you're understating your expenses. You spent that money. Your earnings are getting artificially inflated."

Well, yeah — we spent that money. But you can find it. It's right over here on the balance sheet. And we'll account for it in due course.

FLAWED ACCOUNTING RULES LED TO OPTIONS ABUSE. ACCOUNTING CHANGES ARE SOLVING THE PROBLEM.

Accounting created options problem and is now solving it.

Miller: Now the options thing *was* a problem. Options were a problem analogous to the issue of healthcare liabilities back during the early 1990s — when you *never* accounted for 'em. You only accounted for 'em on a cash basis — which meant GM and everybody else could say, "Don't strike. We'll give you benefits 10 years down the road, and everything will be great. We don't have to account for 'em until we actually write the check to the retiree. So it all gets pushed off."

But as soon as the accounting for options changed, the *behavior* changed. And options accounting is changing the behavior on options and leading to a switch from the use of options to the use of restricted stock.

Restricted stock creates *far* better incentives....

Miller: One of our arguments to companies has always been, "Why are you using options exactly?" And it turns out that they were using 'em because of their accounting treatment. It wasn't, "Well, we've considered all possible forms of incentive compensation — and this is the best." No, it was, "This is actually one you don't have to *account* for honestly. And that's why we're using it."

So what we predicted is what you're seeing — which is that once companies have to account for all forms of compensation the same, they'll use restricted stock. It's a *far* better incentive. It doesn't have a lottery ticket aspect to it. It's got all kinds of different benefits. And it doesn't create an incentive for managements to not pay dividends. It's got all *kinds* of advantages.

Options issuance is only half of the equation....

Attendee: You're not worried that it artificially holds down Google's expenses?

Miller: No. If a company's growing 30% a year and issues options equal to 10% of their outstanding shares — which would be a lot — that would still mean that the shareholders are getting two thirds of the growth of the business.

By contrast, if a company is growing 5% a year and issues options equal to 3% of their outstanding shares, the management and employees are getting *60%* of the business' growth. That's been the problem with options. Companies will say, "Oh, we're only issuing options equivalent to 2% of our shares."

Well, if the company's only growing 5%, those options are giving them 40% of the company's growth. No *wonder* the stock doesn't go up.

Attendee: So Google is growing enough...

Miller: Google's growth is so rapid that the shareholders are capturing almost *all* of the growth. And that won't always be the case, but it is today.

Just to give you a personal note: I talked to [Google co-Founder and President of Technology] Sergey Brin. And he said, "Yeah, I *hate* dilution. I don't want any dilution." That's because Sergey owns a lot of stock himself.

THE CONSENSUS GROWTH ESTIMATE IS 35%. BUT IF ANYTHING, WE THINK IT MAY BE *HIGHER*.

We think Google might grow faster than most people think.

Attendee: But it's not even a question of dilution in my mind. It's accounting honestly for expenses. But what was your analogy — that they're buying a lot of tractors with those restricted shares?

Miller: Google is spending a lot on capex. I think it's really an interesting issue of just how *much* they're spending on capital expenditures. But for all of its $400 stock price and $120 billion of market cap, it's not a big company. And therefore, I think the growth rate it can sustain is much higher than most people realize.

It's not going to be 100%. But do you know what the impled growth rate in Google's stock price is? It's 28% — for the next five years. And we think that's *conservative*.

Attendee: I gather that you calculate that from a discounted cash flow model?

Miller: Actually, that's off our dividend discount model. You solve for the growth rate that's being implied by the stock price. So the growth rate implied by the current stock price is 28%.

Meanwhile, the consensus growth rate is 35% — which we think is certainly reasonable. In fact, we think it's probably going to be *higher* than that.

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Even *we* underestimated its near-to-intermediate growth.

Attendee: So, in other words, you guys believe that Google is trading below its intrinsic value.

Miller: Yeah.

Attendee: And you think Google's still attractive?

Miller: Well, we first bought Google on the IPO. And we did an *extensive* analysis on it — which I think we were in an unusually good position to do. And I say that because we're the largest shareholders of Amazon, except for [Founder and Chairman] Jeff Bezos — and we're a big shareholder of Yahoo! and eBay. So we understand that kind of business model. And that gave us an advantage in that IPO process — because it was an auction process.

Nevertheless, even *we* underestimated the growth that Google would achieve in the near-to-intermediate term....

What do we like about Google? What's *not* to like?

Attendee: But what do you *like* about it?

Miller: What's *not* to like? It's got huge profit margins. It grows very rapidly. The management has executed brilliantly. And it sits exactly in the nexus of where all of the long-term trends are going in media.

It's *effectively* doing something which Microsoft, obviously, is concerned about — and a lot of other people. What Google is doing is using the old media network television model — which is, "we will deliver content to you, the viewer, and because it's ad-supported, you don't have to pay for the content at all".

And what Google is doing is using that model to start to deliver actual content. And I don't mean content in a Yahoo! sense. I mean actual products like Gmail [Ed. note: Google's innovative version of e-mail] — and like maybe an operating system and maybe applications. But they have this powerful model which can subsidize stuff that people are currently paying a lot of money for — and that other companies in strong positions like Microsoft are *charging* a lot of money for.

But it's so early in this entire market — we're talking *very* long term. So you shouldn't bet the farm on it.

HOWEVER, EVEN USING THE CONSENSUS ESTIMATE, WE COME UP WITH A CURRENT VALUE AROUND $800.

But we know the potential downside volatility is huge, too.

Miller: Now this is more my personal take on this. But if we wake up tomorrow morning and Google says, "Our quarter's going to be a little bit light...", then its stock could go down *big* time — 30%, 40% or 50% — depending on exactly how light it comes in. But as we look at the marketplace and what they're doing and their relative competitive position, we're willing to take that risk.

[Editor's note: Of course, Google's stock did wind up declining over 20% — from about $433 to around $343 — in part because of a disappointing first quarter report. And we gather that the main reason for the disappointment was just that Google's tax rate was higher than expected, although it looks like the consensus expectations for the company's five-year earnings growth were down slightly — to something around 31%.

However, as we were preparing to go to press, due to a series of snafus, the perception of Google for the moment had seemingly gone from a company that walks on water and could do no wrong to one known for its frequent goofs. For example, the headlines on a leading business channel on one day alone included, "Google Gaffe", "Google Goofs" and "Google's Frequent Fumbles". And the next day, it was "Google Under the Gun" and a feature about click fraud.]

Assuming consensus growth, Google may be worth $800.

Attendee: And you think that the shares still have room to grow?

Miller: Well, we wouldn't own it if we didn't think that it was [he chuckles] attractively valued — but *long* term, not necessarily near term. Mind you, I'm not saying that it's *not* attractive near term. I'm just saying that I'm not going to make a comment on whether it's a $400 stock, a $300 stock, or a $500 stock.

However, if you run it through a model and you use consensus expectations — which is 35% earnings growth for the next five years — a 12-year fade from that 35% growth rate to something closer to the growth rate of GDP, say 5%... And you gotta understand that GE has been around for over 100 years and is still growing 8-9%.

Attendee: Or more.

Miller: Or more — yeah. But that's a fade from 35% growth in the sixth year to 5% in the 17th year. And then we assign it the implied cost of capital of the overall equity market — which it has, because its volatility is actually equal to the market — of about 9%.

When we do all those things, the value that spits out of our model is $800 a share. That's just one data point. And I'm not saying that's the right number. But I think it gives you some idea of what it *might* be.

TYCO SHOULD BEAT THE MARKET HANDILY. IT'S A PRIVATE EQUITY FIRM'S DREAM.

Tyco looks like it's going to beat the market handily.

Miller: ...We normally tend to like disasters. But really, in this market, everything looks OK. There aren't many disasters out there. So we're *forced* into companies that appear to us to be of somewhat better quality.

For example, Tyco and Sprint Nextel are two of our largest positions. And neither stock is doing anything, although the companies are doing fine. Take Tyco. The company has about two billion shares outstanding. And the stock's around $29. So it has a $58 billion market cap. Well, Tyco should have about $4.5 billion of free cash flow in 2005 — or about $2.25 per share of free cash flow. So that's about a 7.8% free cash flow yield.

And we believe that Tyco's free cash flow will grow at *least* 10% a year. So it has, let's call it, $5 billion or more of free cash flow in 2006.... One of the key metrics we use is free cash flow total return. That's free cash flow yield plus the anticipated growth in free cash flow. So again, we've got a 7.8% free cash flow yield, and a free cash flow growth rate

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of 10%. That's a free cash flow total return of almost 18%.

That's in a market with a 5% free cash flow yield today, where free cash flow might grow 5%, if we're lucky. So Tyco looks like it's going to beat the market handily.

Adding up the pieces, we arrive at a low-$40s value.

Miller: Tyco has $11 billion of net debt — which is going down, because they're paying off converts. In the last couple of years, $15 billion of debt has been paid down. They've closed 600 plants and facilities. And the plastics business will be gone soon. When we do our valuation, we do it a variety of different ways.

But if we take the constituent parts — the electronics business, the fire and security business (which, by the way, is starting to get traction) and the healthcare business — and line 'em up against comps, what we come up with is a low-$40s valuation on the overall business.

Tyco's huge free cash flow is available to benefit its owners.

Miller: However you cut it, Tyco looks like a pretty good business — and a business that could be debt free in two years. It *shouldn't* be, obviously, but it could be. And the company's got a tremendous amount of free cash flow available to be used for shareholders.

Besides paying down debt, however, they're using their free cash flow to buy back stock. They bought back about 3-1/2% of their stock over the last six months — they're buying in a convert. So they're on pace to retire about 6% of their effective float per year. And to us, that's basically the equivalent of a 6% yield.

[Editor's note: ...Because, other things being equal, if the company uses its free cash flow to reduce its shares outstanding by 6%, then its earnings and free cash flow should grow by roughly the same amount. By the way, Miller made the preceding comments about Tyco at the Tomorrows Children's Fund event.

Closer to press time, on February 3rd, he made the following comments — in which, among other things, he expressed significant frustration with Tyco's management for not being more aggressive in their share buybacks.]

I ALMOST DON'T SEE HOW WE CAN LOSE WITH TYCO — ALTHOUGH MGM'T'S TRYING TO PROVE US WRONG.

If I'd only known, I'd have dressed this way before.

Attendee: Bill, you live in the mutual fund space, which is judged very short term, but you have an extraordinary long-term record with very, very low turnover. I just wonder how long you're willing to hold onto an underperforming company? And believe me, I feel your pain — I live in that space.... I'll just ask you about one of them. Are you still a fan of Ed Breen and/or Tyco?

Miller: As regards my living in the mutual fund world, I came in my hedge fund manager disguise today. Actually, I normally wear a suit. And I know that my disguise worked — because people stopped complaining about our fees being too high.... [Audience laughs.]

How patient are we? I'd say we're pretty patient....

Miller: In terms of being patient on underperformers, as I've mentioned before, we owned one company, Salant, through *three* bankruptcies straight on through — you know, bankrupt, up, bankrupt, up, and bankrupt again. So we're pretty patient on these things. [Audience roars.]

[Editor's note: As we recall, Miller has said that that's where he came up with his three bankruptcy rule — if a company that he owns declares bankruptcy three times, then he draws the line and steers clear.]

On a sum-of-the-parts basis, we get high $30s/low $40s.

Miller: With respect to Tyco — which is extremely attractive at current prices — we're a major shareholder. When we did our valuation, because Tyco's a put-together company and you can see the prices that they paid for their pieces — and you can see where comparable pieces trade in the market today — it's very easy to get valuations in the mid-to-high-$30s and low-$40s under certain assumptions.

PORTFOLIO REPORTS estimates the following were Legg Mason Opportunity Trust's largest equity purchases during the 3 months ended 12/31/05:

1. TYCO INTL LTD
2. MICRON TECHNOLOGY INC
3. EASTMAN KODAK CO
4. PULTE HOMES INC
5. US STEEL CORP
6. AMR CORP
7. MITTAL STEEL CO NV CL A
8. RYLAND GROUP INC
9. LENNAR CORP
10. SPRINT NEXTEL CORP

[Editor's note: In a very recent shareholder letter, Miller says he believes Tyco's shares have an intrinsic value in the low-to-mid $40s.]

Current shareholders shouldn't pay for past mgm't's sins.

Miller: About a week ago, [Tyco CEO] Ed Breen said to me, "Given our history with Kozlowski and Swartz, we have to be very careful about what we do — because people will say this or that". I said, "Those guys are sitting in prison. They're in a *physical* prison, but you're in an *intellectual* prison.... You have nothing to do with them. The history of the company is irrelevant in terms of how you construct it right now."

Although it's not as bad as MCI's board, Tyco's basically being run by risk-averse people who are always looking over their shoulder. So instead of buying back tons of stock, they have this crazy idea that they owe some duty to the bondholders to maintain an investment-grade rating. And it looks like they're going to be debt free in two years. For a company this size, that's just crazy.

So we're having a bit of a disagreement about that — that I'd say you should stay tuned for. [Audience laughs.]

It's a private equity fantasy. I don't know how we can lose.

Miller: Let me add one more thing about Tyco — since you got me going on it. If you look at Tyco's fire and security business, you can see the kinds of prices at which

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these things have gone private. And the private equity guys have to be slathering about Tyco — about the ability to spin this thing out with almost no debt — because they can lever up different pieces of it and create even *more* value.

[Editor's note: On January 13th, Tyco announced its intention to split into three parts — Tyco Healthcare, Tyco Electronics, and Tyco Fire & Security/Engineered Products and Services. In that announcement, the company said that it expected to complete the transaction in the first quarter of calendar 2007. In the same announcement, Tyco also lowered its earnings guidance for the first quarter and full year 2006.]

Miller: So it's really remarkable. I think down there at $24-25, it's hard to see how you can lose money on it — although the management seems to be doing a pretty good job of trying to make sure you do. [Audience laughs.]

THE HOMEBUILDERS ARE JUST *WAY* TOO CHEAP. WE EXPECT THEIR MULTIPLES TO RISE SIGNIFICANTLY.

The big gains in housing prices are over. But that's fine....

Attendee: What's your view on the homebuilders and housing prices in general?

Miller: We have a position in the homebuilders. As of our last filing, we own 15% of Ryland, 11% of Beazer, 9% of Centex, and 8% of Pulte. So, obviously, [chuckling] we *like* those names.

My view on that is fairly simple — which is that it's *clear* the big residential real estate price gains are over. The data is very clear on that. I would now expect it to revert back to its long-term historic norm — which means that it's going to track disposable income growth — although maybe with a bit of a lag because it's done so well the last couple of years.

On the other hand, I think that the chance of prices falling significantly in the overall market is *nil*. The chance of prices falling significantly in select markets is probably pretty high — like the Miami condo market. There is froth, as the Fed said, in a variety of different areas.

The homebuilders' multiples are just *way* too low.

Miller: That said, the multiples on those names are just *way*, way too low.... Beazer is now the leader in capital allocation among homebuilders. Centex just announced a 5 million share repurchase. And Ryland has

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40% debt to capital — and will probably raise that — and they've been a leader in share repurchases.

[Editor's note: We recently heard a statistic that the share repurchases authorized to date by the boards of the public homebuilders already totals something like 9% of the industry's total outstanding shares. (To be fair, however, we understand that authorized but uncompleted share repurchases by public companies in all industries have historically been less the exception than the rule).]

Current homebuilder stock prices *scream* for buybacks.

Miller: Of course, the risk-free rate is the 10-year government bond — which today is something like 450 basis points. And the normal equity risk premium might be 300-400 basis points. Therefore, the implied rate of return on equities is around 8-1/2%.

But when you've got some of these companies trading down around 6 times earnings — which means that they can buy back their stock and earn nearly 17% risk free — that's just too good a thing to pass up. And therefore, we're *quite* bullish on those stocks.

The macro numbers on housing *won't* look good.

Miller: For us, this is an example of one of the most common mistakes investors make — which is confusing the direction of the fundamentals with the investment merit. So all the housing starts go down and you start to hear lots of moans about this or that.

And the fact is, yeah, the macro numbers on housing this year will *not* look good. However, I believe that's much more significant for consumer spending than it is for housing stocks for the reasons that Alan Greenspan pointed out in that paper.

[Editor's note: The title of the paper, authored by Alan Greenspan and James Kennedy, is "Estimates of Home Mortgage Originations, Repayments, and Debt On One-to-Four-Family Residences", published in September 2005, and available at www.federalreserve.gov.]

Miller: If you look at the housing market in the U.K. or Australia — where there are many more adjustable-rate mortgages than there are here — and the rise in interest rates over there, I think you can see right away that there just isn't that much of a problem.

The homebuilders are cheap, but they won't *stay* that way.

Miller: Therefore, we believe that the issue becomes purely what multiple you pay for these things. And as we look at these businesses, we see that they're trading at 6 or 7 times earnings. And what will happen if people come to our view on margins, where we happen to be on the other side of most people, as well?

The other issue for me in housing is the managements, which — except when my friend, Jeff Gendell, bludgeons them — aren't doing much right about capital allocation.

[Editor's note: Jeff Gendell is the General Partner of Tontine Partners — a multi-billion dollar hedge fund that we understand specializes in mispriced cyclicals. An October 11th letter from Tontine to the president and CEO of Beazer (which Miller has also been buying recently) references a valuation gap between Beazer's stock and those of its peers, and encourages the company to immediately undertake a significant share repurchase.]

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Miller: If a builder came out and tried to consolidate the industry the way that Lakshmi Mittal at Mittal is doing in steel, these things would all trade 40% or 50% higher. So we *like* those....

We expect their P/Es to rise *significantly*, as with the U.K.

Miller: And we believe that what will happen over the next year or two, in addition to the share buybacks, is that as the market comes to understand that these companies can still grow even in the face of modest normalized house price inflation of a couple of percent a year, the multiples will go up *significantly*.

You can look at the U.K. market, for example, and see where those homebuilders trade. And you'll see that it's at a significant premium to the prices of U.S. homebuilders today. They've already had their housing price correction — and they're still at a significant premium to our market. So we're quite optimistic about that area.

They're below their historical range. And that's too low.

Attendee: You said that some U.S. homebuilders are at a multiple of 6 now?

Miller: It depends on the homebuilder. I think somewhere between 5 and 7 times earnings is the range.

Attendee: And what's their range been historically?

Miller: That's the low end of their historical range. But their historical range is too low.

Attendee: What's the high end of their P/E been?

Miller: About 10 — but that's *still* too low.

WE SHOULD HAVE BOUGHT ENERGY IN 2003.
BUT WE'D RATHER OWN HOMEBUILDERS TODAY.

We were wrong about energy, but not because it went up.

Attendee: Any thoughts on energy?

Miller: Well, we were *wrong* about energy — but not for the reason that most people think, which is that energy went up a lot and we didn't own it. That's sort of an odd supposition if you think about it. In other words, what's the assumption — anything that goes up a lot, you're supposed to own a priori? That doesn't make sense.

A little more sophisticated analysis is, "Energy's a big group in the market. You have no idea which groups are going to do well in any given year. But energy was cheap a couple of years ago." And it was.

So why didn't we buy energy? Well, the answer is that we were finding better values elsewhere.

In retrospect, it was already cheap, and you got a free call.

Miller: However, we were wrong not to own energy because, first of all, they were cheap in 2003. However, more importantly, the valuation spreads in the market were not extreme. So you weren't being severely penalized for owning energy relative to another group.

In retrospect, it would've made sense for us to have a market, or a close-to-market, weight because that would've given us a free call option on energy prices going up.

Today, it's just a play on a commodity we don't care to play.

Miller: However, that was then. What about today? Well, after 2-1/2 years of *big* energy price moves and really five or six years of energy price moves going back to 1998, the oil companies are not terribly expensive. The multiples are reasonable.

But the fact is that the energy stocks have basically traded one-for-one with the underlying commodity. So if you go back two or three years, the commodity's up 105%, and the energy stocks are up 105%. So being long energy, absent a takeover, means making a bet on the commodity.

And our view is that the commodity is likely to be in the price band of $40 to $60 or $65. Therefore, with the price of oil toward the top end of that range today, it's not that attractive. I mean, we would rather own homebuilders at 6 times earnings than Exxon at 11 times earnings.

INVESTORS GENERALLY DO THE RIGHT THING.
THEY JUST DO IT FOUR TO SIX YEARS TOO LATE.

I happen to be short oil right now, but to be fair....

Miller: I heard [Duquesne Capital Management's] Stan Druckenmiller give a real bearish talk. And I hope he's wrong, because I've got some picks that aren't going to work out too well if he's right. [Attendees laugh.]

However, in the spirit of what I said at the outset about what I'm doing personally, I happen to be short oil right now. And I find it really interesting — if Stan's right, oil is not going up [chuckling], I can tell you that.

People talk about the oil shortage and how high it is. Well, gasoline is $2.35 a gallon. Milk is $3.45 a gallon. Water in those big, 20-ounce containers is $3.68 a gallon. And Starbucks' Lattes are $13.20 a gallon.

So even if you could figure out how to run your car on water, it would cost you 50% more to fill up your tank than it does with gasoline right now.

Investors do what they should, only four to six years late.

Miller: And what I find most interesting about the current oil environment is that people always buy today what they should have bought five years ago. [Ed. note: Good old rear-view mirror investing.] So if you go back to 1999, what did they want? They wanted tech and telecom. When *should* they have bought those? — 1995.

Bond yields, I agree with Stan, are unrealistically low. When should you have bought bonds? — 1999 and 2000.

And oil? Well, the BP Prudhoe Bay Royalty Trust is a pure play on oil. Over the last five years, it was up 549%, and the Nasdaq was down 50%. What's interesting is that during the *previous* five years, the Nasdaq was up 524%, and the BP Prudhoe Bay Royalty Trust was down 50%.

So what you have right now is a monster bull market in oil that began in 1999 and 2000, that's taken oil from $10-11 a barrel to $50 a barrel. And interestingly enough, where did the Nasdaq top out? It topped out around 5,000 — up from about 1,000 in 1995. So even the math kind of comes together on that. So I think that certainly if Stan's

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(cont'd from preceding page)

right, oil's going down a fair amount.

China is great, but let's keep it in perspective....

Miller: Incidentally, when people talk about demand from China, it's interesting. China's great, but the Chinese economy is the same size as the Italian economy. And people aren't really worried a lot about what Italy is going to do and how fast it's going to grow. [Attendees laugh.] So we're coming at it somewhat differently.

The U.S. economy is seven times the size of the Chinese economy. So the U.S. economy going from growth of 4% to 3% is like the Chinese economy going from 7% or 8% to zero. And we've just gone from 4% to 3%.

So I think it's always useful to keep the orders of magnitude involved in these things in place....

THE U.S. MARKET LOOKS PARTICULARLY ATTRACTIVE — FOR EXAMPLE, CITIGROUP AND REINSURANCE.

I think the U.S. equity market is particularly attractive.

Attendee: I've been hearing lately that a lot of analysts think foreign markets are more attractively priced than the U.S. market. And of course, foreign markets have been doing better for the last few years. Have you considered boosting your exposure to foreign markets?

Miller: Our big fund is mainly a U.S. large-cap fund. We can own foreign names — and we have a few. In our Opportunity Fund, which can go anywhere in the world, we've been looking overseas, but *not* for the reason that you mentioned. Those markets have done extremely well.

I was with a famous hedge fund manager yesterday. And I won't mention his name, but it's a name that everybody in the audience would recognize. And he said, "You know, Bill, we've been long the emerging markets and short the U.S. market — and it's worked great. But every hedge fund in the world seems to have that same bet on. And that's making me very nervous."

So while I think the overall outlook for equity markets around the world is pretty good, I think the U.S. market is particularly attractive....

Citigroup is misunderstood....

Attendee: Any thoughts on Citigroup?

Miller: Citigroup is buying back 2-3 million shares every single day. It's got a 3.5% yield. And it's going to grow its dividend about 10% a year....

[Editor's note: That was as of December 8th. An 11% increase in the dividend the company announced on January 20th plus a 5% decline in the stock price have combined to increase the yield to nearly 4-1/4%.]

Miller: And I think that it's fair to say that Citigroup is the single most important financial institution in the world. Yet its dividend yield is about what money market rates are.

Attendee: But how can Citigroup make any money with a flat, or even inverted, yield curve?

Miller: Based on its valuation, people are assuming incorrectly that its entire business is a spread business.

Attendee: It's *not* a spread business?

Miller: If the entire business *were* a spread business, Citigroup wouldn't be making a profit today. And to the degree that it *is* a spread business, it's not just based on U.S. spreads. They can borrow and lend all over the world. They don't have to keep all of their capital in the U.S.

[Editor's note: Citigroup was Legg Mason Capital's 9th largest purchase for the quarter ended 12/31/05.]

We believe the reinsurance companies are quite attractive.

Attendee: I'd like to hear you talk about the insurance sector.

Miller: Well, our director of research, Ira Malis, was an insurance analyst for many years. And he's quite optimistic about reinsurance companies in general.

And we have some positions in insurance companies — St. Paul being a good-sized position for us. The reinsurance companies are statistically quite attractive. They're raising capital — which gives you an opportunity to get in. And the outlook there — and I'm just quoting Ira here — is quite favorable....

OBSESSIVE FOCUS ON MARGINS IS MISPLACED — THE WORRY DU JOUR, IT CLOUDS PEOPLE'S THINKING.

OID: As usual, you sound pretty bullish. I gather that you're not worried about higher commodity prices driving a resurgence of inflation.

Miller: No — because I think the PPI stuff and the overall inflation rate has to be... The pressure on margins *at* the margin is commodity prices.

This is a minority view. But my view is that this commodity price cycle is another version of what we've seen in virtually every cycle coming off a recession bottom — which is commodity prices rising significantly, because the demand curve for those commodities shifts faster than the supply curve.

OID: In that case, if relatively low inflation persists, shouldn't higher commodity prices put a squeeze on corporate profits?

Miller: Not really. In fact, I expect the supply curve to shift over the next couple of years — because prices are very high for commodities today. And therefore, that particular pressure on margins will dissipate.

It depends on the company, but companies are trying to pass those things along. We don't see any labor cost inflation at this stage. And the productivity numbers were off the charts the other day — they were fabulous. So I don't see a lot of margin pressure.

And even if we *get* a little bit of margin pressure, there is always a worry du jour in the market. But I think the obsessive focus that many analysts have on profit margins is completely misplaced — because any margin pressure will be offset by capital returns or all kinds of other things. And when people get focused on that too much, I think

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BILL MILLER
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that it clouds their thinking....

OID: As long as you're dealing with the laundry list, what about our huge current account deficit?

Miller: This is a distinctly minority view, but we believe the world — the globe in aggregate — is short on demand and long on supply. So when people point to the U.S. current account deficit and say we spend too much and save too little, what a current account deficit means is that the U.S. is exporting demand to the rest of the world. So we export demand, and they send us supply.

That's good, because if we weren't exporting demand, annualizing the last quarter, there'd be about $700 billion of goods and services looking for customers. So there would be a global depression if the U.S. were not running a giant current account deficit. Therefore, I'm not too concerned about that at all.

OID: So you think that today's current account deficit is sustainable?

Miller: Well, as for the argument that our deficit's too large and isn't unsustainable, I would ask what's the evidence exactly for that? I see no evidence for that at all.

I heard the same thing when healthcare spending was 8% of GDP. All I heard was, "It's growing 10% a year. It's not sustainable." Well, it's now *15%* of GDP.

Our current account deficit is around 6% of GDP. Well, New Zealand's current account deficit is around 8% — and yet New Zealand's currency is at 30-year *highs*. So is it not sustainable? I don't know. In fact, I don't know what unsustainable means. Obviously, it can't be 100%. But should it be 7%, 8%, 4%, 3%? I really don't know. Then again, nobody else does either. It's an aggregation of individual demand.

But, again, what I do know is that New Zealand has a current account deficit equal to 8% of their GDP versus about 6% for the U.S. — and yet that hasn't prevented their currency from rising to a 30-year high.

YOU CAN'T JUST LOOK AT ONE SIDE OF THE EQUATION. IT'S NOT ONLY ABOUT DEFICITS, BUT ASSETS, TOO.

OID: The counterargument to that, I guess, is that continual deficits result in us having a lot of debt.

Miller: It results in foreigners winding up holding a lot of our currency.

OID: And, in effect, being indebted to them, according to Buffett...

Miller: I've heard Warren declaim on this, as well as reading what he's written on it. Basically, his argument, when you boil it down, is one that I don't buy — certainly in the *short* run. His argument is two-fold. He says that what we're doing is selling off bits of the U.S. — we're selling claims on U.S. assets to foreigners. And he says when those claims come due, that's going to be a problem.

Well, if you think about it, that's a *political* argument, not an economic argument. And when it comes to the political side, I totally agree with him that that's a danger. If Chinese National Petroleum wants to buy Unocal because they've got a lot of our dollars — and we say, "Sorry, you can't buy that" — that's a problem. If they've got the currency and they want to buy an asset, we're saying, "You can have our currency, but you can't redeem it." That's a problem. However, it's a political problem, not an economic problem.

OID: But whatever category you choose to assign it to, it's still a problem, isn't it?

Miller: Not as big as most people seem to think. And if you take it one step further, I think you'll see the flaw in the reasoning. And here's what I mean:

The current account deficit is around $700 billion. Annualized, as of March 9th, it's over $800 billion. So the deficit is somewhere in the neighborhood of 6-7% of GDP. That means that we're basically borrowing 6-7% of GDP from the rest of the world to finance our consumption.

Meanwhile, household net worth is $52 trillion as of the latest figures. And it grows at the rate of nominal GDP. In other words, the asset base of the U.S. grows X% from time period T1 to time period T2. That's what GDP growth means — that you're going to grow assets. Right?

OID: Productive capacity.

Miller: Same thing. So the question then becomes, "How much is our asset base growing?" And the answer is that our nominal U.S. GDP is growing about 5% a year — 3% real plus 2% inflation.

So if we're borrowing $700 billion, but we're increasing our househould net worth by over $2.5 trillion (5% x $52 trillion), why is that a problem?

It's only a problem because people get caught up in the numbers. It's a little bit like the U.S. budget deficit. Is the budget deficit close to a record? In nominal dollars, yes, it is. But as a percent of GDP, today's budget deficit is actually lower than the average of the last 50 years.

OID: Talk about an unreported fact...

Miller: It is. And back when people were hung up on the deficit in the 1980s, I'd give talks and ask, "So if I were to tell you that last year, I had no debt, and this year I have $1 million of debt, is that good or bad?" You might say, "Well, I'm not sure that's so good."

"But what if I told you I made $10 million last year? *Now* would I have too much debt?" "Oh, no." See, you have to look at both sides of the equation. [He chuckles.] You can't just look at one side and conclude it's a problem. And that's why the budget deficit is sustainable.

GIVEN WHAT'S HAPPENED TO HOUSING PRICES, A LOW SAVINGS RATE HASN'T BEEN SO IRRATIONAL.

OID: The complicating thing to me is our tax policy. In the U.S., we have enormous incentives to borrow, whereas I gather it's the reverse in most of the rest of the world. For example, Europe taxes consumption. And you'd think it would have an impact...

Miller: It has an impact on rational behavior. But if you go back to what Milton Friedman won the Nobel Prize for — his Permanent Income Hypothesis — basically, when

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you look at something like the calculation of savings, which is weird... But let's assume that it *isn't* weird. Let's assume it actually reflects savings. (It doesn't, but let's assume that it does.)

OID: I can take a joke if you can.

Miller: The fact remains that you have to look at the entire wealth position. So if, in fact, somebody has 90% of their assets in a house that's appreciating 10% per year, why should they save anything else if what they're looking at is their total wealth position?

If housing prices stop rising, the savings rate may rise. That was part of Alan Greenspan's point in that paper he authored about the extraction of equity from homes. I think there's a real issue that if home prices stop going up, who *knows* what would happen to consumption?

But consumers aren't stupid. When interest rates fall from 7% to 2% or 1%, guess what? They change their mortgages to adjustable rates. They refinance. They react to reality.

OID: Have you ever seen a chart that shows the annual appreciation in the price of houses versus other savings by consumers?

Miller: I've seen data sets on total wealth, yes.

OID: As I recall, the charts I saw showed consumers behaving exactly as you suggest.

Miller: Yeah.

OID: When housing prices rose a lot...

Miller: Other savings went down.

OID: Exactly. And I haven't seen a chart adjusting savings for changes in housing and equity prices. But I suspect total savings have been surprisingly steady.

Miller: Sure. If you add 'em all together, you get rational behavior. It's just like people focusing on the current account deficit. I was in London last year talking about why I was bullish on the U.S. dollar when almost everybody else was bearish. And it seemed like everybody was saying, "A 6% current account deficit is unsustainable. So the dollar *has* to go down."

And what I said a year ago was, "Oh, yeah? Well, the two biggest current account deficits in the world are those of Australia and New Zealand. And those two countries have had the strongest currencies in the world, too."

OID: Very interesting.

Miller: So what I got back was, "Oh, then it's the total of the budget deficit *and* the current account deficit."

OK. That actually would be more sensible — because it's the total amount of financeable debt that counts. Let's look at that. So what's the trend there? It turns out that in the U.S., until Katrina hit, that figure was declining even in absolute dollars, but certainly as a percentage of GDP.

And then, if you look at that time series, you actually *do* see a very strong correlation between that total and the value of the currency.

On the other hand, if all of these "if/then" statements actually led to some kind of money-making conclusion, then it would be really easy to get rich. Right? "Oh, the current account deficit is going up? All we have to do is short the dollar and we'll make a lot of money." Well, unfortunately, it doesn't work that way.

OID: Remind us to edit this part out...

Changing topics as quickly as possible, I noticed that Robert Hagstrom completed his first 10 years at the helm of Legg Mason Growth Trust in April. And it's pretty amazing that he's done as well as he has — given that he's owned so many big-cap growth stocks.

[Editor's note: According to *Morningstar*, Legg Mason Growth Trust's performance placed it among the top 7% of all of the funds in its category for the trailing 10 years, and among the top 2% for the past five years.]

Miller: It really is. [Miller laughs.] And David Nelson runs our Leading Companies Fund — which, I'm loathe to admit, has beaten Value Trust over the last five years. And we hired Sam Peters from Fidelity about nine months ago. He runs Special Investment Trust — our mid-cap fund — which happens to be our best-performing fund this year. Feel free to give any of 'em a call.

OID: Speaking of successful money managers, how is Ernie [Kiehne] doing?

[Editor's note: Ernie Kiehne was our first interviewee in the first issue we ever published, and portfolio manager of Legg Mason Value Trust before Miller took the reins.]

Miller: Ernie's doing great. He's 88 years old and in good health. He still comes to the office at least four days a week. And we just set him up with a computer at home [laughing] which he's very happy about — because now he can work *all* the time.

OID: Sounds like the same old Ernie. Please tell him that I asked about him and that I send my regards.

Miller: I'll do that. I know that he'll be happy to get your good wishes. By the way, I mentioned Kirk Kerkorian earlier in the context of GM. I should probably tell you that Ernie likes that one, as well. So Kerkorian isn't the only 88-year-old smart investor who likes GM. [He laughs.]

OID: That's the same old Ernie, all right.

Thanks again, Bill. It was great to see you.

Miller: Good to see you, Henry. Take care.

—OID

To learn more about
Legg Mason Capital Management,
you may contact:

LEGG MASON CAPITAL MANAGEMENT
100 LIGHT STREET
BALTIMORE, MD 21203

(800) 822-5544

GREENLIGHT CAPITAL'S
DAVID EINHORN
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and expenses versus 8.6% per year for the S&P 500. And it hasn't exactly been a bumpy ride for Einhorn's partners so far either — with his limited partners' net returns having exceeded that of the S&P 500 by a full 8% or more in nine of the ten periods.

Here are Greenlight Capital, L.P.'s annual return figures — along with those of the S&P 500 (provided by *Ibbotson Associates*). All Greenlight Capital, L.P. performance figures are net of all fees and expenses and were provided by Greenlight Capital, Inc.

Year	Greenlight Capital, L.P. Net Return	S&P 500 Total Return
1996[1]	+37.1%	+15.0%
1997	+57.9	+33.4
1998	+10.0	+28.6
1999	+39.7	+21.0
2000	+13.6	- 9.1
2001	+31.6	-11.9
2002	+ 7.7	-22.1
2003	+36.8	+28.7
2004	+25.0	+10.9
2005	+13.1	+ 4.9
Trailing 3 years	+24.6%	+14.4%
Trailing 5 years	+22.3%	+ 0.5%
Since inception	+27.4%	+ 8.6%

[1] For the eight months ending 12/31/96.

Incredibly, Einhorn's investors have only experienced monthly declines exceeding 2.5% in a total of four months. And they've never seen a double-digit monthly decline. The *Ibbotson* Small Company Stock Index, by comparison, showed monthly declines of 2.6% or more in 34 months during that same period — and double-digit declines in four of those months.

We've had our eye on Einhorn for awhile now. But when the opportunity arose to bring you what he had to say at the most recent Tomorrows Children's Fund/Ira W. Sohn Investment Research Conference, which occurred on May 5th in Manhattan — and to update his remarks with a series of more recent conversations — well, we couldn't resist.

Einhorn's youthful appearance (he looks closer to 26 than 36) belies the patience and steely resolve that one would be pleased to find in a seasoned investment veteran twice his age. He seems not only willing to stand alone and defend an unpopular position if he believes that he's right, but he seems to actually relish the battle with all comers — including the market itself.

(continued in next column)

And that's fortunate — because at the event in which he gave his presentation, Duquesne's Stan Druckenmiller was so negative that another presenter, Larry Robbins of Glenview Capital said, "I hope that you're learning a lot. I learned that Duquesne means 'scare the hell out of you'." And Carl Icahn, who followed Einhorn, spent a good bit of his time explaining why *he* thought Einhorn was wrong.

However, Einhorn shows no signs of backing down, and has only added to the position (we estimate that it was his second largest equity purchase during the quarter ended December 31st) as sentiment about the industry has continued to worsen and the stock has reflected it. (It hit a new 52-week low as we were headed to press.) In any case, we hope that you find Einhorn's thoughts as interesting and timely as we do.

MY LAST PRESENTATION SET OFF A FIRESTORM — AND I DON'T THINK WE'RE ALL BETTER OFF FOR IT.

When I told you about Allied Capital, little did I know....

David Einhorn: I stood up here three years ago and told you about my best short idea — Allied Capital — and all heck broke loose. Allied is currently under civil and criminal investigation and the government will either take significant action against this company and its management or it won't. We're still short the stock — and the market has long since stopped caring about what I think about it.

But there is one aspect of my personal experience since that speech that I'd like to remark on to you today. In January of 2003, *The Wall Street Journal* wrote that regulators were going to look into my company. Just like its readers, this was the first I'd heard of it. So we had to assemble and send off several boxes of files and e-mails. When the media was tipped about the investigation, the articles immediately harmed my reputation and my firm.

There is no reason to believe that we've done anything wrong — and we haven't. And I, of course, wish that this investigation had been carried out confidentially, as it is supposed to be. While the disclosure of the investigation inflicted unnecessary public damage on my firm, we all persevered — and it appears to us that two years ago, regulators shifted their attention away from us.

It's understandable why most shorts are laying low.

Einhorn: But I believe the bigger problem in this case transcends Greenlight and Allied Capital. The public announcement of a regulatory inquiry into my expression of my beliefs about Allied Capital has had an enormous impact on people's willingness to discuss negative research — particularly on suspected frauds — in public forums. For example, in 2002, there were about a dozen short ideas presented at this conference. Last year, there was not even one short idea mentioned. Notably, even Bill Fleckenstein chose to inform this gathering about his favorite *long* idea.

This year you've had a few short ideas — and I salute Jim Chanos, Jim Grant and Larry Robbins for their courage today. If honest discussion of negative research is going to earn you a visit to the principal's office, who can blame people for deciding that it isn't worth it?

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GREENLIGHT CAPITAL'S
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(cont'd from preceding page)

Instead of being discussed in forums like this one, short ideas are now mostly discussed behind closed doors, without attribution. Are we better off?

MYSTERY COMPANY #1: IS IT A LONG OR A SHORT?

Mystery company #1 — is its stock a long or a short?

Einhorn: All right, imagine a company with an outstanding history of growth and share price performance. Over the previous seven years, earnings per share have compounded at 45%. And shareholders have earned 75% per year compounded on their investment during that time.

Bulls cheer that the company operates in a fragmented industry and is a leading competitor in most of its markets. It has a strong balance sheet with deep financial resources. It has an open-ended growth opportunity as it can apply its proven, money-making practices to new markets.

The bulls argue that it is different this time. And yet trouble lurks. Critics properly point out that the company is not a pure growth company, but at best is a *cyclical* growth company and that it has benefited from a sustained, long-term favorable cycle.

There is widespread suspicion that the industry has turned into a bubble. The company's customers are thought to be low quality, as they pay with capital given to them on terms that historically would be called speculative at best. And an increasing number of customers aren't even *users* of the product. Instead, they are thinly capitalized speculators, taking advantage of the environment to purchase the product with the view that it's in short supply — hoping to hold it for only a short period of time before flipping it for a quick buck. And the stock trades at 75 times trailing earnings. Is this a long or a short?

Looking back, it's no mystery....

Einhorn: The stock is Cisco Systems, the time is December 31, 1998 — and the price is $23 per share. And we all know what happened. This would've been a *lousy* short. Over the next 15 months, the shares rose an additional 350% to about *$80* a share. And the P/E hit 180 before the bubble burst. The shares eventually bottomed at $8 — which was about 25 times earnings at the time.

Since the end of 1998, Cisco has underperformed a flat S&P by 5% per year, as earnings have compounded at 16% per year. And Cisco's stock has just about grown into its 1998 valuation with a current P/E of about 20 times.

MYSTERY COMPANY #2: SOME THINGS ARE THE SAME, BUT ONE THING, AT LEAST, IS VERY DIFFERENT.

Mystery company #2 — same question....

Einhorn: Now let's imagine another company. Over the previous seven years, earnings per share have compounded at 48%. And shareholders have earned 34% per year compounded on their investment during that time. Bulls cheer that the company operates in a fragmented industry, is a leading competitor in most of its markets, that it has a strong balance sheet with deep financial resources, and is an open-ended growth opportunity as it can apply its proven money making practices to new markets.

The bulls argue that it is different this time. And yet trouble lurks. Critics properly point out that it's not a pure growth company, but a *cyclical* growth company and that it's benefited from a long-term, sustained, favorable cycle.

There's a widespread suspicion that the industry has turned into a bubble. The company's customers are thought to be of low quality, as they pay with capital given to them on terms that historically would be called speculative at best. An increasing number of customers aren't even *users* of the product. Instead, they are thinly capitalized speculators, taking advantage of the environment to purchase the product with a view that it is in short supply. They hope to hold it only a short time before flipping it for a quick buck. The stock trades at *seven* times trailing earnings. Is *this* a long or a short?

We have a strong opinion on this one — and a big stake.

Einhorn: The stock is M.D.C. Holdings, the time is today — and the stock is now trading at $67 a share....

I believe this is a long. Of course I'm biased, since, aside from the CEO, who owns 15% of the company, Greenlight is the largest shareholder. I'll be the first to concede that this is a cyclical company that has operated in a friendly environment.

And yes, no question, there's been some speculative behavior in the housing market....

The P/E multiple certainly doesn't look speculative.

Einhorn: But where the critics have it wrong is that M.D.C. has a lower P/E today than it had seven years ago. There's a big difference between valuing a cyclical growth company at 75 times earnings versus 7 times what may or may not prove to be peak earnings. That is what the housing bears are missing.

OF COURSE, THERE'S NO SHORTAGE OF BEARS — SOME OF WHOM HAVE BEEN VERY VOCAL.

Abelson and Kass have expressed a very different opinion.

Einhorn: Consider this from Alan Abelson's column in *Barron's* wherein he cites Doug Kass: "Doug ... is also concerned about the roaring excesses in housing. In fact, Doug cites the probability that this last great asset bubble will pop as his greatest concern for the economy and the stock market.

"He points to the massive rise in existing home sales ... along with exploding prices, as clear indication of mounting speculation. He fears that the rate of turnover, increasingly quickened by gushing prices, will hit the inevitable wall, sales will decline with sudden sharpness, house prices will plummet and the consumer will fold his spending tent, just as corporate America has done."

This could be a paraphrase of Stan Druckenmiller's speech earlier today.

Kass has painted a very scary picture.

Einhorn: "What makes this prospect especially scary, Doug notes, is that the consumer retrenchment would add

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heavily to the strains on the economy, which, in turn, would bring fresh pressure to bear on house prices. And homeowners, with a steadily shrinking equity in their homes ... are unusually vulnerable to a soft housing market and weakening prices."

"Doug's analogy is that today's homeowner is very like a heavily margined stocktrader in a dangerously overvalued stock market. Compared with stocks or most anything else, houses a are notably illiquid asset." And he's short all these stocks — blah, blah, blah.

At the very least, his timing leaves much to be desired.

Einhorn: The problem is that he said that back on August 13th, 2001. [The audience ripples with laughter.] And in fact, like clockwork, Alan Abelson has repeated Doug's misguided views in November 2002, January 2004, June 2004, and October 2004. And Stan Druckenmiller repeated them today.

HISTORICALLY, IT'S BEEN A BOOM/BUST BUSINESS.
BUT WE BELIEVE IT REALLY *IS* DIFFERENT THIS TIME.

In the past, Kass and Abelson might have been right.

Einhorn: The stock market is not giving homebuilders credit for the sustained improvements in their business models and their balance sheets since the last cyclical implosion 15 years ago.

Let me explain why it really is different this time: Fifteen years ago, in order to sell a house at the best price, builders believed that many people needed to see what the house would look like. So they built a house, showed it to the consumers, and they'd sell them. [Ed. Note: So-called "spec" houses.] As the market would heat up, builders would become more aggressive — and when the market would slow down, builders would be stuck with large investments in completed homes. High levels of leverage would create liquidity concerns forcing price cutting to clear the inventory. The price cutting would obviously kill the margin and would result in losses.

This behavior led to a Wall Street consensus view — a proper one at that time, I might add — that homebuilders don't earn their cost of capital through the cycle and thus should be valued at around book value, i.e., the liquidation value of their balance sheet.

But I believe it really *is* different this time....

Einhorn: Today, the process is quite different. Builders rarely complete a house without a customer.

(continued in next column)

Instead, when they start a development, the first house they put up is a sample home — and they use that as the sales office until the development is completed. Customers can tour the sample home and see what it looks like.

Homes within the subdivision can be tailored to individual tastes. Modifications can be shown on computers, giving the customer a clear picture of what the completed house will look like. And these customized modifications are high-margin add ons for the builder. This process has *dramatically* reduced the risk in the homebuilding business.

Are inventory levels at speculative levels? Hardly....

Einhorn: Now we've heard what Stan Druckenmiller said today. And I'm not going to disagree with him about the collapse of the dollar or the economy or the rest of it. But I think that what he was talking about when he put up the slide relating to the speculative inventory was a little bit misguided. And there are two reasons why I think it was misguided:

PORTFOLIO REPORTS estimates the following were Greenlight Capital's largest equity purchases during the 3 months ended 12/31/05:

1. AMERIPRISE FINL INC
2. MDC HOLDINGS INC
3. INTERNATIONAL COAL GRP INC
4. AMERICAN HOME MORTGAGE INVMT
5. LIVE NATION INC
6. NEW CENTURY FINL CORP
7. RADISYS CORP
8. MEDICAL PPTYS TRUST INC
9. CF INDS HLDGS INC
10. WASHINGTON GROUP INTL

First, it includes "frames" — the basic foundations of the houses. Also, it talks about unsold inventory in units — as opposed to days of inventory, which is more relevant because it factors in the current size of the market.

Today, the number of completed, unsold homes is relatively trivial.... For M.D.C., it's a three-day supply. For the industry, there's a 25-day supply at the end of March. Since 1998, the average has been a 30-day supply. From '92 to '97, the average was a *52*-day supply. From '88 to '91, the average was a *65*-day supply — with supply peaking in January of 1991 at 107 days. The days of "if you build it, they will come" have long since passed.

National homebuilders enjoy enormous advantages.

Einhorn: It has also turned out that housing is a scale business. National builders cut favorable deals with suppliers for bulk purchases of materials. The land entitlement process has become quite time consuming. Thus, it takes deep pockets to finance multi-year development projects. In fact, scale economies and ongoing supply constraints have created ongoing barriers to entry that enable large homebuilders to earn sustained excess returns on capital. And this is one industry where we don't have to worry about low-cost imports.

[Editor's note: Not a small point, we suspect.]

Einhorn: And banks remain *very* conservative on

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lending to housing developers. M.D.C., with its investment-grade credit rating, has access to low-cost funds, giving it an *enormous* advantage over the private builders who still control over 75% of the market.

As a result, they're capturing increasing share.

Einhorn: Their best practices and scale economies have enabled the public builders to steadily take share from the private builders. M.D.C.'s national market share is about 1%. That's about 80% more share than it had seven years ago. M.D.C.'s market share gains have had a bigger impact on top-line growth than either pricing or increased market size. And with such a small national market share, it remains plausible, in my view, that M.D.C. can grow 15% faster than the national market for several more years.

Meanwhile, the market itself grows on a secular basis about 5% per year — about 2% from units from population growth and household formation, and 3% from long-term price appreciation. Adding that 5% to the market share gains, M.D.C. is a long-term top-line grower of about 20%. That's a little bit less than the recent rate — which has been aided by better-than-average cyclical tailwind.

And it's reflected in M.D.C.'s results.

Einhorn: Now there's plenty of opportunity for beating the numbers and positive revisions to estimates. Current consensus is that M.D.C. will earn $9.70 this year and $10.50 next. One measure of expected growth is the number of active subdivisions or developments where M.D.C. is currently selling houses. At the end of '03, M.D.C. had 198. At the end of 2004, there were 242. M.D.C. expects to exceed 300 active subdivisions at the end of this year.

With the internal growth plan, M.D.C. can earn more than $10.00 this year. [Ed. note: Indeed, they earned $10.99 in 2005.] And unless the industry cycle turns suddenly, it could earn more than $12.00 next year.

And I believe that this lower risk, lower speculation construction process and a much more conservative capital structure will prevent the capital destruction seen at the trough of previous cycles. While M.D.C. has averaged a high 20s return on equity for the last few years, the chance of it again not earning its cost of capital through a cycle appears *extremely* unlikely.

NATIONAL HOMEBUILDERS HAVE A TAILWIND,
BUT I BELIEVE M.D.C. IS *ESPECIALLY* ADVANTAGED.

We're not counting on future home price increases either.

Einhorn: The possible turn in the industry, though, brings me to the big bear case — which is the so-called "housing bubble". First, let me observe that the so-called "housing bubble" refers to pricing rather than unit volume. For the last six years, new housing construction volume has been growing at about five percent per year — or a couple of points above the long-term trend.

Pricing's also been better than trend and has allowed for additional margin expansion. But keep in mind that you don't need further price increases at the recent rate in order to maintain returns on capital. For deterioration, you would need prices to actually fall. And while it's quite possible for an individual market to suffer price declines, there has not been a material decline in housing prices on a national basis in 70 years.

And M.D.C. is not reliant on any one or two markets.

Einhorn: Over the last several years, M.D.C. has suffered slowdowns in several of its markets. In the early 1990's, California suffered declines and M.D.C. kept growing. In the late 1990's, Virginia and Maryland suffered declines and M.D.C. kept growing. After the internet bubble popped, M.D.C.'s largest market, Colorado, went into decline and M.D.C. kept growing. More recently, Las Vegas and Southern California have gone into decline — and M.D.C. is still growing.

Each time one market slows down, M.D.C. has pushed forward because a portfolio of Virginia, Florida, Colorado, California, Nevada, Arizona, and Texas are markets where household formation and population growth are ongoing. When one market slows down, others grow.

I think M.D.C. has advantages over other builders, too.

Einhorn: I prefer M.D.C. to other homebuilders because it generates about the highest return on equity with about the lowest financial leverage in the industry. The high return on equity is generated through a combination of superior asset turns and margins — which gives M.D.C. a superior return on assets. Asset turns are high because M.D.C. carries only a two to three year supply of land inventory. So M.D.C. has achieved its leading results without a large benefit from rising land values in its inventory.

Of course, this also mitigates the potential exposure to *falling* land prices in the future. As a result, I believe M.D.C. merits a *premium* multiple to the group.

HOUSING SPECULATORS AREN'T ALL DUMB.
IN FACT, SOME OF 'EM ARE ARBITRAGEURS.

I think new housing is attractive for investment purposes.

Einhorn: Much has been made of investors purchasing houses rather than owners. This is supposedly proof that we have a housing bubble. However, new housing is attractive for investment purposes — and not simply because people want to take advantage of favorable financing and the long-term trend of price appreciation.

[Editor's note: We don't believe this has to be true, except at the furthest extremes, in order for M.D.C. to be an attractive investment at today's price.]

Early houses in a development are cheaper for a reason.

Einhorn: A bigger reason for buying houses as an investment is that there's an arbitrage in new developments. It's less attractive to buy the first house in the development than the last one. If you buy the first one, you'll have no neighbors and you'll have to endure years of construction.

Homebuilders and consumers know this. My *wife* knows this. So when we were looking to move to the suburbs, we declined to make an offer on an otherwise perfect house because five more houses were to be built in the area, and we didn't want to be subjected to having

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construction as our neighbors for the next two years.

So in a new development, the early houses go at a discount. By the last house, the construction is over, the neighbors are situated, the grass and some trees have grown in, and the value of all of the houses in the development is higher. Early buyers can resell for a gain.

I once met a guy who made his living by buying the first house in a development, selling it two years later, and then moving on to do it again elsewhere. Frankly, I'm surprised that some of the wise guys in this room haven't set up products to go after this arbitrage. Believe me — it's much better arbitrage than mutual fund market timing. [Attendees laugh.]

So I don't think investor purchases create a big problem.

Einhorn: So while there has been an increase in investor purchases of new housing, this is hardly alarming. Perhaps, at some point, speculators in a particular market will lose some money. [Ed. note: For whatever it might be worth, we're inclined to think this dramatically understates the issue — at least in some markets.] However, on balance, I believe that they're just taking advantage of a recurring and profitable inefficiency. So I don't believe that their presence creates a significant industry problem.

[Editor's note: Of course, Century Management's Arnie Van Den Berg couldn't disagree more — and lays out an explanation of his rationale in a client letter that makes our in-depth features look bare bones by comparison. (See the December 31, 2004 edition of *The Value Investor*, at www.centman.com/library.html.) Who's right? Again, we suspect it depends on which market(s) you're talking about.]

MY WORST-CASE SCENARIO'S NOT THAT BAD.
AND IF I'M RIGHT ABOUT THIS BUSINESS...

What's my downside? Here's how it looks to me....

Einhorn: What if the industry defies my optimism and slows down? Here's where I argue that M.D.C. is a heads I win, tails I win proposition. Again, it all comes down to valuation. If you buy a cyclical growth stock at the top of the cycle at 75 times earnings, you will get hurt in a slow down. However, at 7 times earnings, the story is quite different.

As I pencil the math, having looked at the long-term national statistics, in a broad industry slowdown, housing units would fall about 35% from peak to trough. As I believe M.D.C. will gain market share and do 15% better than the market, M.D.C. would lose about 20% of its units assuming the housing market collapsed in a single year.

If I assume that pricing were to fall an unprecedented 5% on a national basis and that this price decline were to fall straight against the gross margin and everything else were to hold constant — which it wouldn't because management would cut costs — M.D.C. would *still* earn $5.75 in 2006.

And that shouldn't exactly be a disaster for the stock.

Einhorn: My argument is that this bear case scenario represents a reasonable estimate of trough earnings. And as we go from peak to trough earnings, the multiple should expand. I would argue that in a worst case, one should pay a market multiple on trough earnings in a cyclical growth company. Most cyclicals are valued at a significant *premium* to the market at the cyclical trough in anticipation of an earnings recovery. And eighteen times $5.75 is about $100 per share. [Ed. note: It's $103.50, but who's counting?]

I think it's a wonderful business — with prospects to match.

Einhorn: As I've discussed M.D.C. in the last decade, I've heard a repeated chorus of, "This is a bad business that never deserves a double-digit P/E multiple." Many of my colleagues have told me that my interest in M.D.C. reflects my willingness to own bad businesses while they like to own good businesses.

So we've had to content ourselves with watching M.D.C.'s earnings grow 48% per year. The Wall Street consensus has this wrong. This is a *wonderful* business — with a secular 20% internal top and bottom line growth rate, a conservative balance sheet, excellent returns on capital, a defensible market position, significant barriers to entry, and no threat of Chinese or other foreign competition. This is a much better business than Cisco. It should get a premium to the market multiple based on mid-cycle earnings. At this point, that looks to me like it's around $8.50 a share. A 20 P/E multiple would be 170 bucks a share. But why be greedy?

[Editor's note: At the conclusion of his remarks, Einhorn told the event moderator that he thought Tomorrows Children's Fund was a great charity and presented 'em with a check for a cool million bucks.

We told him that was good form after interviews, too. But so far, sad to say, he hasn't complied...]

The following material was excerpted from a series of conversations with Einhorn which took place between December 21st and shortly before we went to press.

WE THINK M.D.C. IS TRADING AT 40¢ ON THE DOLLAR —
AND THAT ITS VALUE'S GROWING 18% OR SO PER YEAR.

OID: I gather that there's been a year of negative developments in the housing industry and positive developments at the company...

Einhorn: Yeah, I guess that's how it goes.

OID: Has your opinion of the company changed in any material way?

Einhorn: No. Not at all.

OID: I understand that M.D.C.'s backlog is actually up — and by a lot.

Einhorn: Yeah. If anything, the company has done a little bit *better* than I would have guessed. But on the margin, I don't think it changed *anything*.

OID: There's been a lot of negative macro

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developments, obviously. One gets the impression that the Fed has even been targeting the real estate market — perhaps even residential real estate and residential real estate finance in particular. And obviously, mortgage rates are up. Those developments haven't caused you to lower your expectations for M.D.C.?

Einhorn: Not really. My remarks at the Tomorrows Children's Fund Conference were pretty cyclically neutral. In other words, my point of view was that even if the cycle were to turn, even based on what I expect M.D.C. to produce in cyclical trough earnings, its stock is a bargain. And then there's the possibility that even if the cycle turns, it doesn't turn sufficiently nasty to revert all the way back to its historical trough — or it doesn't turn at all, but instead keeps growing for some additional number of years. And in that case, you would have even higher trough earnings than I was suggesting.

However, my key point at that time was that M.D.C. has a very high secular growth rate, and that its stock is trading at too low of a multiple where*ever* we may be in the cycle given what a strong company it is. And I believe that argument remains intact even if the macro environment were to deteriorate considerably.

OID: So you haven't lowered your estimate of M.D.C.'s normalized earnings or intrinsic value.

Einhorn: Not at all. And the reason why we haven't is that we're just maintaining our point of view that the long-term, secular growth rate in housing is a few percent — something, say, in the low single digits per year — and that M.D.C. can gain market share and grow 15% per year better than the industry for a good, long time.

So it's effectively a 20% grower priced at a third of the market multiple.

OID: Where would M.D.C. be fairly valued in your view?

Einhorn: That's an interesting question. I think that the *minimum* value that we would assign to M.D.C. would be to assign a market multiple to trough earnings.

OID: So today, that would imply a value of...

Einhorn: Let's say that the market multiple is 15. So I'd estimate trough earnings at just under $6.00.

OID: So your floor valuation would be up around $90.

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Einhorn: That's right. And I think that a fair value for M.D.C. would be something a little bit better than a market multiple on *mid*-cycle earnings. And the reason why I'm suggesting that it deserves something better than a market multiple is that M.D.C. is clearly better than the average company.

OID: Which would imply a fair value for M.D.C. of...

Einhorn: Mid-cycle earnings, I believe, are around $9.00 per share. And as a better than average company, I'd argue that M.D.C. deserves a P/E multiple of 18.

OID: So you think it's worth around $162 a share.

Einhorn: That's right.

OID: But you know it's worth at least $90.

Einhorn: You've got it.

OID: Assuming M.D.C. continues to deliver the results you expect, what are the odds that its stock ever trades anywhere near your estimate of fair value?

Einhorn: Let me answer you this way: I've been surprised for a decade that this company doesn't get rewarded with a better valuation. I mean we've owned it for nine years. And the P/E today is *much* less than it was the day that we bought it. But since the company's done so well, it's still been a fabulous investment.

OID: What was the P/E when you bought it?

Einhorn: We paid around 10 times earnings.

OUR WORST-CASE SCENARIO'S NOT ALL THAT BAD — AND WE DON'T THINK IT'S VERY LIKELY EITHER.

OID: Clearly, you have a very different view of what the future holds for M.D.C. than the average investor. What could lead you to change your view?

Einhorn: I'd have to rethink my thesis if I concluded that the company really didn't have an opportunity to gain market share — and I'd have to rethink my thesis if I came to the conclusion that the downside of the cycle was likely to be much deeper and worse than I do today.

OID: And obviously, there are a lot of very thoughtful macro bears.

Einhorn: Yeah. But the funny thing is that whenever we speak with those macro bears and ask them to give us their forecasts for the market and the margins and, therefore, what M.D.C.'s earnings are likely to be, no matter how hard we try, we can't pin 'em down. All they'll say is that the economy is going to get worse and that housing is going to get worse. And they'll either say that M.D.C.'s earnings will completely collapse, or they'll say, "In 1990, M.D.C. lost money. So I'm sure that will happen again."

But they don't do any rigorous analysis. Or they'll say, "Look, I think the earnings are going to fall. And it doesn't matter — because the stock will fall if the earnings fall." But they don't do any rigorous analysis to say, "Given where this company is today, if you run out my macro forecast, here's what the earnings will be in two years' time" — or three years' time or whenever they think the bottom of the cycle will be. "And here's why the stock is overvalued

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based on that scenario."

OID: Yeah, but they sure can paint a scary picture. The argument that gives us the most pause is the one that points to the very high and growing debt burden — directly and indirectly — being carried by the average U.S. consumer. And, that argument goes, consumption is at an unsustainably high level — including consumption of housing.

Einhorn: Yep.

OID: And therefore, aggregate expenditures on housing are well above normalized levels. But I guess that doesn't necessarily conflict with your thesis.

Einhorn: No — because my trough scenario assumes that on an industry-wide basis, unit sales of new homes fall 35% and that the average new home price falls 5%. And in that scenario, I assume that the 5% price reduction falls straight to M.D.C.'s bottom line and that the company isn't able to do anything about it — other than continuing to gain volume of 15% per year from continuing growth in market share. In other words, I assume that M.D.C.'s volume declines 20% while industry-wide volume declines 35%.

OID: And even using those assumptions, you figure that M.D.C. should earn close to $6 per share?

Einhorn: That's right. And I think that would be a pretty extreme negative macro outcome. That would put the new unit sales back to historical trough levels. And that's how I get to my bottom-of-the-cycle estimate. So my worst-case-scenario isn't all that bad.

And a 5% nationwide pricing decline in housing would be *huge*. I mean, that hasn't happened since the 1930s. There's been lots of busts that were worse than that in *individual* markets. However, on a national basis, there hasn't been a nominal decline in the last 70 years. So we're talking about a real housing bust here.

OID: So if M.D.C. turns out to be a mistake, you don't think it's likely to be because you were too optimistic in your macro outlook.

Einhorn: Exactly. Also, historically, they've done a very good job of identifying geographies to participate in that stand to benefit from long-term secular positive trends — the kinds of places that stand to experience sustained long-term population growth at above average levels. So I think the odds are very high that their markets do better than the U.S. market as a whole.

So again, what could lead us to change our view? Basically, we'd have to rethink our thesis if we didn't think they would be able to continue to gain market share.

M.D.C.'S THE MOST ATTRACTIVE BARGAIN WE OWN — AND, I'D SAY, BY A CONSIDERABLE MARGIN, TOO.

OID: But don't the public homebuilders bang heads at some point — and share gains, like all good things, come to an end?

Einhorn: Eventually — that's right. However, the share for the public homebuilders today is only about 30%. So I think the time when those share gains end is way off in the future. But don't ask me when.

OID: You're no fun. But to be fair, presumably, this is a business where it's particularly easy for managements to flush shareholder value down the proverbial toilet — either by significantly overpaying for land or doing some equally dumb transaction in the normal course of their business.

Einhorn: There's always the possibility that management wanders off the reservation and does something stupid — although in this case, in contrast to probably most of my portfolio, I think the probability of that is really low. And I say that because management owns a ton of stock — and the fellow who runs this company's a pretty serious guy. I don't see him clowning around with our money.

[Editor's note: Although we gather that you're not allowed to be a member of the homebuilder fraternity unless you agree to be pretty significantly leveraged, Einhorn points out that M.D.C. utilizes much less leverage than the average homebuilder.]

OID: And as I recall, it looks like the company has been more aggressive with their share buybacks recently than they have in some time.

Einhorn: Yeah. But so far, that's been more on the authorized side than on the completed side.

[Editor's note: On October 25th, M.D.C. nearly doubled the number of shares authorized for repurchase to 4,000,000, or roughly 9% of shares outstanding.]

OID: Plus, that's not saying a whole lot — since they don't appear to have ever been very aggressive repurchasers of their own shares in the past.

Einhorn: Yeah. Plus, I'm not touting M.D.C. as an aggressive share repurchase story.

OID: No, that's our job.

But speaking of touting, is there anything else that you own that's as attractive a bargain as M.D.C.?

Einhorn: There really isn't. In fact, I would say that it's the most attractive bargain in our portfolio by a considerable margin.

OID: Well, whether that's true or not, you certainly know how to get rid of us. Thanks again for sharing your insights.

Einhorn: It's been my pleasure.

—OID

For additional information
you may contact:

GREENLIGHT CAPITAL
2 GRAND CENTRAL TOWER
140 EAST 45TH ST, FLOOR 24
NEW YORK, NY 10017

(212) 973-1900

LONGLEAF PARTNERS FUNDS'
MASON HAWKINS, STALEY CATES ET AL.
(cont'd from page 1)

you would never know it. Longleaf Partners handily beat the S&P 500 for the 18+ years ended December 31, 2005 — with a compound return of 13.9% per year versus 10.5% per year for the S&P 500. And not only has the fund run circles around the S&P 500 Index for the trailing 10 and 15-year periods ended December 31st — beating it by 3.6% and 4.6% per year, respectively, during those periods —but it's trounced it by an even more impressive 8.1% per year during the trailing five calendar years.

The excerpts which follow were selected from comments by Southeastern Asset Mgm't's Staley Cates, John Buford, and Andrew McDermott at Longleaf Partners' annual meeting in Memphis on May 4th, and firm founder and chairman Mason Hawkins at client luncheons on September 13th in New York and October 19th in Boston, and their answers to their clients' questions at each.

We always find their comments highly educational and extremely insightful. And this time was no exception. We hope that you find them as valuable as we do.

WE'RE BACK IN THE EQUITY INVESTING BUSINESS — AND WE'RE EXCITED ABOUT THE IMPLICATIONS.

Our competitive advantages are even more important today.

Mason Hawkins: Patience, discipline, analytical ability, and a long-term time horizon are Southeastern's competitive strengths. And we believe our advantages grow in a world where hedge funds must report results every 30 days.

Those of you who've been associated with us know that we really do think in terms of a decade.... And for the three-plus decades that we've operated as Southeastern, it's always been about long-term investing and business, people and price.

Common stock buyers often forget the importance of price.

Hawkins: Buyers of creditworthy bonds understand that returns increase as the offering price falls in relationship to coupons and to par. And because the coupons, the maturity date and the payment of par at the maturity date are all contractually fixed, bond investors know that the *only* way to get an increased return is to buy the bond at a larger discount.

The same return calculations and mathematics apply to common stock investing, even though the company's earnings coupons and intrinsic value are variable and the maturity is longer. But very often, stock buyers forget the paramount importance of price to the return calculation....

It's not just about numbers. Qualitative factors matter, too.

Hawkins: Everybody understands less than 60% of appraisal is the quantitative aspect of what we demand. I'm not as sure that all of you appreciate the emphasis we place on the qualitative issues. Our main focus is on the competitiveness of the enterprise, and the capabilities, integrity, and sagaciousness of management.

And these qualitative things need to line up for us, too.

Diageo was a no-brainer....

Hawkins: Qualitatively, it's extremely rare to find a Diageo at 60% of value. Why? Well, to start with, all of this company's returns are in cash — and it earns high returns on capital. It also has pricing power and twice the market share of its nearest competitor. And it's run by a terrific operator and capital allocator in the person of Paul Walsh.

The company's top-line growth was virtually guaranteed. And its long-term margin improvement was clear. It had almost *complete* predictability that its competitive advantage would prevail, and possibly grow.

And the company was *given* to us at 60% of appraisal in the first quarter of 2000 when everybody wanted to own more and more Vodafone because it continued to rise higher and higher and became a larger percentage weighting in the FTSE. In our view, that was absolute craziness — insanity. People felt like they had to buy more Vodafone simply because it became a larger percentage of an index — and they were selling Diageo to fund that lunacy.

And as you know, the outcome was quite predictable: Vodafone's stock has fallen over 80%, while Diageo's has almost tripled. To us, it was really like shooting fish in a barrel. We'd *love* to see that kind of insanity return, along with the volatility, and the extremely mispriced businesses. Here, you had the #1 liquor company in the world, run by a great partner, generating forecastable, almost certain free cash flow — and nobody wanted it during the first quarter of 2000.

But we found precious little to do in much of '03 and '04.

Hawkins: Between then and now, we suffered through a dry spell in '03 and '04. Southeastern was almost out of the equity investing business entirely for an 18-month period through the end of '04. During this hiatus, we only bought one new company, Cemex, in Longleaf Partners Fund. We looked around the world for qualifying investments — and our cash built and built and built. And many of you asked why we'd want to own an asset that only earned 2% or 3%.

The answers we gave you probably weren't satisfying, but we thought they were good ones. What we told you was that we were comfortable owning Treasury bills until something with a *very* attractive price-to-value ratio and other characteristics we require in an investment — both quantitative and qualitative — was available.

After a long hiatus, we've once again begun to buy stocks.

Hawkins: That leads us to where we are today. We're happy to report that we think we've found and purchased for you a number of Diageo equivalents — in terms of their franchise strength, in terms of their returns on capital, etc. Our investees are mostly unique leaders in their fields that are predominately managed by owner/operators committed to shareholders — and we've purchased our stakes at the requisite margins of safety of value over price.

Since year-end '04 through the end of September, we've purchased four new positions in Longleaf Partners Fund, seven in Longleaf Small-Cap, and three in Longleaf International. Cash has declined from 26.4% to 6% in Longleaf Partners, from 29.5% to 5% in Longleaf Small-Cap and from 14.7% to under 10% now in Longleaf International.

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

Longleaf International had over 30% cash when we closed the fund in February of '04.

We're excited about our new investments....

Hawkins: And because of the recently added investments, we think that they all have a shot at meeting our goal of inflation plus 10% over the next year or so.

So we're excited about the foundation that we feel we've established — and we're very, very excited about what it implies for the next decade of returns for both Southeastern's institutional clients and Longleaf's shareholders who are partners with us....

WE BELIEVE WE'LL MAKE *MORE* MONEY IF OUR HOLDINGS STAY CHEAP FOR AWHILE.

Most of our investees are aggressively repurchasing shares.

Hawkins: While it may shock some of you who haven't been with us the last 30 years to hear me say this, we *hope* that over the next year or so stocks are down. The reason, using Longleaf Partners as a proxy, is that 15 of our 20 companies are aggressively buying in shares.

We both encourage and applaud these intelligent capital allocation decisions. Our intrinsic values are accreting much more rapidly as a result of their buying in shares at substantial discounts from intrinsic value.

In the extreme, we'd love to be the only remaining shareholder in most of these businesses. If the market just stays where it is for the next 12 months or so, and we get to shrink the denominator by a substantial amount, not only does intrinsic value per share rise significantly as a result of these wise purchases, but our percentage interest in the businesses increases, as well.

As long as the repurchases continue to be executed at discounts to intrinsic value, our outcomes down the road will be greatly enhanced.

Quantifying our expectations for a recent investment....

Hawkins: We're decade-plus investors. But in our modeling and appraisals, we look out five to eight years — always paying great heed to the Dupont model, focusing on where revenues, margins, tax rates and shares might be in five years.

A recent Southeastern Asset Management investment is one that dominates its industry and is as advantaged as any that we've ever owned. We (and management) believe that its revenues can grow 15% annually over the next five to eight years. But in our model, we assume revenue growth of 12% annually for the next five years. We hold margins constant, tax rates flat and shares outstanding unchanged for that period. And using those assumptions,

(continued in next column)

we project that the company will achieve almost 14% per year compound growth in its value.

But that's what we would earn if the company's stock were to continue to trade at 60% of value. If that discount were to close, however — if it were to rise to intrinsic value at the end of the fifth year — we estimate that we would earn a compound return of some 25% annually.

What a difference aggressive share buybacks can make....

Hawkins: But if this company's free cash flow and balance sheet cash are used to repurchase shares ratably over the next five years at 70% of their value — and, again, we estimate that they're trading at approximately 60% of their value today — and the company's stock rises to reflect its intrinsic value at the end of the fifth year, we estimate that the investment would provide us with a compound return of about 31% annually.

But if sales were to grow 15% annually, as we expect, rather than the 12% that we've modeled, margins were to rise half a point per year and its tax rate were to decline 1% over five years, as we expect, and the company's balance sheet cash and a little debt are used to repurchase shares aggressively in year one, then we estimate that we'd earn a compound annual return of over *50%* during our projected five-year holding period. Hopefully, this example gives you an idea of why we focus so dramatically on intelligent capital allocation — and especially on share repurchase when shares are discounted from conservative appraisals.

We trust the preceding gives you a feel for how we think as opposed to what you read in most financial publications or Wall Street research which seems to mostly focus on the next quarter.

[Editor's note: Lest you think these are merely theoretical opportunities, we note this description of a recent purchase from their December 31st letter:

"In the third quarter we bought Dell, which we have wanted to own for a number of years. The price declined after our initial purchase, hurting the Fund's fourth quarter and full year return. The bigger discount presents an opportunity to pay fire sale prices for this entrenched brand that is growing revenues and profits at double-digit rates. Dell is overweighted in the portfolio because the company is a high quality business and has management with proven operational and capital allocation prowess. Because of how aggressively Dell is repurchasing its stock, the price weakness is causing value to grow even more rapidly."]

PORTFOLIO REPORTS estimates the following were Southeastern Asset Management's largest equity purchases during the 3 months ended 12/31/05:

1. DELL INC
2. SPRINT NEXTEL CORP
3. COMCAST CORP CL A SPL
4. LIBERTY MEDIA CORP CL A
5. ANHEUSER-BUSCH COS INC
6. DIRECTV GROUP INC
7. TELEPHONE & DATA SYS SPL
8. NEWS CORP CL B
9. POTLATCH CORP
10. ODYSSEY RE HOLDINGS

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

WHAT DO WE LOOK FOR IN MANAGEMENTS?
OWNER/OPERATORS WHO ARE MUCH LIKE US.

Just as you place your trust in us, we place it in others.

Shareholder: We've read a lot about bad managers recently, but you deal with many good managers. In terms of process, do you look at just the CEO or the chairman of the board — or do you look at the whole management team? Also, do you really try to understand the company's board of directors or its largest shareholders?

Hawkins: We invest Longleaf's assets in around 20 companies per portfolio. And you give your monies to us because you think we have a set of skills that enables us to compound capital at a reasonable rate.

Well, we do likewise. We have to make the choice as to whom we entrust our capital. And we vet it every way you can — we've done it 30+ years. Fortunately, we have computers that can remember it. And when you've partnered with Jack Byrne — and gotten to know him, his affiliates and his associates, his family including his sons, and his board and his managers — you learn a mountain of information about every competitor in the property and casualty insurance business.

You start with the proxy statement....

Hawkins: And this cross knowledge of character and ability and what have you isn't *that* difficult to run down. I mean, you start with the proxy statement and you see what the guy makes, you see how he gets paid, and you see whether it's fair.

We want to pay people a whole lot of money if they *earn* it, and we don't want to pay 'em *anything* if they don't. And we've seen every iteration of that — from A to Z.

And we look for owner/operators who are a lot like us.

Hawkins: The best examples are the partnerships like ours. We have our net worths in these funds. And we own a lot more than anybody else in this room. So we're paying attention.

There are a lot of companies that are our investees that are very comparable to that, where people either built the companies or manage them themselves with their capital and their team's capital in 'em. And that's the kind of dynamics that we want. We want owner/operators at the helm. We want people who are capable operators in terms of growing sales, keeping margins up and costs down, and taking advantage on the capital side of opportunities to repurchase shares when they become cheap.

GREAT OPERATORS RARELY ALLOCATE CAPITAL WELL.
BUT FORTUNATELY, THERE ARE EXCEPTIONS.

Great operators are *very* rarely great capital allocators.

Hawkins: But I dare say, in my 30+ years of experience, we can count on the fingers of two hands those managers who have been terrific operators and also *very* intelligent capital allocators. That's a real package. Coca-Cola's Roberto Goizueta might have been one. And we were so smart that we never owned it.

But there are some managers that have that dual set of skills that are so invaluable. And then there are others who are terrific operators that we worked with on the capital allocation side in terms of their asking for our counsel and advice — not that it's always accepted.

And in investing, there's no penalty for called strikes.

Hawkins: The thing we ask our partners is, "Don't bring it to us as a research team unless you'd put all your net worth in it." And that's because when Staley says we need to take a look at Hilton at $6, in effect, he's suggesting that we put a big piece of our net worth in Hilton.

And we don't have to do anything. That's the great thing that we've learned over the years. I mean, there's no investment we *have* to make. And if you say "No" 99 times out of 100, nobody's going to throw you out. But they *are* going to throw you out if you pull the trigger and it's wrong.

Where there's a will to get answers, there's usually a way.

Hawkins: So I just think owner/operators at risk with their capital, with their careers, and with their reputations is important. You don't want hired hands that are really working against the long-term shareholders' interest taking in egregious option comps and big, big bonus packages that aren't earned.

But there's no magic answer. Start with the proxy, see how much they own, see how much they get paid, and see how their comp works. You want to go to the board. With *very* rare exceptions, there's not a company in America with a market cap over, say, $5 billion where we don't know somebody on the board.

So you start there. And, you know, there's only three or four degrees of separation. You can find out something about somebody with about four phone calls even if you don't know 'em. And so we do a lot of that.

That doesn't mean that you'll always be right. And the most well intentioned individual can make mistakes — and we've certainly had our share of those. But anyway, it's an imperative process for us — it's not a destination.

QUALITATIVELY, JAPAN HAS A LONG WAY TO GO.
BUT WE SOMETIMES GET OFFERS WE CAN'T REFUSE.

We've made a lot of money in Japan already....

Shareholder: You've got people on the ground in Japan. There's a lot of talk about Japan turning around and about there being a lot of opportunity there. You've said that you invest on a stock-by-stock basis, but can you make a macro comment on what you see happening there?

Hawkins: Sure. As you know, we've been in Japan for seven years now. We started Longleaf International because of the Asian Crisis in '98. It obviously pertained to Japan as well. Japan has been terrific to Southeastern — to Longleaf. Longleaf International's long-term record is top of the chart. And it's in great measure due to our foray

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

into that world over there at those prices.

Good things are happening, but there's a long way to go.

Hawkins: There are lot's of good things going on over there. You can talk about Koizumi's election and what he stands for. As we predicted, Japanese managements are becoming more shareholder-oriented and more capital disciplined, as are their lenders. So lots of good stuff is going on over there.

It's probably inning number two — maybe one out — in this nine inning game of getting governance the way that you'd want it ideally, and getting capital committed the way we would want to have it done as owner/operators with our *own* money.

Price is the great arbiter....

Hawkins: But that doesn't mean that you can't find great investments. You know, we bought a lot of companies for less than their cash and got their businesses for free. Give us that chance each time and we can deal with fewer qualifying qualitative aspects. So when the quantitative just so overwhelms the investment case, you can have a little less on the qualitative side, and still make a *lot* of money with zero risk.

We do have a number of investments in Japan where we are [he chuckles] working 24 hours a day, it seems, to get these managements to think like *owners* — as opposed to just stewards of employment. [He begins to laugh as he talks] But if you get it cheap enough, we can make a lot of money where things just aren't ideal.

For example, DoCoMo & KDDI's cash flow is mind boggling.

Shareholder: In Japan, you've had great success with Nippon Broadcasting in the broadcast area. However, some of the Japanese telecom companies have struggled a bit during this past year. Is there anything fundamental that's changed?

Hawkins: You're correct that we made a lot of money in Nippon Broadcasting. We did it twice, actually — once back in '98 and again more recently. We have two Japanese telecommunications investments in Longleaf International — DoCoMo and KDDI.

And we've made a lot of money in KDDI. We're a little behind in DoCoMo. For those of you that don't know, they're the two almost duopolistic competitors in Japan's cellphone industry. And it's by far the most advanced cellular country. And the cash flow generation is just mind boggling.

We see a future for DoCoMo that's very bright....

Hawkins: There are some moving parts as to where both of those companies are vis-a-vis the other. But when you run the numbers out five years and you look at ARPU [Average Revenue Per Unit], and you look at fixed costs, and you look at unit growth, and you look at the other different revenue drivers — some of which may be advertising — you see a future there that's bright, where the cash flow streams are just galloping right along.

And there seems to be real rational price behavior there recently — which is encouraging.

Three of our four metrics at DoCoMo look good....

Hawkins: KDDI went to the most advanced technological state first. DoCoMo is now getting up to speed. DoCoMo is running two platforms — the old and the new. So they're bearing those costs of the old, say, Level 2 approach versus Level 3 of technology. And it is a cost that people haven't really focused on that will go away when we shut down the one system once everybody's migrated over to the next.

So we think DoCoMo is a very interesting case, both on revenue *and* margin as you look down the road. And they've been *very* aggressive on the share repurchase front — which is interesting for Japan.

So three of those four metrics — save the tax rate — look good to us going down the road.

FOUR TIMES EBITDA IS AN EXTREMELY LOW PRICE FOR ONE OF THE BEST BUSINESSES IN JAPAN.

We first looked at DoCoMo as a short candidate.

Hawkins: But I'm going to let our Japanese colleague, Andrew McDermott, talk more about KDDI and DoCoMo.

Staley Cates: [Wisecracks] He's actually not Japanese.

Andrew McDermott: DoCoMo and KDDI are the #1 and #2 cellular providers in Japan.... What's interesting about these investments, I think, is that they relate to the notion of buying good businesses at great prices versus buying great businesses at high prices.

PORTFOLIO REPORTS estimates the following were Longleaf Partners International Fund's largest equity purchases during the 3 months ended 12/31/05:

1. BRITISH SKY BROADCASTING GRP
2. NEWS CORP CL B

We first looked at DoCoMo five years ago as a short candidate, because it was trading at around $15,000 per subscriber and, I think, 20 times EBITDA — an extremely high implied price for a business that had not proven itself to be a great business at that time. It still required tremendous investment in 3G capacity and so on.

The business is now better; and the valuation's down 80%.

McDermott: If you roll ahead to today, both KDDI and DoCoMo have the best and most fully functional 3G networks. Their capex program is basically complete. They've generated *tremendous* amounts of free cash flow. And yet DoCoMo is trading at about 4 times EBITDA. So that price has come down from about 20 times cash flow to around 4 times. Meanwhile, both of them have extremely strong balance sheets and are repurchasing shares.

And to us, DoCoMo and KDDI are two of the most attractive businesses in Japan. We believe that cellular telephones are going to be an important and growing part of life going forward. In Japan, they're already using cellular phones to make payments at grocery stores. They're using them to unlock their doors at their homes.

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

They're using them for video telephone conversations between two users.

So we think that four times EBITDA is an extremely low price for a business that's going to keep growing.

Plus, there's been major progress in capital allocation.

Shareholder: What makes you think that they're going to be great capital allocators with their free cash going forward? Admittedly, there have been some management changes at the top at DoCoMo, but they haven't been great capital allocators in the past.

McDermott: That's a great question. That was a key item when we made the decision to invest in DoCoMo. And just to take the most relevant example, five years ago, DoCoMo paid, I believe, $24 a share for AT&T Wireless, which at the time was too much.

Then they got a new CEO. And the first thing he did was to sell AT&T Wireless at around $14 a share. That, of course, was lower than the original price, but the risk that *we* were concerned about at that time was that rather than selling, they would roll into auction and buy. And instead of doing that, they sold it — and they took the proceeds and bought back their own shares.

That, to us, is the most important capital allocation change that we've seen in a large-cap company in Japan. And it's something that's really not appreciated. The rest of the market seems to think that repurchase showed they don't have anything else to do with their cash. Well, to us, that was the right thing to do with an undervalued stock.

WHAT MAY BE OUR BEST MANAGED COMPANY IS OUR BEST VEHICLE FOR THIRD WORLD INVESTING.

Wall Street didn't like Cemex's acquisition, but we *loved* it.

Shareholder: Cemex's margins are almost criminal — just fabulously rich. What did you have to get over to invest, not just internationally, but in an emerging market?

Hawkins: Cemex is a Monterey, Mexico-headquartered company that shares the world cement market with Holcim and LaFarge. It's really a three-company oligopoly. Its margins are very high in Mexico, but *very*, very low in England. So there's huge opportunity.

As you may know, Cemex bought RMC — the original "Readymix" concrete company in England. It was a mess. It was *horribly* managed. Cemex paid for it in cash. And they took on some leverage — and Wall Street didn't like the leverage. We *loved* it.

Most people don't realize just how well managed Cemex is.

Hawkins: Cemex may be the best managed company in our universe of *all* of our companies. It's managed by the most fabulous guy — Lorenzo Zambrano. And for those of you that don't know, he's just a real hero of ours. I mean, he's a top graduate of Stanford Business School. Most people never knew that — they didn't take the time to learn about it, or go to Monterey and get to know the culture. Cemex sponsors the top engineering students at the top engineering school in Mexico out in Monterey. Each year, they get those.

Their logistics are on par with FedEx's. You don't crank a truck up until you know where you're going — whether it's picking up your aggregate rock out of a monopoly granite rock pit and taking it to make concrete, or taking it from there to the customer.

It's likely our best vehicle for investing in the Third World.

Hawkins: Cemex has plants in Bangladesh, Colombia, Venezuela, and Indonesia. And through these subsidiaries, they provide employment and infrastructure and a guarantee that they will never contribute to any political party. Their employees get terminated on the spot if that happens.

So, regardless of whether it's the Left or the Right — the communists or the capitalists, or whoever — a cement plant is a very welcome entity, because it's helping build your hospitals, bridges, highways and homes. And it's providing significant employment, as well.

So we are comfortable having Zambrano be our partner in emerging economies. They are probably our best vehicle for investing in under-invested countries.

> *PORTFOLIO REPORTS* estimates the following were Longleaf Partners Fund's largest equity purchases during the 3 months ended 12/31/05:
>
> 1. DELL INC
> 2. SPRINT NEXTEL CORP
> 3. ANHEUSER-BUSCH COS INC
> 4. LIBERTY MEDIA CORP CL A
> 5. COMCAST CORP CL A SPL
> 6. DIRECTV GROUP INC
> 7. TELEPHONE & DATA SYS SPL

It's cheap today — *before* achieving lots of economies.

Hawkins: It's not only a terrific entree into future growth around the world, it was one of the cheapest stocks we've ever bought. We bought it around $31 only seven or eight months ago — and it's $51 or $52 today. At *this* price, it's trading at 7 times our estimate of free cash flow for 2006 — which assumes they get it right with RMC, their big acquisition in England.

[Editor's note: In their 12/31/05 shareholder letter, Hawkins and Cates provided this update on Cemex's progress in integrating the two companies, as well as the market's reaction to that progress:

"Not only has Cemex already reached savings at RMC that are 50% larger than predicted, but cement demand has continued to increase, aided by strong worldwide economic growth. The stock price somewhat reflects these results, but the best news for Longleaf shareholders is that our appraisal of Cemex has grown by over a third. The Fund holds an overweighted position in the company because, in spite of the stock's rise, Cemex remains closer to a buy than a sell."]

Hawkins: And we think there are *lots* of economies of scale — and lots of operating leverage, when you can just get

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

rid of all the SG&A [sales, general and administrative costs] in England, and put your manager with the "Cemex way" in charge. All of a sudden [he laughs], the two management systems they had there become zero — other than the plant managers.

CEMEX ALSO IS THE TOUGHEST COMPANY AROUND — WHICH COMPETITORS HAVE LEARNED THE HARD WAY.

Pricing-wise, they're the toughest company I've ever seen.

Hawkins: If you look out 10 years as we do, it's a certainty that cement is one of the most important infrastructure ingredients. And Cemex is one of the toughest companies that we've ever seen on the pricing front.

I won't mention this particular competitor — it's run by a friend of ours out of Florida. But a few years back, some cement showed up in Tampa and was sold at a discount to what cement prices were in the state of Florida. So this particular competitor decided to send a few trucks down to Mexico to kind of counterbalance that. Well, here we are, many years later — and those trucks are still in Mexico. And Cemex is still shipping cement out of Mexico [he chuckles] into Tampa.

You know, a recent article in the *Wall Street Journal* talked about a whole ship of cement that came from the Far East to be unloaded in Mexico. Months later, the ship was still anchored. It never unloaded.

So there's great pricing discipline. And it's not because there's collusion. It's because of something called "retaliation". [He laughs.] We saw that LaFarge, which is a French company, and Holcim, which is in Switzerland, both attempted to dump cement in Mexico. Mr. Zambrano was able to make a purchase in Portugal — for no other reason than to be able to truck cement into Paris. And so, all of a sudden, you get rational pricing in a very necessary ingredient.

Katrina's just a blip. We're looking down the road.

Hawkins: A lot of people think the stock's risen because of Katrina. Well, that has nothing to do with it. That's just a short-term demand blip that will be evanescent. The real thing that attracts us is looking down

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the road a decade and saying this is what's going to be demanded, this is what the prices are going to do, and this is the fixed-cost nature of our business.

Cemex has a significant cost advantage. One reason why....

Hawkins: The other thing they've done at Cemex is they've taken advantage of a by-product of the refining process. They contracted for almost *all* of the petroleum coke out of the refining industry in Galveston and Houston and all of the big refiners a decade or so ago. And they took petroleum coke, which the industry was *paying* to get rid of, and they used it in the powering of their cement kilns. Their competitors today are paying exorbitant prices for natural gas, coal, and oil to power their operations. So Cemex has a significant cost advantage in energy.

We like rock pits. You can draw a ring around them 300 miles out, and anybody that gets in that ring, you have this huge transportation-cost advantage....

Anyway, that's probably more than you ever wanted to know about cement, but we love cement. [He laughs.] It's our second time. One of Staley's first contributions was Puerto Rican Cement, but it was a tiny, little niche player.

SOME OF THE WORLD'S GREAT BUSINESS FRANCHISES HAVE BECOME ORPHANS IN PUBLIC EQUITY MARKETS.

Fortunately, we're seeing some stress *outside* the U.S., too.

Shareholder: Can you comment on opportunities you're finding domestically versus overseas — whether you're finding more ideas in one place or the other today?

Hawkins: We may have answered that indirectly when I said we'd bought four new positions in Longleaf Partners and seven in Longleaf Small-Cap and three in Longleaf International. A couple of those names overlap. For example, there's one brand new name that both Longleaf International and Longleaf Partners have been buying offshore. It's a company that we've wanted to own for 30 years and finally have gotten right in terms of price and management and what not.

[Editor's note: The new overseas company that was purchased in both Longleaf International Fund and Longleaf Partners Fund in the third quarter was Nestle.]

Hawkins: So I'd say it's about balanced between domestic and international. [Laughing,] And it's by the *hour*. Fortunately, we're seeing some stress put on various markets.

As the new low list gets longer, we get more interested.

Hawkins: But it's one business at a time. Obviously, we look at the new low list every day around the world — and we have machines that help us with that. So, as you might imagine, we're intrigued by there being a lot more new lows each day than we had, say, in '03 and '04. There was a lot more comfort and lack of volatility in '04 than we're beginning to see now.

The mispriced stocks include some of the world's best....

Hawkins: We've got a wish list of what we consider to be the 200 best companies in the world. And I'd say that there wasn't one attractive to us a year ago because their prices weren't *close* to being discounted enough.

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LONGLEAF PARTNERS FUNDS'
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That wish list of 200 great businesses around the world... Diageo, for example, is on that list. Its dominance and pricing power and cash on cash returns qualify it. And we're finally beginning to see some breaks in the dike share-price-wise on some of those great franchises.

If a company can't be taken over, no one seems to want it.

Hawkins: What is interesting is that if a company's not takeable, it seems to be almost *ignored* now. And this *is* a statement I can make: Small cap, midcap, what have you, have done pretty well over the last year or so because of all the private money washing around the world — private equity and M&A [merger and acquisition], etc. Meanwhile, some of the great business franchises in the world have kind of gone wanting in the public markets because certain behemoths weren't takeable.

We've been buying companies that dominate their fields.

Hawkins: But now time has passed, and a lot of earnings have built up within these large companies while their stocks have been ignored and drifted downward. And fortunately, we've purchased a-half-a-dozen or so of these "non-takeable" *really* significant franchises.

We've bought some of the most unbelievable consumer nondurable type companies about which everyone in this room would say, "It's by far and away the dominant producer in its field."

Before you know it, it adds up to real ~~money~~ high returns.

Hawkins: And we are so excited as we look out at those four things that we focus on — revenues, margins, taxes and shares. You know, if a company's growing 5% or 6% in units, and they're getting 3% or 4% in pricing, and it gets some margin improvement, and you take your share base down significantly over five years, you can get 50% a year compounded.

We want 'em taking their shares down a lot when they're cheap. We want 'em to ignore 'em when they're not. We want to be in business with opportunistic, throat-biting management teams. And we're pleased to tell you, we've found a few of those....

WE SEE POSITIVE DEVELOPMENTS IN LEVEL 3
— AND ENORMOUS UPSIDE IF WE'RE CORRECT.

Level 3's growth? We think it's a matter of when, not if.

Shareholder: Any comments on Level 3?

Cates: Level 3 is the hardest thing to value that we've ever appraised — because its core IP network enjoys 100%+ unit growth, while that unit growth is entirely offset by price declines. So major business opportunities and voice over internet protocol [VOIP] are needed to offset some declining parts of their business. It's impossible to know when their network will resume revenue growth — even though we do think it's a function of when and not if.

So with a wide appraisal range and no sense at all of the timing, we've approached Level 3 in a pretty conservative way — as a lender with huge possible equity-like returns if we're right. We get paid well to wait. We have enormous upside if things play out as we believe. And we think we get our money back in a worst-case meltdown.

[Editor's note: Presumably, what Cates is referring to is the fact that most, albeit not all, of their Level 3 holdings consists of convertible and high-yield bonds. The breakdown in their two funds that hold Level 3 is $525 million in bonds versus $311 million in equity as of 12/31/05.]

There are good signs, and positive industry developments.

Cates: This company is a low-cost survivor in a commodity that is vital and growing and is managed by people who have successfully operated in different parts of this industry for decades. And Level 3's management is seeing anecdotal signs of pricing finally turning.

[Editor's note: No doubt — although one of the reasons why your editor gave up on Level 3 back in 2003 was that it seemed as though Level 3's management saw signs of pricing turning quarter after quarter after quarter.

On the other hand, one of the best contrary indicators we've ever found is to follow the trail of investor disgust — including (perhaps even especially) our own. And, it might be worth noting, Level 3's stock has doubled since Cates made these comments.]

Cates: Also, we're more than thrilled at the MCI deal, which signals long overdue telecom consolidation. That deal puts the MCI network under a Baby Bell, right after AT&T's network was sold to a Baby Bell — and Qwest is *already* part of a Baby Bell. So Level 3 is now left as the only major network provider who can claim neutrality in the wholesale broadband wars.

[Editor's note: And industry consolidation continues, with Level 3 buying WilTel — which we suspected would be a tough competitor — from Leucadia in the fourth quarter after WilTel's anchor client, SBC Communications, exercised its option to exit the relationship and instead use the network of (newly acquired) AT&T.]

Some of our holdings that are hated today....

Cates: GM and Level 3 have recently gotten the most media scrutiny of our holdings. [Ed. note: Of course, long-time readers of *OID* are familiar with Longleaf's contrarian views on both.] You should know, though, that while on Main Street these are the top two that are vilified and therefore cheap, we own other names that are equally hated on Wall Street, if not on Main Street. TDS and DirecTV are incredibly out of favor in the stock market. However, they won't ever get as much mainstream media coverage as GM or Disney.

IT'S NOT THAT WE DON'T UNDERSTAND HEALTHCARE,
IT'S JUST THAT WE UNDERSTAND IT ALL TOO WELL.

Can we say a few words about Service Corp — uhh, no....

Shareholder: I don't think I'm telling tales out of school, because Service Corp is in your report. So would you talk about Service Corp International?

Hawkins: Uhh, no — we won't.

(continued on next page)

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

I'm not unfamiliar with the healthcare area....

Shareholder: Okay. My next question: The last time we were here, I asked if you were doing anything in the drug or healthcare area. Without mentioning names, are there any drug or healthcare names that you have?

Hawkins: There are no drug or healthcare names in our funds.... Clearly the world needs better healthcare. And therefore health expenditures are going to grow for a long, long time.

I started out as an ethical drug analyst, so we obviously know certain things about that world.

In pharma, you have to run hard just to stay in place.

Hawkins: There are a lot of things we *don't* know, however, about what's going to work and what's not. There are a lot of new costs there that didn't exist a few years ago in terms of the trial lawyers' cost.

And there are also other major dilemmas — among them is that it takes two or three blockbuster drugs for Pfizer to stay even. It's not unlike our oil and gas industry. You deplete reserves, so you've got to make new discoveries just to keep your production flat. Well, you've got to make a *lot* of new discoveries to keep your production growing in the case of Pfizer.

Pfizer could get cheap enough though that even *we* might find it interesting.

WMI GENERATES A TON OF FREE CASH. AND WE LIKE WHAT THEY DO WITH IT JUST FINE.

When there's very little to do, they do very little.

Shareholder: Is Waste Management acquiring other companies?

John Buford: Not really. Waste Management is acquiring $100 to $200 million dollars of revenue per year, but that's kind of like a rounding error for them. So, no — they're not actively acquiring, other than what you might call tuck-in collection, where they can just buy the route and take out all the SG&A when they fold it in. And that's a good use of capital. But otherwise, they've said that the prices being asked for collection are too high. So that's just not their focus right now. In fact, it hasn't been something they've focused on for a number of years.

We like what they're doing with their free cash just fine.

Buford: So what we've seen them do with all the free cash the company generates — and it generates a ton of it — is to split it almost evenly between increased dividends and share repurchases. About two years ago, they raised their dividend dramatically. So even though that stock has doubled over the last few years and is not nearly as cheap as it was, it still yields almost 3% today because they've aggressively increased the dividend.

Then most of the rest of the cash has been going towards share repurchase. They've been buying in $500, $600 million a year of their shares. And I'd imagine they will continue to do that as opposed to ramping up their acquisition program.

By the way, if they can justify an acquisition, that's great. But we'd just as soon see their free cash allocated to dividends and share repurchases....

Call it what you will, it's all about truly free cash flow.

Shareholder: Is your definition of free cash flow very close to Buffett's definition of owner earnings?

Hawkins: [He very rapidly recites the following...] Well, ours is net income plus depreciation plus depletion and amortization of goodwill and deferred taxes, minus required capex and working capital needs. It's what's left over that you can put in your pocket. [Attendees laugh.]

Cates: Which is the same as Buffett's definition.

A FEW WORDS ABOUT OUR APPRAISALS — AND WHY WE THINK THEY'RE CONSERVATIVE.

Reinvestment rate doesn't just apply to equity investments.

Hawkins: I want to talk a little bit about a concept that is probably new to most of you. Everybody knows the three components of a bond's return — the yield, the accretion of the discount or the write-down of the premium to par, and finally, the interest on the interest.

If you buy an 8% bond at par with a 10-year maturity and you hold it all 10 years, most people would say that you get an 8% return. However, that's not true — because every six months you get a coupon. In order to get an 8% return, you have to invest every single coupon back at 8%.

> *PORTFOLIO REPORTS* estimates the following were Longleaf Partners Small Cap Fund's largest equity purchases during the 3 months ended 12/31/05:
>
> 1. POTLATCH CORP
> 2. RUDDICK CORP
> 3. SERVICE CORP INTL
> 4. DISCOVERY HOLDING CO CL A
> 5. SAKS INC

A hidden source of conservatism in our appraisals....

Hawkins: When we do our appraisals, we project out the free cash flows that the business will generate, put a terminal multiple on it about eight years out, and bring it back to the present by discounting those cash flows at an appropriate discount rate. And our discount rates are very conservative — something on the order of 9%. Thus, the implicit assumption we're making in order for our appraisal to be absolutely accurate is that every coupon gets reinvested at 9%.

However, in the case of Waste Management, if that board gives us the money, the dividends — either in a direct dividend payment or through share repurchase — and we put the cash dividend back to work at *more* than 9%, then our appraisal's going to be conservative.

It speaks to why Berkshire Hathaway can pay a full price for a brick company or a rug company. It's because every single cash dollar that Shaw produces is going back

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

to Mr. Buffett who puts it to work at a return that's a lot higher than his discount rate. So the value of that free cash flow is a lot greater to him as a shareholder than a simple appraisal would suggest.

We're being conservative in our appraisal a *couple* of ways.

Hawkins: And similarly, we like to think that when Maury Myers (or now, David Steiner) elects to give us all the cash, we're going to earn more on it than our discount rate; and he's going to keep stealing — I mean repurchasing — his shares at a discount, which is going to build our appraisal even further over time. And so therefore, our metrics are too conservative....

[Editor's note: When Hawkins says that his metrics are too conservative, I can vouch for what he's saying. When we've heard their assumptions, they've definitely sounded conservative to us.

On the other hand, sad to say, whenever we've looked back at our *own* projections, it seems like they've invariably been too *aggressive*. So I guess everything's relative....]

Hawkins: The preceding may be boring, but the reinvestment rate is *very* important to compounding. And it affects us materially as long-term owners.

VALUES ARE STARTING TO GET OUR ATTENTION,
BUT WE WON'T BE HAPPY 'TIL WE FEEL SICK.

It's started to get our attention, but we're not nauseous yet.

Shareholder: Mason, could you put in perspective the price-to-value ratios in your funds today compared to where they were at the beginning of 2000 and some of the other real low points in past cycles.

Hawkins: I think the lowest price-to-value ratio that we've ever seen was a *very* ephemeral, temporary, 49% in late February, early March of 2000. But that was a blip. The long-term average is 68%. So Longleaf Partners Fund is seven percentage points lower than 68% — or a little over 10% more attractive than it has been on average over its long history.

That's not to say that it's not going to get cheaper. You probably know more than we do about that. But we'd like to see the whites in people's eyes — and we're not seeing them yet.

We want to get nauseous ourselves. That usually happens when bottoms occur. That's our rule of thumb. We're long-term investors. And we know roughly what companies are worth, whereas something like 99% of investors don't. So when we're feeling pain, at serious stress points, most investors get *much* more concerned than we do.

The anchor to windward for us is being conservative on our appraisals — so if the worst does happen, we have enough value to protect us and to enable us to navigate against the psychological tide. That way, we're also able to shut our eyes and buy a lot more.

But a 61% price-to-value ratio in Longleaf Partners is beginning to get our attention....

WHAT IT TAKES TO BE A SUCCESSFUL INVESTOR...
BUT LET ME ADD ONE MORE ITEM TO THE LIST.

My father introduced me to Graham back in high school.

Shareholder: How, exactly, did an outpost of Graham and Doddsville end up in Memphis? Did you have a sort of Road to Damascus experience, or did your investment philosophy evolve slowly over time?

Hawkins: My dad gave me *Security Analysis* and *The Intelligent Investor* when I was in high school — and, you know, I thumbed through them. Then it was required text in a few finance courses and the CFA program.

It was intuitive. It makes common sense. And I think some people get it immediately — that is, the idea of buying dollars for 50¢. I think that it's pretty sensible. Others *never* get it.

It stuck with us. All of our partners have had to go through those two texts. And it's amazing — even in your fourth or fifth reading, you still learn things, and you relate experiences to what you've read.

We've lectured on what it takes to be a successful investor.

Hawkins: You know, we recently lectured at the Columbia Business School and also at the Ivy School up in Canada. And the subject was, "What does it take to be a successful investor?"

And there were four major points made: First, you have to have a great search strategy. Second, you have to be able to value businesses and evaluate the qualitative aspects of management and the competitive stance of the company. Third, you have to be disciplined — which for us means not paying more than 60¢ on the $1 using a conservative appraisal. And last, but not least, you've got to be patient....

But I'd like to add one more item....

Hawkins: However, after having done these talks, there's another thing that I would want to add to the list: You've got to have some intestinal fortitude. Has anybody here bought General Motors lately? [Attendees laugh.] You not only have to believe your appraisal, you have to *act* on it. And it's *tough*. I mean, here it is. [He holds up the cover of *Business Week* (about GM), with a picture of a car going over a cliff.]

And you have to be somewhat masochistic, I guess. [Hawkins laughs.] So it's evident. [He points to his receding hairline.] Little hair. It's grey. That's what it takes.

—OID

For additional information
you may contact:

LONGLEAF PARTNERS FUNDS
6410 POPLAR AVE., STE. 900
MEMPHIS, TN 38119

(800) 445-9469

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

Once each year, shareholders and other admirers from around the world gather in Omaha to attend Berkshire Hathaway's annual meeting and learn from and be entertained by the most successful, best known and most respected investors on the planet. Past lectures have included warnings about the S&L crisis, derivatives, incentive compensation, and misleading accounting before those problems came home to roost.

The latest installment was delivered on April 30th, when an estimated 21,000 Buffett and Munger fans crammed into the Qwest Center to hear the philosopher/ superinvestors' latest installment of their outlook and views on Berkshire, investing, business, politics and life.

To the degree it makes sense to study success, who better to study and learn from than Buffett and Munger? As we've said before, anyone who chooses to ignore what they have to say does so at his or her own peril. We hope that you find their insights as valuable as we do.

HOW TO BE SUCCESSFUL? START YOUNG, READ EVERYTHING, AND LEARN WHAT WORKS.

Charlie and I complement each other quite well....

Warren Buffett: Good morning. I'm Warren, he's Charlie. We work together. We really don't have any choice — because he can hear and I can see.... [Audience laughs.]

Buffett's interest in investing started early....

Shareholder: When you were younger, what first sparked your interest in investing? And what advice would you give a younger person if they wanted to invest in the stock market?

Buffett: Well, I probably got interested when I was seven or thereabouts. I *wasted* my time before that. [Buffett and audience laugh.] It's a little like W.C. Fields — when he inherited some money, somebody asked him what he did with it. And he said he spent half of it on whiskey and the rest he wasted. So there I was dawdling around.

But my dad was in the business. So I would go down to his office and I would see these interesting books — and I would read them. He was on the fourth floor of what's now known as the Omaha Building at 17th and Farnham — and on the second floor was Harris, Upham & Company. They had a board. And I would go down there on Saturday for two hours — the market was open on Saturdays in those days. And I saw all these interesting things going across the tape.

My advice? Read everything in sight — and start young.

Buffett: And I just read a lot. I probably took out every book the Omaha public library had on investing or on the stock market. I was very interested in the New York Stock Exchange. I thought maybe I'd become a specialist when I grew up — and maybe I still will. [He chortles.] But I took all the books out and read 'em.

Finally when I was 11, I bought three shares of stock. But I was *fascinated* by the subject. And when my dad got elected to Congress, the library became even bigger, and I took all the books I could out of the Library of Congress on the stock market. And I used to chart and do all of that sort of thing.

And then, finally, when I was 19, I read Graham's book — *The Intelligent Investor* — when I was at the University of Nebraska. And that changed my whole framework.

But the advice I would give is to read everything in sight — and to start very young. It's a *huge* advantage in almost any field to start young. And if you start young and you read a lot, you're going to do well.

A sky-high I.Q. is not required. The right temperament is.

Buffett: There are no secrets in the investment business that only the priesthood knows. We do not go into temples and look at tablets that are only available to those who have passed earlier tests. It's all out there in black and white. It's a simple business.

It requires qualities of temperament *way* more than it requires qualities of intellect. If you've got more than a 125 I.Q., you can throw away the rest of the points — or give them to other members of your family — because you don't need it in investing.

What you *do* need is a certain temperament that enables you to think for yourself.

Learn what works, enjoy what you do and keep learning.

Buffett: Then you have to develop a framework. And I developed a very simple framework from reading Ben Graham — I didn't come up with it myself. And then you have to look for opportunities that fit within that framework as you go through life.

And you can't do something every day. You can *learn* every day, but you can't *act* every day. I've been reading the annual reports of Anheuser-Busch for 25 years, and I'd read the reports of Coca-Cola and Gillette and all kinds of companies long before we invested in 'em. And if you don't enjoy the game — like playing bridge or baseball or whatever — you probably won't do well at it.

But I would advise you to start early, read everything in sight, and look for a framework that's been successful for people. And there's nothing like Graham's, in my view. With this framework, you'll have a lot of fun — and you'll probably make a lot of money.

[Editor's note: And, might we add, with the emphasis on "that's been successful". As we've said many times, we don't think it's any coincidence that Buffett, Munger and John Templeton all say it pays to study success. They all do it — and the late, great Sam Walton and Ben Franklin did it, too. As Templeton says, "Success leaves clues."]

UNDERSTANDING MONEY MANAGEMENT IS ONE THING, PRACTICING THE PROFESSION QUITE ANOTHER.

Munger doesn't view money management as a high calling.

Buffett: Charlie?

Charlie Munger: Well, I'm at a disadvantage here. Warren has made himself into kind of a dean of investors — starting as a boy. And he has a greater respect for the

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

process than I do. I have a good bit of Keynes' attitude that money management is a low calling compared to being a surgeon.

I think corporate managers ought to study investing more, because they'd be better managers. And I think that everyone who thinks through the investment process learns more about how the world really works. And I think that knowledge is very much worth having.

But I do not like as big a percentage of GDP as we now have going to money management and its attendant frictions. And I don't like the percentage of the nation's brainpower that is now in all of these different forms of highly-compensated money management. I don't think this result is a good thing for the country — and I *hate* the fact that we've contributed to it by our own predilections.

Buffett: Charlie's only sitting up here next to me as part of his outreach program, actually.

Munger: Yeah. [Munger cracks up.]

Buffett: Please don't take any pictures that you could blackmail him with for being associated with me. [He laughs.]

CEOs seem to be schizophrenic about money management.

Buffett: Charlie made a very good point about how managers could do better if they understood investments. I find it absolutely fascinating — and I've seen this close up throughout my life — that I have friends who are CEOs of companies that have somebody else handle their money. And if you ask them if you should buy Coca-Cola or Gillette or something like that, they'll say, "That's much too tough. I don't understand that sort of thing. What do I know about investing?" So they really don't feel they're qualified to make $10,000 decisions with their own money.

But then some investment banker will walk in the next day with the idea that they buy a $3 billion company — [chuckling] which is just buying a lot of shares of the stock of one company. And they'll sit through some little two-hour presentation and turn it over to a strategic planning group and then think that they're the ones that should decide whether their company should buy a multi-billion dollar business.

It's *extraordinary* what you see in corporate America in the acquisition activity. It's a little like what they say about making sausage and making laws — it's better unobserved. [Chuckling,] Charlie, do you have any further thoughts on that? You've seen a lot of it with me.

Eras like the present one have not ended well.

Munger: Well, I do think that the present era has no comparable precedent in the history of capitalism. I think

(continued in next column)

we have a higher percentage of the attention of our intelligent classes diverted into buying little pieces of paper and trying to get rich doing it — and in promotional activities with big profit sharing fees. I can recall no past era that had a similar concentration of this type of activity.

Can you, Warren?

Buffett: No, but I think you would probably say, too, that when we've seen sort of *baby* versions of this that something subsequently happens.

Munger: Oh, yes. If you want to talk about the future implications, a lot that I see now kind of reminds me of Sodom and Gomorrah.

Buffett: [Laughing] We weren't *there*, incidentally.

Munger: No, but there's a published account. [Buffett cracks up.]

In the past, I think that when you got as much regrettable activity going on, feeding on itself in frenzies of envy and imitation, bad consequences followed.

Buffett: On that cheery note, we'll move on.

IN TODAY'S OVERHEATED ENVIRONMENT,
THE ODDS OF US FINDING MUCH TO DO IS SLIM.

The $64 billion question....

Shareholder: Last year, I asked you how you saw the increased competition for buying companies given the rise of the private equity industry, and how that affected Berkshire's ability to buy great businesses at fair prices. And you said that there were still enough business owners who'd rather sell to Berkshire than a private equity fund.

This year, I want to ask you how you see Berkshire positioned against the hedge fund industry. We see hedge funds going into all investment strategies. And you've spoken about the fees of the hedge fund industry. But I'd like to hear how you see Berkshire positioned as a competitor. Are returns in strategies like merger arbitrage and convertible bonds going down because of the increased competition? And are there other factors where Berkshire can be unique versus the hedge funds?

Buffett: Well, that's a great question — that's the $64 billion question. There's no doubt about it — there's far more money looking at deals now than five years ago. And they're willing to pay up more for the good but mundane businesses that we've been successful at buying in the past.

Businesses are getting flipped like condos.

Buffett: You mentioned the private equity firms — and they are bigger than ever. But the hedge funds have also gotten into the game to some degree. So if someone is auctioning off a business today, there are people lined up to bid on almost *anything*.... In fact, you have private equity firms selling their businesses to other private equity firms — and a lot of companies are being sold to someone who's buying to resell 'em in a fairly short period of time.

In today's environment, we're not positioned for success.

Buffett: We can't compete in that field today. And that's a source of distress to us, but that's the way it is. However, it won't go on forever in our view. We still occasionally can make a deal where we and the party on

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

the other side don't go through an auction process. So we see that occasionally. But we don't see it as often as we did four or five years ago.

So in terms of the near-term outlook for Berkshire in doing what it's important that we do successfully — which is to buy businesses and keep adding to this collection — we are not positioned favorably at *all* for that.

At the moment, we've got more money than brains....

Buffett: But we're looking for bigger acquisitions. We'd love to buy something that would cost us $5 or $10 billion. And our check would clear, I assure you. I think we ended the quarter with about $44 billion of cash, not counting the cash in the finance operation.

So at the moment, we've got more money than brains [chuckling] and hope to do something about that....

BUT JUST WHEN YOU LEAST EXPECT IT,
THINGS CAN, AND DO, CHANGE VERY QUICKLY.

But things can — and do — change fast.

Buffett: But over the decades, both Charlie and I have found it *extraordinary* just how fast things can change. There have been at least three times — maybe more — in my own career where it's looked to me like there was so much money sloshing around that it would be impossible to do intelligent things with money.

I actually terminated a partnership back at the end of 1969 because I felt that money was coming out of the woodwork. There were all kinds of people who wanted to use it and compete. And I didn't feel that we could do intelligent things. However, within four years, I saw the greatest opportunities that I've ever seen in my lifetime.

For example, there were *incredible* opportunities in 1998.

Buffett: And we've had several experiences like that. In the fall of 1998, when Long-Term Capital Management got in trouble and other things were happening, you had *incredible* opportunities available in the investment world. People were just as smart then. You had all these people with 150 I.Q.'s running around — and they actually had money. But the world became paralyzed for a short period.

And you literally had a 30-basis point differential between so-called "on the run" Governments, which were the most recent issue, and "off the run" Governments — both issued by the U.S. government and payable in dollars. So it was a 30-basis point differential between the 30-year and the 29-1/2 year. (Of course, they were both quite liquid — with the "on the run" being more so.) And bear in mind [that the 30-basis point differential equated to roughly] a three point difference in price.

Well, you wouldn't have believed that could happen in the United States of America in 1998, but it *did* happen.

And high-yield bonds were being *given* away in 2002.

Buffett: Then there was the situation in high-yield bonds less than three years ago. In the fall of 2002, you had all these high-I.Q. people in the financial world, and you had lots of money.... And there was a friend of mine who was buying high-yield bonds at anywhere from a 25% to a 60% or 70% yield basis. We were doing pretty much the same thing. And within 12 or 14 months, he had sold these same bonds on a 6%-yield basis.

You don't need to do that very many times in a lifetime. But that was 2-1/2 years ago, with all these people who'd graduated with MBAs and studied modern finance theory and had money coming out of their ears — and all of 'em had a desire to make money. And yet conditions like that could exist.

We bought about $7 billion of junk bonds during that fairly short period. So things do happen that change the landscape dramatically — *really* dramatically — in financial markets from time to time.

TODAY, THERE'S A DISINCENTIVE FOR RATIONALITY.
BUT WE DON'T GET PAID FOR *SPENDING* MONEY.

It's hard to compete with buyers mostly motivated by fees.

Buffett: But right now, we are positioned very badly in terms of buying businesses. It's a big negative. And your Berkshire stock will not do as well under these conditions as it would under the conditions of five years ago or 20 years ago. And I don't have any magic solution for that, except just to tell you what the facts are. Charlie?

Munger: Yeah. A lot of the buying by private equity funds in both real estate and stocks and for companies is *fee*-motivated. In other words, the investment manager will rationalize any price paid because he likes the extra fees for managing the extra assets.

I have a friend that tried to buy warehouses with a lot of family money — and he stopped when every bid was topped by some professional manager of other people's money paid on a fee basis. So this is a very peculiar era where all these asset classes have been driven to valuations that are very high by historical standards.

Sometimes the ethical thing to do is send the money back.

Munger: Some investment operations are very ethical in avoiding fee-driven investments of other people's money. I think Howard Marks is here today. He sent a lot of money back, and stopped soliciting money from his clients in certain activities when the opportunities went away. That's the right way to behave, but it's not normal.

Buffett: Yeah, but I don't think he'll mind. I didn't know Howard was here today — but those yields I mentioned are actually Howard's figures for one of his funds. And like I say, we were doing similar things. We didn't know it at the time, but we found out we had some similar positions later on.

[Editor's note: Howard Marks is co-founder and chairman of Oaktree Capital Management and has managed convertible and high-yield bond portfolios for over 30 years.]

Fees can motivate managers to do very novel things.

Buffett: About five or six years ago when the terms of these deals were somewhat different, I actually had a fellow call me (whose name most of you would recognize). And he started asking me questions about the reinsurance business because he said he was thinking about buying a

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given company — which got sold. And he didn't really know much about the business, but unless he spent these X dollars, he was going to have to give it back to his investors in a few months — because the term of the initial sign-up period expired at that point, and any unexpended funds would have to be returned. And he was going to get 2% a year on those funds regardless of how they did.

So he was looking at businesses that he didn't understand with the hope that he could place the money.

Charlie and I don't get paid for *spending* money.

Buffett: Well, Charlie and I are at a disadvantage in buying businesses — because we have almost our entire net worths exposed to the downside as well as the upside. If you paid us a 2% fee and 20% of the profits and just a good-bye kiss for any losses, that would be a different equation than exists at Berkshire. We run it as if it's 100% our money — and it *is* close to 100% of our net worths. And we own the downside, too. And we don't get paid for *spending* the money — we get paid for *making* money.

However, competing right now is tough and likely to be relatively futile — although we do have one or two things that could happen that could involve the expenditure of real money.

We're in a different world right now.

Munger: I don't think *any* of the businesses that have sold to us over the years — which are run by the kind of people we like being associated with — would've wanted to sell to a hedge fund. So there is a class of assets out there that doesn't want to deal with hedge funds or private equity funds — thank God. [Buffett laughs.]

Buffett: And we've seen no deal anybody else has made in the last year that we wish we had made. That was not the case 15 or 20 years ago. There were *plenty* of deals made with other people that we would've liked to have made if they'd come to us.

But I've seen nothing that if it sold for 10% less than the advertised price that we would have had any interest in buying. So we are in a different world right now.

WE LIKE THE STOCKS WE OWN JUST FINE. WE JUST DON'T OWN ENOUGH OF 'EM.

Today, we're mostly in the no-buy/no-sell zone....

Shareholder: Back in the old days, when somebody turned 100 in Hong Kong (where I'm from), they got to have tea at Buckingham Palace with the Queen. I don't know what you have here in America, but I hope that in 2030, we come back to watch you do 50 push-ups at the White House.

Munger: That's not the way to bet.

Buffett: Will you settle for *10*? [Buffett chortles.]

Shareholder: In 1968-69, you liquidated all your partnerships. And I guess aside from your holdings in Berkshire Hathaway, you got completely out of the market and stayed out. In 2000-2001, you mentioned to us that in the coming decade, markets would go, at best, nowhere. But despite $50 billion in cash, you — and, therefore, we — have remained substantially invested in the market. What about the investment climate is different today than it was in 1968-69 that makes you comfortable remaining substantially invested?

Buffett: Well, we do own certain securities which we probably wouldn't buy at these prices. Some of 'em we would, some of 'em we wouldn't. We're not unhappy with anything we own. On the other hand, we're not happy with putting more money in. So we're in a zone in some of those securities where we wouldn't buy 'em and we wouldn't sell 'em.

Now part of that decision relates to the kind of quantities that we deal in. If we owned 100 shares of each one of the stocks instead of many billions of dollars worth, it would be an easier decision to go in and out. However, we would face significant costs — and not only taxes, but other transaction costs as well — going in and out of the large positions we have.

And basically, we like the underlying businesses. Therefore, we may feel like we wouldn't want to buy more today, but we are not unhappy about being in the businesses in which we have big equity holdings.

We like what we own, but we own relatively little.

Buffett: Notwithstanding all of that, a lower percentage of our intrinsic value *is* represented by the common stocks we own than at just about any time in our history — with the exception of the period at the end of 1969 when we liquidated the Partnership. So we have not made any big statement by purchases of stocks or the ownership of stocks that in any way says that we think this is a particularly attractive time to own them.

But we are not unhappy with Coca-Cola. We are not unhappy with American Express. And we're not unhappy with Wells Fargo or Moody's. Those are *very*, very good businesses we own. Would we buy them at today's prices? Well, the answer is we're not. We've got money. And we may buy more later on. We're more likely to buy more later on than we are to sell those sorts of investments.

[Editor's note: Indeed, in the third quarter of 2005, Berkshire purchased 28,367,100 shares of Wells Fargo — over $1.6 billion worth based on the end-of-quarter price per share.]

Buffett: But there is a zone in which — because of size and because of taxes — we'd be neither a buyer nor a seller. And we do not see lots of attractive stocks. But we also don't think that there's as much silliness in the market by *far* as there was roughly five years ago. Charlie?

For us, small has been beautiful. But everything's relative.

Munger: One of the things that's interesting about Berkshire lately is that if you take the last four or five things we did in the stock market — with a goodly number of billions, but small in relation to Berkshire's overall size — our record is much like it used to be in some of the best days. Where we were able to move around with small amounts of money, the results were quite respectable.

However, where we were facing the problems of being enormously rich, we were prevented from having the kind of nimble money-making record we had in the past.

I don't think that's a permanent state of affairs, but

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it's never going away forever.

Buffett: Explain that one. [Buffett laughs.]

Munger: Well, we may be able to deploy *large* amounts of money eventually at very satisfactory rates, whereas in recent times, we have deployed only *small* amounts of money at very satisfactory rates — but better small than nil.

And small is still billions. [Audience laughs.]

WE'LL GET A CHANCE TO DO SOMETHING INTELLIGENT IN NOT TOO MANY YEARS — MAYBE A LOT SOONER.

Very infrequently, at extremes, I think things are obvious.

Shareholder: You said that you devote very little time to looking at the total market, and that you instead look for individual opportunities. But in the past, you've made some excellent presentations on points to consider in projecting reasonable 10-year returns for the stock market — and you advised reducing our expectations.

Where do we now stand on your stock market and economic measurements, and expected 10-year returns?

Buffett: Every now and then — *very* infrequently — you probably can say something intelligent about markets as a whole. You do see circumstances that are extreme enough that you can make a statement that is likely to look reasonably intelligent five or 10 years later. I've seen a few of those times in my lifetime — and I've spoken out a couple of times. For example, I did that in '69 and '74 — and I did it a few other times. But most of the time, you're in an in-between zone.

Obviously, you get more for your money in equities now than you got, say, in the summer of 1999 — which is when I delivered a talk out in Sun Valley that later got turned into an article for *Fortune*. But I spoke out then because it was extreme.

At that time, I knew in a general way that I was going to be right, particularly in certain aspects of the market, but I didn't know when — and I didn't know *how* right. And in the mid-'70s, you could have done the same thing in the other direction.

I don't think financial markets are at extremes today.

Buffett: I think that if you had to make a choice today between owning long-term Treasuries — which are now yielding only a little over 4-1/2% — or owning equities for the next 20 years, and you couldn't make a change in that decision, I would certainly prefer equities. But I think people who have expectations that they can earn more than 6-7% in equities, or that they can find somebody else to do it for them, are making a big mistake. And I think that they're making an even *bigger* mistake when they start expecting double-digit returns.

But 6% or 7% is not the end of the world at *all*. And it gets treated better taxwise right now than it's been treated at any other time in my life.

So I don't think that we're in bubble-type valuations in equities at all. But I don't think that we're *remotely* close to bargain valuations either. Therefore, I don't think that it's an extreme enough period that you can speak out in some very definitive way about the outlook.

I think opportunities will arrive — and sooner than later.

Buffett: However, if you told me that I had to go away for 20 years and choose between what's obtainable in an equity index fund or be committed to long-term bonds, then I would rather take equities.

But I think you will get a chance to do something that's more screamingly intelligent in not too many years — and maybe a lot sooner — than the alternatives that you're being offered now. Charlie?

Munger: Well, I can't improve on that at *all*....

THERE WILL *ALWAYS* BE BIG REASONS TO WORRY. BUT THERE'LL ALWAYS BE BIG OPPORTUNITIES, TOO.

As a net buyer of stocks, we'd *like* to see lower prices.

Shareholder: A year or two ago, there was still an ebullience of emotion about the stock market going up and making everyone rich. It seems like that ebullience has dropped — and I'm hearing anticipation of a bear market. And I think you wrote several years ago that it's hard to make money in bull markets — and that the real opportunities come in bear markets.

So I'm wondering if you would give us a clue as to what your strategies are going to be if it's really true that the market gets dismal over the next few years.

Buffett: Well, if the market gets cheaper, we'll have many more opportunities to do intelligent things with money. Now whether we'll have blown the money in the meantime is another question. But we're going to be buying things, one thing or another — whether it's operating businesses, stocks, high-yield bonds, whatever — for as long as I live.

Munger: Longer than that, Warren.

Buffett: Yeah. [Buffett and Munger crack up.] Charlie's just *waiting* to take over after I'm gone.

I'm going to be buying groceries the rest of my life. Now, would I rather have grocery prices go up or down [chuckles] if I'm going to be buying groceries tomorrow and next week and next month and next year? The answer is, obviously, if I'm a net buyer, I'll do better if prices are *lower*.

It doesn't pay to worry. There are *always* reasons to worry.

Buffett: But we're not good at forecasting markets. We knew, in a very general way, that we were getting enormous bargains in the mid-'70s — and we knew that the market went crazy to some extent in the late '90s. But Charlie and I spend *no* time thinking or talking about what the stock market is going to do. And that's because we don't know.

Sometimes we *do* know we're getting very good value for our money when we buy some stocks (or some bonds, as the case may be.) But we are not operating on the basis of any kind of macro forecasts about stocks.

There is *always* a list of reasons why the country will have problems tomorrow. But there's always a list of opportunities, which don't get mentioned quite as often.

So we don't sit down and make a list of the bad things that are happening in the economy and the good things that are happening — and, therefore, forecast the stock

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market. Such forecasts will often fail, even if you correctly forecast some of the bad things or good things.

IF THE BUSINESS AND THE PRICE ARE RIGHT, IT'S *CRAZY* TO LET WORRIES MAKE YOU SIT IT OUT.

The U.S. is the most remarkable success story in history....

Buffett: Overall, I'm an enormous bull on the country. This is the most remarkable success story in the history of the world, if you think about it. In 1790, we had less than 4 million people in this country — and there were 290 million people in China. There were 100 million people in Europe. And they all had the same intellect we had, they were in the same general climate, and they had lots of natural resources. And here we are 215 years later, and the country that had those 4 million people has 30% or so of the world's GDP.

So it does not make sense to bet against America. That doesn't mean all our policies are smart or anything.

[Editor's note: Or that they *usually* have been.]

Buffett: But I wouldn't get pessimistic on the country. The big worry is what can be done by either terrorists or governments that have access to nuclear, chemical or biological weapons. But in terms of the basic economics of the country, your children are going to live better than you live — and your grandchildren are going to live better than your children live.

So we do not focus on macro factors. Charlie?

Buffett is more optimistic than Munger....

Munger: Well, I agree with you that the economics of the country are probably going to increase for a considerable period ahead. But I suspect that, in very important ways, we are at or near the apex of a great civilization. [There's a long pause, during which the room remains silent.]

Buffett: [The silence is finally broken by the sound of Buffett chortling] You heard it here first, folks. [Laughing] If you leave the NCB (nuclear, chemical or biological) out, I do not feel that way. [Holding back a laugh] But you'll get to see which one of us is right 20 or 30 years from now.

It's crazy to let macro concerns drive your decisions.

Buffett: I've seen so many people pass up opportunities because they get focused on a single economic variable or a single problem that the country faces and they forget about the good things. If you can buy very good businesses at attractive prices, then it's *crazy* to say, "I think I'll sit this one out because it might get a little cheaper next year," or "because the world's going to hell."

We've never operated that way. We've never decided not to buy a business we like because of a macro view, have we?

Munger: [After a pause] Not yet.

Buffett: Okay. [As he chortles] It's hard to get him to *really* agree with you. I've been working on it for years.

THE SECRET OF AMERICA'S SUCCESS IS OUT — WHICH SHOULD BE GOOD, GENERALLY, FOR US.

The U.S. has been pretty remarkable....

Shareholder: The U.S. has had a dominant role in the world economy for about 100 years. Its dominance resembles that of an economic monopoly. Would you say that the U.S. is "a castle with a moat"? And if so, how can we make the moat any bigger?

Buffett: Well, the U.S. has been pretty remarkable, as I indicated in my earlier comment. With essentially the same population pool, it's garnered a remarkable share of the world's wealth over this 215-year period.

It's an interesting question as to just why this group of people here have been able to do *so* much better than the rest of the world — considering we're not any smarter or anything of the sort.

The rest of the world is catching on to how we've done it.

Buffett: I wouldn't call it an economic castle anymore. What we do is no secret. I think the *relative* importance of America — of course, we've been a *dominant* factor in the world post-World War II — will decline somewhat (although I'm not an alarmist on that). But I think that to some extent, the rest of the world — or some of the rest of the world — is catching on, and adopting sort of "best practices" as they say in industry.

[Editor's note: What some would term the spread of some form of dollar democracy — loosely defined.]

Buffett: So our castle will grow in size, but there will be more castles around it.

And that's a *good* thing....

Buffett: And I think that's basically a very good thing for the world. I think the more prosperous, generally, the rest of the world is, the better, generally, it will be for us. I've talked before about our trade problems. But the more trade we have, the better. We had an estimated $1.1 trillion of real trade with the world last year in this country. And then we had another $600 billion — 6/10ths of a trillion — that we bought unilaterally.

Well, I'd love to see the $1.1 trillion grow and grow and grow. That would be good for us — and good for the rest of the world. But I don't think our future prosperity will come at the *expense* of the rest of the world at *all*.

I do think there are parts of the world that will grow much faster economically — from a lower base — than the U.S. And basically, I think that's a good thing. After all, there are 6 billion people in this world — a lot of whom don't live very well. And I'd hope that, 20 or 50 years from now, a higher percentage of 'em *would* live well. But I don't think it comes out of our hide at all. Charlie?

But we may not remain the richest, most powerful country.

Munger: Well, I don't think it comes out of our hide in that sense. But if we are now the richest and most powerful nation in the world — and in 50 or 100 years, we're a poor third to some country in Asia — sure, we're richer, but it's a peculiar type of richness where you've lost your relative position in the world.

If I had to bet, I would bet that the part of the world that does best is Asia — in terms of percentage gains per

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annum. And I think that it might do *amazingly* well if it doesn't blow up in some way. And if it does amazingly well, it will eventually be a much richer place than ours.

BUD'S EARNINGS WON'T DO MUCH FOR AWHILE, BUT THAT'S JUST FINE WITH US.

I've been following Anheuser-Busch for about 25 years.

Shareholder: Can you describe how you made your decision to invest in Anheuser-Busch — and how you estimated its intrinsic value? How long did it take you to make this decision? And is Budweiser an inevitable like Coca-Cola?

Buffett: We don't get into much in the way of a description of things that we might be buying or selling. However the decision takes about two *seconds*. I bought 100 shares of Anheuser — and I haven't looked it up, but I would say about 25 years ago — when I bought 100 shares of a whole lot of other things. And I do that so I can get the reports promptly and directly. You can get 'em through your brokerage firm, but I've found that it's a little more reliable to put the stock in a direct name. So I've been reading their reports for at least 25 years.

It's true that beer industry sales are flat.

Buffett: I just generally observe consumer habits. And sales are very flat in the beer industry. Wine and spirits have gained in that general category at the expense of beer. So if you look at the industry figures, they're not going anywhere.

Miller has been rejuvenated to some degree. So Anheuser, which has had a string of quite substantial gains in earnings and market share over the years, is experiencing — as they've described — very flat earnings. And they're having to spend more money to maintain share — in some cases, by having promotional pricing.

So they are going through a period that is certainly less fun for them than was the case a few years ago.

Earnings won't do much for awhile, but that's fine with us.

Buffett: It's a fairly easy product to understand. And consumer behavior's fairly easy to understand. It's an *exceptionally* strong business. In fact, what's happened in the beer industry over the last 50 years has been fascinating to Charlie and me because this is a brewing town that we grew up in. And Charlie knew members of the Storz family — a number of them — well. Storz had over 50% of the Omaha market in beer post World War II, and basically disappeared as the national brands took over. So it's an interesting phenomenon.

The beer business is not going to grow significantly in the U.S. Worldwide, beer is popular in a great many places — and Anheuser will have a very strong position in it. But I would not expect the earnings to do much for some time. That's fine with us, though. Charlie?

BUD HAS A *VERY* STRONG CONSUMER POSITION. AND CONCENTRATION TREND IS LIKELY PERMANENT.

BUD's what we like: a very strong company in a bad patch.

Munger: Yeah. At our scale of operation now, if we're ever going to buy into a terribly well-regarded company, we almost *need* a little patch of unpleasantness.

Buffett: Yeah. That's been the best time to buy Berkshire, incidentally, too. What we're looking for is businesses with a durable competitive advantage. I don't think there's any question that Anheuser has a very, *very* strong consumer position. Now, as I said, Miller has been rejuvenated to some degree.

But the other thing about it, of course, is that in beer, you don't see the prevalence of private labels or generic products that you see in a great many consumer products that had strong positions over the years that are being attacked. So that's a small plus. But beer consumption per capita is going no place — and there's nothing that will change that.

Beer consumption is falling, but not like coffee.

Buffett: Interestingly enough, the average person in this climate drinks about 64 ounces of liquid a day. And I think roughly 27% of that will be carbonated soft drinks. And of that, Coca-Cola products will be 40-odd percent. So of the 64 ounces of liquid that each American is drinking every day, you can figure something like 7 ounces, on average, will be a Coca-Cola product.

I could be wrong on this, but I think beer is about 10% of all liquids consumed by Americans. So one out of every 10 ounces consumed by Americans of *any* kind of liquid, I believe, is beer.

Incidentally, despite what you read about the popularity of Starbucks — which is very real, of course — coffee drinking has gone down and down and down over the last 30 or 40 years.

I think the trend toward concentration is permanent.

Buffett: I'm still drinking Coca-Cola. The meeting might get a little exciting if we were drinking Bud up here. [He laughs.] Charlie, do you have any thoughts about your consumption habits — [he pauses and chuckles] — that you can talk about? [Audience laughs.]

Munger: Well, there are people here that may remember Metz beer. In this country, we had hundreds of breweries. And small places would have two or three brands. But I think this trend toward concentration into a few giants is permanent.

Buffett: Yeah, Schlitz was #1 for awhile, as I remember, after World War II. And I think Anheuser was #4 at that time.

If you want to learn more, here's a book on the subject....

Buffett: There's actually an interesting book, if you're a beer enthusiast, that came out a few months ago by a *Wall Street Journal* reporter that sort of toured the country sampling beers. I don't know how it affected his writing, [he chuckles] but it's a pretty good book if you like reading about the history of beer.

[Editor's note: The book is *Travels with Barley: A*

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Journey through Beer Culture in America by Ken Wells, published in October 2004 by Free Press.]

GM/FORD MGM'TS HAVE *VERY* TOUGH HANDS — THEY FACE PROBLEMS NOT OF THEIR OWN MAKING.

GM/Ford managements have taken on *very* difficult hands.

Shareholder: Many years ago, Warren, my wife did a portrait of you drinking a can of Coke. Next year, I'll bring one of you drinking a can of Bud.

Buffett: You'd better stick with Coke. [Buffett laughs.]

Shareholder: I'd like you to speculate on something: Given the competitive disadvantage of GM and Ford with their huge healthcare liability costs for their employees and retirees, what do you think might happen there? Do you think there might be a bankruptcy to get rid of the liabilities, or a government bailout?

Buffett: Well, I would say that Rick Wagoner at General Motors and Bill Ford at Ford have been handed *extremely* difficult hands to play by managers of the past. Their challenges are not the consequences of their own doing at all. Both have walked into what people call "legacy" situations. They have inherited cost structures, brought about by contracts put in place, maybe decades ago, that make it *very* difficult for them to be competitive in today's world.

Just imagine if Ford or General Motors had signed contracts that made them pay several thousand dollars more per ton for steel than their competitors did. People would immediately feel that was untenable.

General Motors and Ford are in the position of having commitments in strong contractual terms to pay sums for retired workers — in both the annuity field and in the health field — that are *staggeringly* high compared to some of their competitors. Meanwhile, their competitors can buy steel, aluminum and rubber at the same price. So when you get all through with it, their competitors have huge advantages on the healthcare and annuity side — and it's not going to be a fair fight.

Mind you, those contracts, to some extent, go back to when General Motors had 50%+ of the U.S. auto market — and now it has 25%. And I think even if the company had a 50% share today, it would *still* be having trouble. So it's a very, very tough situation.

I'm not sure what I would do if you put me in charge. When Bill Buckley ran for mayor of New York many years ago, he was asked, "What's the first thing you're gonna do if you get elected?" And he said, "I'll ask for a recount." Well, that's a little like the way I would feel if I got elected CEO of General Motors.

Today, the workers effectively own nearly 90% of GM....

Buffett: From the standpoint of the UAW, they have a contract. They made a deal. And it's kind of interesting. They have around $90 billion in GM's pension fund. And the healthcare fund has a little more, too — another $20-something billion, as I recall.

Meanwhile, the whole *equity* of GM is selling for about $14 billion. So after all these years, there's $110 billion set aside for the retirees — and there's only about $14 billion of equity value (an amount, of course, that's been heading south) for the owners.

Obviously, it's not a viable situation.

Buffett: Imagine if GM had a steel contract that called for above-market prices. For the sake of discussion, let's say there was a ton of steel in every car, and they were paying $2,000 a ton over market, or over what their competitors were paying. People would say that that's not a viable situation for the long term.

But they're in a similar situation with their labor-related costs because of contracts they voluntarily signed.

IT WAS A TRIUMPH OF ACCOUNTING OVER REALITY. BUT THE TIME TO DEAL WITH THE PROBLEM IS NOW.

In the past, imperfect accounting obscured the sad reality.

Buffett: And part of the reason that they signed those legacy contracts back when they did undoubtedly was that they bore no accounting consequences at the time. It's a *terrible* mistake for managers to think in terms of accounting numbers rather than reality.

But back in the '60s, you did not have to account for pensions on an accrual basis. And up 'til the early '90s, you didn't have to account for healthcare on an accrual basis. So people said, "Well, if we don't have to count it, it isn't real."

Well, believe me, it *is* real. And the managers today are facing the consequences.

What do I think? I think you're being too optimistic.

Buffett: So the managements at General Motors and Ford have *very* tough hands to play. I read about it in the papers. I don't know what's going on there necessarily. But in my view, something will have to give in that matter.

What do you think about GM and Ford, Charlie?

Munger: What do I think? Well, I think Warren just gave you a very optimistic prognosis [Buffett tries to restrain a laugh...]

The time for GM and Ford to deal with their problem is *now*.

Munger: Just because it hasn't happened yet doesn't mean that the problem isn't real. If you jump out of a window on the 42nd floor and you're still doing fine on the way down when you pass the 20th floor, it doesn't mean that you don't have a serious problem.

If I were the governor of Michigan or the President of the U.S. — or a director of General Motors or Ford, or a family member of Ford — I would want to address the problem right *now*. I do not think it's getting better — or that a magician is going to come over the mountain with a magic wand and make the problem go away. I think that it would be better faced....

WE DON'T GET PAID EXTRA FOR THE HARD ONES, SO WE JUST THROW PHARMA IN THE "TOO HARD" PILE.

We just throw pharma in the "too hard" pile and go on.

Shareholder: The major pharmaceutical companies

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have faced a myriad of fundamental and legal challenges in recent years. With that in mind, and given the apparent ongoing nature of those obstacles, how should investors be thinking about the long-term prospects for this very important industry?

Buffett: Well, my answer is, I don't know — but maybe Charlie will. It's a terrific question. It's just that that industry *is* in a state of flux now.

It does very important things for mankind. It's historically earned very good returns on invested capital. But it could well be that the world will unfold differently for those companies in the future than it has in the past — and that may not be the case.

I don't think I'm qualified to give you a good answer on that because much of it is in the political realm — and my judgement about what politicians will do is probably not better than yours. Charlie?

Munger: I share Warren's agnosticism on the subject. We just throw some decisions into the "too hard" pile and go on to others.

We don't get paid *extra* for the hard ones, so we just pass.

Buffett: Incidentally, there's a lot of wisdom in that remark. There are things in life that you don't have to make a decision on that are too hard. Many years ago in one of our reports, I said one of the interesting things about investing is that there's no degree-of-difficulty factor. What I meant by that was that if you're seeking a gold medal in diving in the Olympics, you get *paid* more, in effect, for certain dives than others — because they're more difficult. They properly adjust for that factor.

However, in investing, there is no degree of difficulty. And if something is staring you right in the face and it's the easiest decision in the world, the payoff can be *huge*.

If we're going to err, we'd rather err on the side of caution.

Buffett: We get paid not for jumping over 7-foot bars, but for stepping over 1-foot bars. And the biggest thing that we have to do is decide which ones are the 1-foot bars and which ones are the 7-foot bars, so when we go to step, we don't bump into the bar. And that's something I think we're reasonably good at.

Maybe we cast out too many things as being too hard, and thereby overly narrow our universe. But I'd rather have the universe be interpreted as being a little smaller than it really is, than being interpreted as larger than it is. Charlie?

Munger: Obviously. [Buffett laughs.]

FREDDIE/FANNIE CHANGED THE MORTGAGE BUSINESS, BUT THEY GOT CAUGHT UP IN THE EARNINGS GAME.

Freddie and Fannie were modeled after the FHA and the VA.

Shareholder: The current regulatory environment in Washington appears to be growing much more negative on Fannie Mae, Freddie Mac, Farmer Mac and so forth. What might the implications for the U.S. consumer specifically and the U.S. economy generally be if the GSEs [Government Sponsored Enterprises] are effectively bridled or significantly restricted from their past charters? Could this prick what some private economists are calling a real estate bubble? And what do you think the fallout would be?

Buffett: The GSEs, in effect, expanded their original charter and reason for being. The thought originally was that they would guarantee mortgages. And they had this very limited — I think $2-1/4 billion — line of credit from the Treasury. But they were brought in, to an extent, to do what the FHA and VA had done for mortgages in their arena — which was to give people confidence in lending money far away from their own geographical location.

They reduced the need for knowledge about the borrower.

Buffett: When I borrowed money on my house, which I bought in 1958, I went down to see Mr. Brownlee at the Occidental Building & Loan — and he knew something about me, my parents, where the house was, and all of that.

But as the mortgage market became more institutionalized, and the source of funds became geographically far more distant from the user of the funds, in order to have an efficient market, the GSEs were a very logical development.

So the GSEs — including Freddie and Fannie — came on to the scene. The idea was that for a fee, which used to average about 25 basis points, they would guarantee these mortgages. So somebody living 3,000 miles away could buy them through securities and not worry about the individual property.

GSEs' portfolios became dominant source of their earnings.

Buffett: And then the portfolio operations developed over the following years. And of course, they enabled the GSEs to earn high rates of return on capital — because, in effect, the GSEs were looked at as government-guaranteed. So people would lend them money without worrying about the degree of leverage employed.

In effect, they became *huge*... They hugely developed what might be called the "carry trade". They used the government's credit to earn a spread between what they paid on their money and what they got on mortgages. And that became the dominant source of their earnings.

But GSEs got caught up in the earnings growth game....

Buffett: But they got very carried away with delivering promised rates of growth. I remember reading a Freddie Mac report some years ago where they talked about delivering earnings growth in the low teens or mid teens or something like that. And I thought, this is *madness*. You can't *do* that when you're running a big carry trade operation — because the slope of the interest rate curve will determine your profitability. There's no way to match assets and liabilities in a way that's risk free when you lend money for 30 years to somebody who can pay you off 30 seconds later. The only way you could safely do it would be to issue a 30-year bond of your own which you could call 30 seconds later — and people don't buy those. So as a practical matter, you could not perfectly handle the risk of significant interest rate changes.

But, again, the GSEs got caught up in the game of

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delivering increasing earnings all the time to Wall Street. So they first enlarged their portfolios. And later, as we've seen, they got involved in some accounting shenanigans — which really sort of boggles the mind when you think of two of the most important institutions in the country, with all kinds of financial experts on the board, and top-name auditors and everything. But it turned out that billions and billions of dollars were misreported. It shows you what can happen in a system.

Now Congress and Greenspan have noticed....

Buffett: Now Congress is reacting, the Administration's reacting and Alan Greenspan's reacting, and they're asking, "What have we created? What is this situation where these two companies have $1.5 trillion or more of mortgages they own — and people really think that the federal government is on the hook?"

The federal government wants to say it isn't on the hook, but the truth is that it *is*. And institutions worldwide own the securities based on this implied promise. And it was all being done because basically these companies want their earnings per share to go up.

They say they did it to maintain an orderly market and all that stuff. But the reason why they were really set up was to guarantee mortgage credit without taking on unsafe amounts of interest rate risk.

WE DON'T EXPECT FORCED PORTFOLIO LIQUIDATION, BUT TOUGHER ACCOUNTING AND CAPITAL RATIOS.

Congress will step in. And it *should*....

Buffett: So there's going to be a reaction in Congress. There'll be a huge fight. And both of those institutions have been *heavy* supporters of various legislators over the years. They've got lots of clout in Congress, but not as much as they had a year ago.

On the other hand, people have lost faith — at least to some degree — given what they've done. And they've also seen the consequences of the government issuing a blank check to two institutions that are trying to produce annual gains in earnings per share of 15% — and doing it by accounting means when they ran out of the ability to do it by other means.

(continued in next column)

So it's something that Congress *should* be giving a lot of attention to.

Tougher accounting and tougher capital ratios? Probably.

Buffett: But they can't cut 'em off, in my view — and I think in the view of most people. They can't say, "Get rid of your portfolios" or anything like that.

So I would guess that there'll be some kind of a curtailment — tougher accounting requirements and maybe tougher capital ratios — and that over a long period of time, the government tries to figure out something that eases them out of this position where it's basically backing two entities that at times have acted like the two biggest hedge funds in history. Charlie?

I don't expect forced portfolio liquidation.

Munger: What he was asking, partly, is what happens if the government reins these two institutions way in and forces a big reduction in their asset base.

Buffett: Well, I don't think the government's going to do something that results in them selling off hundreds of billions of dollars of mortgages.

But if they curtail it — let's just say that they say, "You've got to operate in a runoff mode for a few years" — there are *plenty* of people out there to buy mortgages. They're already buying the securities of Fannie Mae and Freddie that are financing the mortgages.

So it isn't like Fannie and Freddie independently were coming up with the funds to finance these mortgages. They got 'em from somebody else. And that somebody else can leave Freddie and Fannie out of the picture and buy the mortgages through some other form. It would not be the end of the world at all if Freddie and Fannie no longer had new portfolio purchases. I don't think it would change things in any significant way in terms of the cost of home ownership or anything else. How about you, Charlie?

Munger: Well, I agree. I don't think it would have enormous macro effects if future growth were curtailed.

Derivatives accounting genie's out of the bottle....

Munger: I do think that a lot of the troubles that arose came from a large use of derivative books and from Fannie and Freddie both believing a lot of silver-tongued salesmanship from derivative traders.

And as many of you know, I think there is much wrong with derivative accounting and derivative trading operations in the U.S. Stupid and dishonorable accountants allowed the genie of totally improper accounting to come out of the bottle and descend into the derivative books of the world. And once that's happened — once people have used it to create masses of assets, masses of earnings reports, and bonuses, and status and so on — getting the genie back in the bottle will be no small task, because now you have these *huge* vested interests fighting you. And what ordinary housewife, as she puts in the morning's toast, is thinking, "My God, I have to do something about derivatives?" [Munger laughs.]

So the people who have a vested interest in the current system are powerful — and the rest of the people don't care. Therefore, this evil genie stays out of the bottle and does more and more mischief with each passing day.... And I

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

don't think the full penalties have yet been paid.

Buffett: Yeah. It's always *fascinated* me how people are able to write a derivative contract — and on both sides of it, the trader will show a profit by the end of the month....

We've come a long way from "It's a Wonderful Life".

Buffett: When you can have a $5 billion mismark in one direction at one of these firms... Bear in mind that these are among the most scrutinized companies in the *world* [chortling as he speaks] and with outstanding people on their boards in terms of financial expertise. But if you can have a $5 billion mismark in one direction, while at the same time the other one has a $9 billion mismark in the other direction, I would say we've come a long way from Jimmy Stewart in "It's a Wonderful Life". [He chortles.]

Munger: Yeah.

IF YOU WANT PRECISION IN YOUR STATEMENTS, YOU BETTER STAY AWAY FROM FINANCIAL COMPANIES.

Financial institutions *are* more difficult to analyze.

Shareholder: Four of the handful of AAA-rated companies — AIG, Fannie Mae, Freddie Mac and MBIA — are under formal investigation for accounting shenanigans, or are in the process of restating their financials. Like Charlie has said, I think of a AAA-rated company as an exemplar — a company that should behave with the highest accounting and ethical standards.

So how can investors comfortably invest in any financial service company when a decent percentage of the AAA-rated companies have false or misleading financials? And why don't the rating agencies perform some independent due diligence from an accounting standpoint so that they can help serve as a watchdog on this issue?

Buffett: Well, financial companies *are* more difficult to analyze than many companies. As an example, within the insurance business, the single biggest element that is very difficult to evaluate, even if you own the company, is the loss and loss adjustment expense reserve. And that has a *huge* impact on reported earnings of any given period. And the shorter the period, the more the impact can be from just small changes in assumptions.

There's less precision in financial companies' statements.

Buffett: We carry, let's say, $45 billion of loss reserves. But if I had to bet my life on whether $45 billion turned out to be a little over or a little under, I'd think a long time. And you could just as easily have a figure of $45-1/2 billion or $44-1/2 billion. And if you were concerned about reporting given earnings in a given period, that would be an easy game to play. Similarly, in a bank, it's basically whether the loans are any good. I've been on the boards of banks — and I've gotten surprises. It's tough to tell.

By contrast, if the company you're analyzing is something like See's Candy, WD-40, our brick business or whatever, they may have good or bad prospects, but you're not likely to be fooling yourself much about what's going on. With financial institutions though, it's much tougher.

Then you throw in derivatives on top of it. No one, probably, knows perfectly — or even within a reasonable range — the exact condition of some of the biggest banks in the world.

And you get greater adjustments required and more fraud.

Buffett: But that brings you back to the due diligence question of the agencies. You had very high-grade, very financially-smart people on the boards of both Freddie and Fannie. And yet, apparently, one was $5 billion off and one was $9 billion off. Those are big numbers. And I don't believe that those people were negligent. It's just very, very tough to know precisely what's going on within a financial institution.

Charlie and I were directors of Salomon — and Charlie was on the audit committee. And I forget the size of a few of those things that you found. But what *wasn't* found? And that doesn't mean that the people below are crooks or anything like that. It just means that with thousands and thousands and thousands of complicated transactions — sometimes with computations involving multiple variables — it can be very hard to figure out where things stand at any given moment.

And then, of course, when the numbers get huge on both sides, and you get small changes in huge numbers, they have an incredible effect on quarterly or yearly figures, because those adjustments get lumped in — in effect, they get recognized — during a short period of time.

So I think you have to accept the fact that insurance, banking, finance companies... I mean, we've seen all kinds of frauds and just big mistakes over time in finance companies — just one after another over the years. It's just a more dangerous field to analyze. It doesn't mean you can't make money in it. We've made a lot of money in it — but it's difficult.

AND YOU GET MORE FRAUD AND MISTAKES, TOO. IT'S JUST IN THOSE COMPANIES' NATURE.

And it's not for lack of trying....

Buffett: Now obviously in the case of a GEICO, where you're insuring pretty much the same thing — auto drivers — your statistics are going to be much more valid than they would be if you're having to factor in the impact of something like asbestos liability. In the latter case, of course, you're subject to far greater errors in estimation. It doesn't mean those people aren't operating in good faith. But if you were to take the asbestos liability estimates of the 20 largest insurance companies, I would bet you that they're way off — but I don't know in which direction. And that's sort of the nature of financial companies.

So I wouldn't fault the rating agencies in terms of not being able to dig into the financials and determine where the accounting is off. All the companies you talked about have had big-name auditors. How many hours did our auditors at Berkshire spend last year? I don't know what it was — probably 60 or 70 thousand hours.

And I'm sure if you take major banks, they're spending more than that. But can they be certain of their numbers? I doubt it. Charlie?

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

Some types of businesses are just inherently more risky.

Munger: Yeah. Warren is obviously correct that where you've got complexity — which by its very *nature* provides better opportunities to be mistaken and not have it come to notice, or to be fraudulent and have it not be found out — you're going to get more fraud and mistakes than you are if you're in a business where you shovel sand out of the river and sell it by the truckload. Just as a business that sells natural gas is going to have more explosions than a business that sells sand, businesses like these major financial institutions by their nature are going to have way more problems. And that will *always* be true.

And it's true when the financial institutions are owned by governments. In fact, some of the worst financial reporting in the world is done by governments, and government-owned institutions like banks in China, etc. So if you don't like the lack of perfect accounting in financial institutions, you're in the wrong world.

EASY MONEY IS FACILITATING THE HOUSING BOOM. AND GIVEN FANNIE & FREDDIE, IT'S NO WONDER....

All home construction represents somebody's savings.

Shareholder: Do you think that the shift in the banking system during the '90s to finance home purchases with zero percent down impacted the overall savings rate — given that home purchases are the largest investment that most people make — and the overall rise in home prices driven by these marginal buyers? If so, how would you suggest that we correct the problem?

Buffett: Of course, any time a home is constructed, it represents a use of somebody's savings. The homebuyer may be buying it for nothing down, but that means that he's borrowing 100% of the purchase price through a mortgage with capital that somebody else has saved somewhere — although it may be intermediated three or four times or something of the sort. But home construction comes about through savings.

Easy financing has helped facilitate the real estate boom.

Buffett: Now there's no question — and I've talked to certain mortgage bankers about this subject — that terms have become easier and easier as prices have increased. That is absolutely counter to how people think about lending in general. Generally, the more the asset class becomes inflated, the less a prudent banker will lend.

But in this country — and I'm thinking of Freddie and Fannie, so we're talking about lower-priced houses — you now have mortgages intermediated in a way that the person buying the mortgage doesn't really need to *care* about what kind of a financial transaction the purchase is. All they have to do is look at the guarantee. And they look at that rather than whether somebody's put any money down or anything of the sort.

So I think you've had easy financing facilitating a boom in real estate prices even at the higher levels.

Beware lenders bearing gifts....

Buffett: And that's occurred in other asset classes in the past. The farm bubble I talked about was facilitated by the fact that banks in small towns — who generally had been very conservative in lending — went crazy around 1980. And they lent amounts that the farm itself could never repay. They started saying that a farm was an asset appreciation investment, not an income investment. And once you talk about something being an asset appreciation investment — ignoring the underlying economics of what you're lending on — you're really playing the greater fool game. In effect, you're saying you know it's a silly price, but that there'll be a bigger fool that comes along.

And that actually can be a profitable game for awhile, but it's nothing that bankers should engage in. So I'd say that easy lending obviously does contribute to lower savings rates for some people. But in effect, somebody has to save for somebody else to borrow.

PONZI STRUCTURES HAVE PONZI EFFECTS — WHETHER THEY'RE PREMEDITATED OR NOT.

U.S. current account deficit is driven by U.S. consumption.

Buffett: The rest of the world is saving. They're investing $2 billion a day in the U.S. Meanwhile, in return, we're sending them, in effect, claims or ownership of $2 billion a day.

A lot of economists will say, "Well, what's really going on is that the world loves our assets so much — and they have so much confidence in America — that the present current account deficit is *driven* by the fact that they want to invest."

Well, I don't believe that. I think it's silly to make that argument. Mostly, they're investing because they *have* to — because of our consumption habits — and not because they want to. And I think the declining dollar is evidence of that. Charlie?

[Editor's note: It should be noted, however, that although U.S. financial assets are highly imperfect, they don't exist in a vacuum — and non-U.S. financial assets, in most cases, may leave even *more* to be desired.

Also, if international financial market participants don't wish to hold dollar-denominated assets, it's not obvious to us why they would be unable to exchange them in this ultra-efficient market for assets denominated in other currencies, and why any such preference would not quickly be reflected in their price.

On the other hand, we don't mean to suggest that we think Berkshire's approximately $13.8 billion investment against the U.S. dollar is ill advised — just that we feel current prices represent investor choice, not coercion.]

But easy lending can only drive up prices so long.

Munger: It's obvious that the easy lending on houses causes more houses to be built and causes housing prices to be higher.... But eventually, of course, if you construct enough new *anything*, you can have a countervailing effect. In other words, if you build way too many houses, you eventually cause a price decline.

Buffett: I'll give you a fanciful illustration. Let's

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assume that Omaha had a totally constant population — no one was allowed to leave, no one was allowed to enter, the birth rate equalled the death rate, all of that sort of thing.... And nobody could build any more houses — we just passed a city ordinance to that effect.

But every year, everybody sold their house to their neighbor. So the first year, everybody sold their $100,000 house to their neighbor, and they both switched houses and that was fine. And then the next year, they agreed to do it at $150,000. How could *that* be? Well, they'd all go to Freddie or Fannie and get their mortgages guaranteed for a larger amount — and somebody in New York or Tokyo or someplace would buy the Freddie or Fannie paper.

Well, as a result, we'd have an inflow of $50,000 per household. We'd all have the same number of houses, and we'd all still be living one house to a family. However, we'd have marked up our houses. And we'd now have a bigger mortgage, but we'd have $50,000 more available to spend that year. And all we'd have to do in return is service a higher mortgage. And we might do the same thing the following year for $200,000, and so on.

It's not premeditated, but there are Ponzi aspects today.

Buffett: Now that would be very transparent. And people might catch on to the fact that there was something funny going on in Omaha. But you can have an *accidental* aggregation of behavior lead to the same kind of effect. If you keep marking something up and the payment for the marked-up price comes from someone else who feels that they're not bearing any risk because they've got the government guarantee in-between, the money can *flood* in. And everybody can feel very happy for a long time.

We don't have anything going on in the economy like the fanciful example that I just gave you, but I think that we have certain aspects of it.

[Editor's note: Others, including Arnie Van Den Berg of Century Management, would suggest that we have something very *much* like it going on in California today. Might a tax policy which rewards borrowing against homes by making it deductible for tax purposes, and which makes gains of up to $500,000 per couple every two years tax free, go a long way towards explaining a great deal of what's happening in financial markets in the U.S. today?]

Buffett: Charlie, would you agree or not?

Munger: Yeah, I do agree with that. You have buried Ponzi effects in various parts of any modern economy. And they're very important — and they're very little studied in economics.

WE'VE SEEN REAL ESTATE BUBBLES BEFORE. PEOPLE JUST PERIODICALLY GO CRAZY.

For us, a pricked real estate bubble could be a net *positive*.

Shareholder: What do you think the consequences of a strong decline in the housing market will be for sales of carpet retailers and manufacturers?

Buffett: Well, if there is a strong decline in the housing market, my guess would be that whatever we might lose in carpet, we would make up somewhere else.... A lot of the psychological well-being, as well as the financial well-being, of the American people comes from the fact that they feel so good about what has happened with their home ownership over the years. And with many people, it's been by *far* the best behaving asset that they've had.

So if there is indeed some kind of a bubble and it's pricked at some point, my guess is that we would feel that in various ways in our operating businesses — but that in terms of what we could do with our capital, the net effect to Berkshire might well be quite positive.

But we haven't made our money predicting macro factors.

Buffett: However, we're not big on macro forecasts. This foreign exchange thing is quite different than what we've done over time — and the way we've made money. So it isn't like we've got some great track record of predicting macro factors and have made a lot of money doing that.

We've made money by looking at things like PetroChina or whatever it may be, and just deciding that here's a very good business selling at a very cheap price.

People just periodically go crazy....

Buffett: Certainly at the *high* end of the real estate market in some areas, you've seen some extraordinary movement. And I've referred to this before, but 25 years ago or so, we saw the same thing in farmland in Nebraska and Iowa and the surrounding areas. People were running from cash — in effect, saying "cash is trash" — because they were worried about the fact that inflation was out of control in the late '70s before Volcker did his stuff. So people were *fleeing* from cash.

And one of the ways they gave vent to that fear was to rush into farmland. For example, there was a farm about 30 miles north of here that sold for about $2,000 an acre around 1980. And a few years later, I bought it from the FDIC for $600 an acre. You might ask, how can you go crazy about farmland? It's going to produce about 45 bushels an acre of soybeans and 120 bushels an acre of corn. And there's no way you can dream about it tripling or the internet causing corn yields to go up or anything of the sort. But people went *crazy* on it.

And the consequences can be *huge*.

Buffett: And the consequences were *huge* in terms of banks failing — *lots* of banks failing — in this area, including banks that had gone through the Great Depression. But people went a little crazy. People go crazy in economics periodically in all different kinds of ways. You had the Resolution Trust Corp. come out of the savings & loan nuttiness that took place in real estate — where they financed everything that was put before them.

I don't know where we stand in terms of the residential housing cycle. It has different behavior characteristics simply because people live in the houses they own in a great many cases. So it will not necessarily behave the same as other markets.

That said, when you get prices increasing at far, far greater rates than construction costs or inflationary factors, sometimes there can be some pretty serious consequences.

Charlie?

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

Don't count on me for residential real estate advice.

Munger: In a place like Omaha, there's not much of a housing price bubble, is there, Warren?

Buffett: No, there's not been a bubble. But I'd say that residential real estate probably has increased in price at a rate quite a bit faster than the general inflation rate.

Munger: Yeah, but if you get to Laguna, California, or Montecito, California or the better suburbs of Washington, DC, you have a real asset price bubble.

I have a relative who, to move to a good school district in the suburbs of Virginia, will have to pay four times as much as she can get from selling her nice Omaha house. *That*'s a price bubble.

Buffett: Yeah. I sold a house a few months ago in Laguna for $3-1/2 million. Now, it sold the first day, [chortling] so I probably listed it too cheap. So don't count on me for residential real estate advice. But that house — the physical house — would probably cost a half a million or thereabouts. So in effect, the land went for $3 million implicitly. And the land is probably in the area of 2,000 square feet, which is a little less than 1/20th of an acre.

Now you've got streets involved and all of that sort of thing. But basically I think that land sold for about $60 million an acre — which, as that fellow that you saw in the farm outfit in the movie said [he chortles] sounds like a pretty fancy price for almost *any* kind of land.

Charlie, you've witnessed it first hand, though, out there.

If a good view costs $27 million, I'll stare at my bathtub.

Munger: Yeah. One of the Berkshire directors lives adjacent to what I regard as a pretty modest little house which sold for $27 million recently. Now these are houses that look right at the ocean — and there isn't a great deal of available shoreline in California, and there are a lot of people. But you have some very extreme housing price bubbles going on. And you'd think there might be a real possibility that it could go in the other direction some day.

Buffett: At $27 million, I'd rather stare at my bathtub.

Munger: Yeah. [Munger cracks up.]

COMMERCIAL REAL ESTATE USED TO BE A BARGAIN. HOWEVER, IT'S QUITE *UN*ATTRACTIVE TODAY.

We *don't* find real estate very exciting today.

Shareholder: Considering the characteristics of larger-size commercial real estate investments, like REITs, that can have the behavior and financial returns of an operating business, why do you not invest in real estate? Is it because you just don't like the returns, or because you believe that the businesses are not attractive?

Buffett: Well, Charlie got his start in real estate, right, Charlie?

Munger: First, in a corporation like Berkshire that's taxable under sub-chapter C of the internal revenue code, owning real estate is grossly disadvantaged compared to owning it directly by individuals such as yourself. Also, real estate is having bubble valuation problems of its own right now. All my rich friends who own real estate are selling their worst properties — and they're getting bids that are coming in higher than their highest expectations. People are competing to take these things off their hands.

So I don't find it exciting — and it *certainly* doesn't fit Berkshire. Name me a lot of C-corporations that have been passive owners of real estate and have done well over a whole lot of years. It's almost a null class.

Not that long ago, I found it *very* exciting.

Buffett: Yeah, both Charlie and I — more Charlie than I — have had certain personal real estate investments over time. And it's a field that, in general, we understand. We don't bring that much special to the game, but we understand it — and we've made money in it.

Actually, about the time that the Nasdaq hit its high, REITs were quite cheap, in my view. And I have less than 1% of my net worth outside of Berkshire — but basically, I had that portion *all* in REITs (they were all small ones) at that time. However, they were selling at discounts to the values of the properties — and those property values were much more conservatively figured than today.

REITs are unattractive today — even for individuals....

Buffett: Today, real estate sells for *very* fancy prices. And on top of that, REITs often sell at a premium to those. So I regard REITs as quite unattractive now — certainly compared to five or six years ago....

Munger: And that's for an *individual* that you regard them as unattractive.

Buffett: Yep.

Munger: And for a corporation, that's much *more* so.

Buffett: Yeah, that's right. The situation's changed dramatically from five or six years ago. In many respects, the stock market is down significantly from the 1999-2000 period, while REITs are up significantly. REITs were very unpopular five or six years ago — and now they're popular.

And it's better to pay attention to something that's being scorned than something that's being championed. So there's really been a big change in the REIT situation in the last five or six years.

Munger: And the REITs have phony accounting.

Buffett: [After a pause] Otherwise, we *love* 'em. [Buffett laughs.] You don't want to bring up anything in these meetings. [He chuckles.]

THE REAL ESTATE BROKERAGE BUSINESS IS HUGE. AND WE EXPECT TO BE A *MUCH* BIGGER PLAYER IN IT.

We don't believe homeowners will trust internet brokers.

Shareholder: You've covered many different areas today in real estate, such as the long-run performance most people obtain in their personal real estate holdings, the GSEs and REITs, and the real estate bubble.

But one of the things that appeared in today's paper quotes Mr. Buffett about building a brokerage powerhouse.

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

And that seems to say that you envision changes in the way people buy and sell their houses and so forth. So could you tell me a little bit more about where you envision Berkshire Hathaway going in this area?

Buffett: Yeah, I'll be glad to. We are hoping to build a powerhouse that's built very much on the model of today. In other words, we do not envision big changes in residential real estate brokerage, which is what we're in.

They talk about "sides" in real estate — the buy side and the sell side. We participated in sides that totaled $50-odd billion last year — and we're the second largest residential real estate brokerage firm in the country. But we expect that business really to be conducted quite similarly in the future to how it has been in the past. Of course, there are people that disagree with that. And many of them think that way more will happen via the internet.

However, the purchase of a home is the single most important transaction for most people in their lifetimes. It can be partly emotional. It's partly something that they appreciate people guiding them through. So it's something where I think one-on-one relationships will be very important in the future, as they have been so far.

This is a huge business — with enormous potential.

Buffett: In this country alone there are going to be millions and millions and millions of homes that get sold every year — just in terms of people moving and dying and moving up in their economic potential. So the real estate brokerage business is going to be a very, very big business. And I think it will tend to be a very *local* business. And we've bought leading local firms in a number of markets. They've retained their individual identity. We haven't gone for a Century 21 approach, or anything of that nature, where we put 'em all under the umbrella of a single brand. Rather, we have individual brands in given communities — and they're usually very strong brands in each community.

But we've only scratched the surface. And it has nothing to do with the potential for real estate. It just relates to the fact that tens and tens of millions of people own their own homes and some of them are going to move around every year. And I think they'll continue to have a real estate broker involved in most transactions.

We're already big today, but I think we'll be a *lot* bigger....

Buffett: We would like to be very big in that business. We're already big. But I'd think it's almost certain that we'll be a lot bigger in that business five or 10 years from now — and I mean, a *lot* bigger — than we are now. And for us, it's just a question of acquiring these firms.

Generally, they're proprietorships — they're owned by a single individual or a family. They come up periodically because of family or individual circumstances, but there's a lot of 'em out there. And we're a logical buyer — and we've been found to be a good owner. So I think it's going to be a good size field for us over time.

Our opinion of the economics? We voted with our feet.

Munger: We voted by buying the brokerage operation instead of the real estate. So, obviously, we regard it as having better economics than the underlying real estate which Berkshire could buy....

WE DON'T HAVE ANYTHING AGAINST EUROPE,
BUT ITS REPORTING RULES DO MAKE IT TOUGHER.

We have a big stake in Europe via MidAmerican Energy.

Shareholder: Over time, I've bought many companies in the United Kingdom and Europe. And I've seen many American value funds buying the same companies. But I've seen very little activity from Berkshire and its subsidiaries. And I didn't know whether that was a reflection of your views on the UK and Europe and the world, whether you just see a lack of investment opportunity, whether it's outside your sphere of competence — or is there some other reason that I see less activity from you in Europe?

Buffett: That's a good question. As you know, we own 80%-or-so of MidAmerican Energy — which has a very large business in the UK. But that's an operating business.

There's a rule in the UK that requires reporting when you own 3% of a company's stock. And actually, there are some conditions under which the ownership will be reported even sooner than that 3%. There's a provision, I think, that if there's an inquiry, it has to be responded to. So take a company with a market cap of £5 billion. If we bought £150 million of it, we'd have to report it. And that tends to mess up subsequent purchases.

But reporting requirements make us think twice with stock.

Buffett: So we bought stock — and we still own stock — in Diageo, which was Guinness at the time. And we've owned stock in some other UK companies. But we've thought twice before going over 3% because of the reporting requirements — and then we'd have to report if we were selling and all of that. So that's a deterrent, but it's not an overwhelming deterrent.

If we get a chance to buy a significant piece of something we think is cheap — particularly if we can buy it in one purchase... But there are a lot of special rules that kick in over in the UK that don't in the United States.

Incidentally, there was something in the *Wall Street Journal* the other day that said that we had to report if we bought over 5% of a company within 10 business days in the U.S. That is not true. That was a mistake. But it *is* the case in the UK that at 3%, reporting is triggered.

We're looking for the same thing over there as here.

Buffett: But we would feel very comfortable with lots of UK businesses. And it would be the same criteria that we've applied over here: a durable competitive advantage, a management that we like and trust, and a reasonable price. We have seen some of those. For example, there was an insurance company in the UK a year or so back that I would very much have liked to have bought. But we couldn't come to terms on price.

But we have no bias whatsoever against buying businesses in the UK. And, as I say, at Yorkshire & Northern Electric, we have a business that — as it shows in our report — made more than $300 million pretax. And actually, considering my views on currency, I would give a

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slight *edge* to buying something where the earnings would be in Sterling in the future rather than in dollars. Charlie?

OUR PREFERENCE FOR NON-U.S. CURRENCIES IS ODD FOR US — AND A RECENT DEVELOPMENT.

Our preference for European currencies is a recent change.

Munger: Well, I regard it as amusing that we ended up preferring the currencies of Europe, when it's so much more socialized than the U.S. That's a queer occurrence....

Buffett: Yeah. Up 'til three years ago, if I came back from Europe with a euro in my pocket, I couldn't wait to run to the bank.... I was afraid it would depreciate before I could get rid of it. But I changed my views a few years ago.

[Editor's note: Of course, one disadvantage the U.S. has is that it shoulders the burden, in effect, of being the world's policeman. And there's no obvious way to unload that burden without raising the risk of disaster to an unacceptably high level.

On the other hand, a U.S. tax policy that subsidizes consumption, especially housing-related consumption (by allowing the deduction of housing-related interest expense and eliminating capital gains of up to $500,000 per couple for houses lived in for two or more years) at the same time it penalizes savings is, arguably, a self-inflicted wound — especially relative to countries which tax consumption.]

Europe's less disadvantaged growthwise than most think.

Buffett: We hope to buy businesses — and stocks — in other places in the world. And Charlie mentions the difference in political climate.

You read about slow growth in Europe and Japan — and it's true. But the growth figures that you see are usually not on a per capita basis. And since the population of Europe has generally changed very little, whereas the U.S. population grows 1% or 1-1/2% a year, if you look at growth figures in the U.S. and somebody says, "3-and-a-fraction percent," that's not on a per capita basis. You have to deflate that by the growth in population — whereas if you read about the growth in Europe, generally, you're dealing with a population base that hasn't changed.

So the differences in growth rate on a per capita basis are not as wide as the headlines would suggest....

PETROCHINA SOLD AT A RIDICULOUS PRICE — AND ALL YOU HAD TO DO WAS READ THE ANNUAL.

PetroChina is a *huge* company....

Shareholder: What is your view on PetroChina?

Buffett: We bought PetroChina a few years ago — again, after reading the annual report. And fortunately, it was in English. It was the first Chinese stock — and really the last... It won't necessarily *be* the last, but it's the only one we've owned so far. We put about $400 million into it.

At the time, and still, it produces about 3% of the world's oil — which is a lot of oil. We think that they've done a good job in running the business. They've also got large gas reserves which they're starting to develop.

[Editor's note: Mark Mobius wrote in last year's semi-annual letter to Templeton China World shareholders that PetroChina owns over 70% of China's oil and gas reserves.]

Buffett: It probably produces 80% or so as much as Exxon Mobil will produce. It's a *huge* company. Last year, it earned $12 billion. Now if you look at the Fortune 500 list, my guess is you won't find more than about five companies in the United States that earn $12 billion or more. So it's a major company — a very major enterprise. It employs almost 500,000 people.

We thought the price was ridiculous. And so far, so good.

Buffett: And at the time that we bought it, PetroChina's total market value was $35 billion. So we bought it for only about 3 times what it earned last year. And it doesn't have unusual amounts of leverage.

But interestingly, a few years ago, relatively few people in the investment world probably even *thought* about the fact that PetroChina was over there and was much larger than just about any oil company in the world aside from BP and Exxon Mobil....

However, it's interesting... (I think I'm right on this.) At the time, Yukos — which is the big oil company in Russia — was probably far better known among the investment community in the U.S. than PetroChina. And I compared the two at the time and thought to myself, would I rather have the money in Russia or China? And PetroChina, in my view, was *far* cheaper — and I felt that the economic climate was likely to be better.

But if it had been selling at the same multiple as a U.S. domestic company, would I have regarded it as more attractive? No. There are some disadvantages always to being in a culture that you don't perfectly understand, or where tax laws or ownership rules can change. But the discount at which PetroChina was selling compared to other international oil companies, was, in my view at the time, ridiculous. So that's why we bought it.

And PetroChina's annual report laid it out for all to see.

Buffett: In the annual report, they say something which very, very few companies say, but which I think is actually fairly important. They say that they will pay out about 45% of what they earn. So if you can buy it at what turned out to be 3 times earnings, you get 45% of 33%. So we're getting a 15% cash yield on our investment.

The annual report of PetroChina is a very good report — which, like I say, is easy to read and understandable. In it, they declare their policies.

And anybody can get it and read it. We did not go over to China or anything. In fact, we never had *any* contact with the management before we bought the stock, and we never attended an investor presentation or anything of the sort. It's all right there in black and white in a report that anybody can get. We just sit in our office and read these things.

And we were able to put $400 million to work that's now worth about $1.2 billion or something like that.

Berkshire and the Chinese government control PetroChina.

Buffett: Do you have any thoughts on PetroChina,

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

Charlie?

Munger: It would be nice if this sort of thing happened all the time. But, unfortunately, that hasn't been true in recent years.

Buffett: Incidentally, the Chinese government owns 90% of the company. And we own 1.3%. So if we vote with them, the two of us control the business. [After a pause,] It's a thought that hasn't occurred to them, but I'll keep pointing it out. [Buffett chortles.] But it's a very major business at what *was* a very attractive price.

But for a reporting quirk, we'd have been able to buy more.

Buffett: Unfortunately, the government's shares and ours have the same economic interest, but are classified differently. So the government's 90% are called one thing and the 10% with the public are called H shares. And we have to report in Hong Kong when we own 10% of a company's shares — or at least we did then. And unfortunately, the 10% applied only to the H shares. Therefore, we had to reveal our ownership when we only had a 1% economic interest in the company.

So we would have bought more, but the price jumped up. And we are happy to have our 1.3% or whatever it is....

[Editor's note: And even your editor might be tempted down around 3 times earnings. But the price has more than quadrupled since then. And the over/under on when the Chinese government will come to the conclusion that it should nationalize the company altogether (and who-knows-what-other assets along with it) is anyone's guess.]

IF YOU THINK IN TERMS OF CENTURIES, SOME EXTRAORDINARY THINGS CAN HAPPEN.

When there's trouble, *everything* correlates.

David Winters: How do you try to manage risk at Gen Re and National Indemnity so you can be comfortable while maximizing returns? Especially, how do you prevent a catastrophic loss or unexpected correlation?

[Editor's note: In May of last year, David Winters left Franklin Mutual and launched Wintergreen Fund and its advisor Wintergreen Advisers.]

Buffett: That's a very good question — because we are doing things in different parts of our insurance operation where there is correlation. And there's not only correlation among the insurance risks. Just take a really major earthquake in California in the wrong place. There have been about twenty-five earthquakes registering 6.0 or more in the last 100 years, but most of 'em don't occur where a lot of people are. If you get the wrong one in the wrong place, it would not only hit National Indemnity and General Re, as you mentioned, but it might very well have a severe effect on See's Candy. It might very well have a severe effect on Wells Fargo. We don't own Freddie or Fannie now, but we owned Freddie at one time — and it could have a severe effect on it. It can have all *kinds* of secondary and tertiary effects that you might not think of initially. So we find when there's trouble, everything correlates.

My job is to think absolutely in terms of the worst case.

Buffett: And part of my job is to have at least a general idea of the sort of risk that the various enterprises might be running operationally, and then integrate that into my own notion of the risk that we run in terms of investments — and in terms of all *kinds* of things. That is my job.

The most likely mega-cat at any time is a hurricane. We have more exposure to that. On the other hand, if you're talking about insured catastrophes of $25 billion and up — maybe $100 billion and up — an earthquake might be just as likely as some Force 5 hurricane that would come in at the wrong place.

My job is to think *absolutely* in terms of worst case — and to know enough about what's going on in both investments and operations to make sure that no matter *what* happens, I don't lose sleep that night over whether there's a 9.0 quake someplace, or a Force 5 hurricane that actually goes up the east coast and enters at places that it very seldom enters.

In Long Island, for example, there is a huge amount of exposure. How often is Long Island going to have a major hurricane? Not very often. I think there was one back in the '30s — but there were potato fields there in the '30s, and now there's *all* kinds of insured value.

If you think in centuries, extraordinary things can happen.

Buffett: And everything that can happen will happen. In terms of what we know of history in this country — basically the last 300 or 400 years — the most severe earthquake by far was centered at New Madrid, Missouri. And who would've guessed that that quake would happen? And there were two subsequent quakes. They were far enough apart so they didn't exactly seem like aftershocks. All three of those were higher than 8 on the Richter scale. Nobody thinks about that. And they've had 'em in Charleston, South Carolina.

You will see — maybe not in your lifetime, but if you take the centuries — that some *extraordinary* things can happen. And it's Berkshire's job to be prepared absolutely for the very worst. And by and large, I'd think hurricanes and quakes are the biggest thing now. But a few years ago, we did not have nuclear, chemical and biological risk excluded in policies — and we had *huge* exposure, which we've subsequently gotten rid of.

TAKING ON LARGE RISKS IS OUR BUSINESS. RISKING OUR EXTINCTION AS A BUSINESS IS NOT.

We insure large risks that nobody else will cover.

Buffett: But we do take on large risks. I'll give you a couple of examples. And nobody else will write this stuff, basically, because they would want to reinsure it with someone else and they're not set up to do it. But just the other day, one large international airport came to us — and we wrote a policy for $500 million excess of $2-1/2 billion from any action that was not caused by nuclear, chemical or biological means. So if that airport is taken out in some

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way, but not by nuclear, chemical or biological activities, someone else worries about the first $2-1/2 billion — and we cover the next $500 million.

There's a sub-limit so that only $1.6 billion can be counted for business interruption. And that airport would have to be out for a couple of years to have $1.6 billion of business interruption — so you'd need $900 million of physical damage on top of that. However, somebody is willing to buy that policy — and there is a real risk.

For example, we insured the NCAA Final Four down in St. Louis against being cancelled — not postponed or having those Final Four games moved to another city. But if it was cancelled totally (and again, not through nuclear, chemical or biological) we'd have paid $75 million. We did the same thing for the Grammy's.

We take on risks that very few people want to write. In the end, we're willing to lose a lot of money in one day, but we're not willing to do *anything* that causes us any discomfort in terms of writing checks the following morning.

We're not going to intentionally risk business extinction.

Buffett: Incidentally, while I'm on the nuclear subject — while we're talking about unpleasant subjects — in the annual report, I recommended the book *Nuclear Terrorism*. And if you go to lastbestchance.org, you can obtain — or will soon be able to obtain — a free tape that the Nuclear Threat Initiative has sponsored which contains a dramatization of something that's fictional, but not fanciful. It's something that could happen — that the Nuclear Threat Initiative is working to minimize the chances of.

And on that program, in addition to this dramatization of what could happen in that field, you have Sam Nunn and Senator Lugar with Tom Brokaw discussing the subject. It's an important subject. It didn't get a lot of attention in this last campaign — although I think both candidates fully recognized the importance.

But we'd regard ourselves as vulnerable to extinction as a company if we didn't have nuclear, chemical and biological risks excluded from virtually all of our policies — although we *intentionally* take on the risk periodically, but only in an amount we feel we can handle. We do not write it and give it away for free — and we do not want to write it promiscuously — because there could be events that could happen that would make it impossible for our checks to

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clear the next day. And we're not going to get ourselves in that position. Charlie?

We naturally worry about things most people don't....

Munger: Yeah. We're likely to do better than most other people in dealing with what concerns you. We care more about that kind of correlation. We naturally have minds that think about tidal waves in California where they've never had one in modern California civilization. Can you imagine what a 60-foot tidal wave would do in California? There's nothing physically impossible in having a 60-foot tidal wave in an earthquake zone, which California is in. But it's never happened — at least, it hasn't in modern history. It is the kind of thing that we do think about, though.

WE TAKE DOWNSIDE RISK *VERY* SERIOUSLY — EVEN BORROWING MONEY TO INVEST....

Nobody worries more about the downside than we do.

Munger: Warren, do you think any other company has as much and as rigorous nuclear-and-so-on exclusion as we do?

Buffett: Well, I would say that nobody's attacked it any more vigorously than we've attacked it....

Munger: Yeah....

Buffett: Individually, we probably worry more about the downside than just about any manager you can find. Collectively, [laughing] it's Armageddon around here every day. But we *care* about that.

We're not even in favor of borrowing money....

Buffett: We've never used a lot of borrowed money. Back when I started out, I only had $10,000, but I just didn't want to borrow any significant amount of money. There's no *reason* to. We're living fine. We were living fine when I had $10,000.

The idea of risking what you need and is important to you for something that you *don't* need and is unimportant is just craziness. And we try to run Berkshire with that principle in mind.

I don't want our shareholders relying on Social Security.

Buffett: I had a 98-year-old aunt — my Aunt Katie — that died last year. She had everything she had in Berkshire. And the idea that I should be doing something to try and add a few dollars to my net worth or a few percentage points to the record and be risking the fact that she would have to go back to Social Security is, I think, kind of crazy for a manager.

Now maybe if I had a 2% and 20% arrangement with my Aunt Katie, [he laughs] I'd have behaved differently — but I *hope* not.

"FINITE" REINSURANCE IS A MISLEADING TERM. THE VAST MAJORITY OF INSURANCE IS FINITE.

"Finite" insurance is a misnomer. *Most* insurance is finite.

Shareholder: There's been much erroneous stuff written recently about finite reinsurance. Can you simply

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explain the product and its importance to Berkshire?

Buffett: Well, that's a good question — because the term, "finite" reinsurance, has been used a lot. And basically, almost *all* insurance is finite. If you have a $200,000 homeowner's policy, or a $100,000/$300,000 auto liability policy, that's a finite policy. The insurance company will pay you that much and no more.

With the exception of worker's comp — and maybe there's something else that I'm forgetting about — basically, all insurance is denominated in some amount with a limit. Similarly, that $500 million policy that we wrote on that airport — I mean, we could lose $500 million, but I don't think that we could lose $501 million. So I think the term "finite" has gotten to be convenient to use without anybody describing it very well.

Actually, when the SEC sent out its first request for information, I think they called it "nontraditional" insurance. And I think that that may be a better term to use in terms of what's being looked at.

There's nothing wrong with finite insurance per se....

Buffett: Of course, there's nothing wrong at *all* with finite insurance. We're issuing finite insurance policies every day when we issue auto policies and everything else. And there's nothing wrong, in my view, at all with retroactive contracts.

For example, a few years back (and this is very rough, but it's been in the press so I'm not violating the confidences of any clients) we wrote a contract as I recall (and I may be just a little off on this) to pay $2-1/2 billion of claims from the past when INA was being sold to ACE. And I think we got a premium of around $1-1/4 billion on it.

Now we were making an estimate, or a guess, as to whether the whole $2-1/2 billion would be paid, how fast it would be paid — a *lot* of things. ACE, on the other hand, was getting rid of $2-1/2 billion of potential liabilities. They didn't have the capital strength of Berkshire. And that contract went before the Pennsylvania Insurance Department and was approved. It had value to both parties. And you can argue that it had value to the public in that Berkshire was a stronger insurer.

And actually, in 2004's first quarter 10-Q, you'll see that we recorded a loss of $100 million because the payment pattern on that contract turned out to be faster than we anticipated. So there was clearly risk involved, although it was all retroactive — a *perfectly* proper contract in my view, and, I think, in anybody's view.

And in the future, we will do more of that business. In fact, we looked at a very, very big one here recently.

AND DOES INSURANCE SMOOTH EARNINGS? OF *COURSE* IT DOES — FOR *EVERY*BODY.

"Nontraditional" insurance is probably a better term....

Buffett: Understandably, what the authorities are looking for are contracts that had no purpose and were possibly misused by some party in the accounting. And the facts on that remain to be seen. But I think calling it "finite" — I just don't think that's the right descriptive word. Like I say, I think "nontraditional" is a better word for it.

Again, we issue nontraditional products all the time. Last year, I talked about the $1 billion contract we wrote for Pepsico. I mean, that certainly wasn't traditional, but it's real insurance.

The question is whether risk is transferred. And there were *several* risks on the ACE contract, for example: First, we had a risk as to whether the whole $2-1/2 billion would be paid, the second risk was how fast it would be paid, and the third risk was what we could do with the money in-between. And money hasn't been worth very much to us lately. So there was risk there. But that's what insurance is all about. Charlie?

But "nontraditional" is an imperfect term, as well.

Munger: Well, I certainly agree with you about the word "finite" reinsurance. You could hardly invent a worse word to use to describe a new class of insurance. It's a meaningless rubric. Of course, "nontraditional" is imperfect, too — because we have *traditionally* issued nontraditional insurance. [He laughs.] But we have to use some words to describe what's happening.

Of *course* insurance smooths earnings — for everybody....

Munger: There's no question that the corporate world has gotten more and more interested over the last 10 years in having regularity in earnings reports. And they've resorted to a *huge* variety of ways to try and do that.

Reinsurance is a very minor part of the whole picture. But there *has* been more reinsurance sought because people were more concerned with reducing volatility in their reported results.

Buffett: But of course, insurance is a way to reduce volatility — and it's a perfectly *proper* way. If you pay $1,000 a year on your auto premiums for the next 30 years, you are going to have a more regular income stream than if you self-insure — in other words, if you don't pay the premiums every year and you have one $25,000 accident in one year. So people have bought insurance to reduce the volatility in their own personal and business results. So reducing volatility, per se, is not bad at *all*.

Munger: Yeah.

Buffett: It's the reason there are $400 billion worth of insurance premiums paid in this country every year.

But there are also abuses of that. And that's what people are looking at to find out what the real situation is.

[Editor's note: As Tom Gayner of Markel Gayner Asset Management pointed out to us in our 12/31/04 edition.]

We don't know how every client accounts for reinsurance.

Shareholder: What obligation does a financial intermediary, or party to a transaction, have to ensure that the other party to the transaction properly accounts for it?

Buffett: Well, that question may come up [chuckling] in a very *real* sense. We obviously have lots of reinsurance transactions. Banks have lots of transactions with people. And certainly, if you are *knowingly* doing something that causes a company to do something improper — if you're participating in it — you may have very serious obligations on that.

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But on the other hand, we reinsure hundreds of companies. They have legal departments. They have auditors. And there could be somebody out there today... Well, they could be doing *anything* with their accounting. It probably wouldn't be limited to the contract they had with us — it might well be other things.

It's *probably* about knowing participation — for now.

Buffett: But I'd say it really gets down to whether there's knowing participation. Isn't that right, Charlie?

Munger: Well, as you say, it's a subject rife with ambiguities and different issues. You have had some bartender liability. If you serve a drink to somebody that's already inebriated, some people say the bartender is liable. On the other hand, radio stations in America are allowed to sell advertising time to people who use it for perfectly obvious fraud. And nobody ever sues the radio station.

It's very hard to predict what things are going to get legally shifted around so a supplier gets liability for his customers' behavior....

HOW CAN YOU IDENTIFY GREAT MANAGERS EARLY? THAT'S TOO TOUGH. SO WE'VE RARELY TRIED.

Predicting who will be a great manager? That's too tough.

Shareholder: I have a question related to a statement in this year's annual report, and I quote: "Our experience tells us that extraordinary business ability is largely innate."

If these characteristics are inherent, and you were to attempt to consistently identify future great managers or entrepreneurs before there's a track record, how would you go about doing it? In particular, is there a way to know before someone's made a lot of money and built a business they love and feel passionate about that they'll develop those types of qualities later in life?

Buffett: That's a terrific question. We've *dodged* it largely over the years by buying businesses from people where we've seen their record. I'm not sure I can go — in fact, I'm quite sure I *can't* go — to an MBA class of 50, and sit down and talk with each one, examine their grades and their extracurricular activities, talk to their parents, etc. and rank those 50 very well in terms of their potential for future business success. And of course, some of it would depend on what areas they entered into in business. So I think it's tough.

I think it's tough to go out to the practice tee where people are not actually hitting balls, but where they're just taking practice swings, and say which one is a 2 handicap, which one's a 15 handicap, and which ones could make it on the Tour. I think I could tell a little bit, maybe, but it's very hard to calibrate.

And I don't think we've had much success in doing that. But we also haven't *tried* very much to identify the people who will be superstars before they've had a record.

Identifying stars is easier once they've performed....

Buffett: We've taken the easy way. Somebody comes to us with a business that's done phenomenally well for 10 or 15 or 20 years — or maybe even for *50* years — and we've seen what their batting average is. So we've actually seen that they batted .350, or whatever it may be, in the Major Leagues. We just assume that we won't screw it up by hiring 'em, and that they'll live to be 100 — and we buy the business. That's far easier.

It's far easier to tell the great baseball batters after you've seen a couple of seasons of their batting in the Majors than it is to go to high school or even college baseball teams and try to pick out the ones who are going to turn into superstars....

BUT CERTAIN CHARACTERISTICS DO CORRELATE WITH SUCCESS — LIKE BRAINS & TEMPERAMENT.

One variable that may be useful in anticipating success....

Buffett: I wish I could remember where I saw this study, and it may not even be a valid study, but I recall seeing something many, many years ago where they tried to correlate business success with various variables. And they looked at grades in school, whether they got MBAs and all of that sort of thing. But what they found is that the best correlation with business success turned out to be the age at which they first started their own business. The people who got very interested in starting lemonade stands or whatever tended to correlate better with business success than any other variable they looked at.

[Editor's note: Buffett should know about starting one's first business early. According to Roger Lowenstein's excellent *Buffett, The Making of an American Capitalist*, "When [Buffett] was five, he set up a gum stand on his family's sidewalk and sold Chiclets to passersby. After that, he sold lemonade in front of [his friend and young business partner Bob Russell's family's] house, where the traffic was heavier."

And according to William Proctor's excellent biography of living legend John Templeton, *The Templeton Touch*, he started his own business even earlier — at age four — growing beans in his mother's garden and selling them to a local country store. And at age eight, he concluded that "because there was no fireworks store in his hometown, there was a vacuum in the market — and hence an opportunity for him. So John did a little research to see how he could buy quantities of fireworks at cut-rate prices, discovered a mail order outlet in Ohio, and soon, about a month in advance of each holiday, was ordering various kinds of fireworks and sell[ing] them to [his classmates] for five times [his cost]."]

Buffett: We've got a lot of MBAs running businesses for us, but they ran 'em for a long time before we hired them or before we made the deal. And we've got others that never set foot in a business school.

I tell students that what we're looking for when we hire somebody, beyond their passion, is intelligence, energy and integrity. And I tell them if they don't have integrity, the first two will *kill* you — because if you hire somebody without integrity, you really want them to be dumb and lazy, don't you? [Chuckling] The last thing in the world you

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want is for them to be smart and energetic. So we look for those qualities. And generally when we buy businesses, it's clear to us that those businesses are coming with managers with those qualities.

It's partially about the wiring and partially how you use it.

Buffett: I *do* think there's a lot to wiring. I think there's also a lot to working with the wiring you have and developing it over time. I don't think it's all innate. And I don't think you can't improve — *I know* you can improve — on what you're given at birth. But I do think an awful lot of it's in the wiring — more so than I would've thought 30 or 40 years ago. And I've certainly seen it in businesses....

There are people with no formal business training. Charlie never went to business school, but he thought about it. And I've never heard Charlie say anything dumb about business yet, except when he disagrees with me. [Buffett chuckles.] But the truth is I've never heard him say anything dumb about business *period*.

And there are other people. I have never heard Tony Nicely say anything dumb about business, *ever*. They're just wired so that it doesn't flicker. They get the right answers. It doesn't mean they'd be great ballroom dancers or great baseball players or great politicians, but they are wired for business. Charlie?

With the right temperament and intelligence, it's a shoe-in.

Munger: Part of it's intelligence, and part of it's temperament. I don't know if Bill Ginn is in the audience, but by the time I was 14 years of age, I knew Bill Ginn would be rich. He was a classmate of mine in high school, and a very intelligent man. And he *wanted* to be rich. And he was sensible in the way he handled life.

I think sensible people with the right temperament and the right intelligence, if they live long enough in our system, will get rich. But I think temperament is, to some extent, inherited, too. Don't you?

Buffett: Yep. His daughter, incidentally, is a partner with my daughter in a knit shop — String of Purls — which I hope you'll patronize while you're here. We've united the Ginn and the Buffett family. [He chuckles.]

Charlie and I shared an early interest in games of chance.

Buffett: Charlie, when did you first think business was something of interest to you?

Munger: Very early.

Buffett: Uh huh. [After a long pause, audience begins to laugh.]

Munger: I loved games of chance — and I loved trying to learn how to *win* at them.

[Editor's note: One of Buffett's enterprises as a youth was a publication with Bob Russell for those interested in gambling on horses entitled *Stable Boy Selections*. And Proctor writes that John Templeton paid 25% of his college expenses at Yale with his winnings from playing poker.

As Legg Mason Value Trust's Bill Miller frequently points out, investing is all about taking calculated risks.]

Buffett: Yeah, it's interesting for me simply to think about the question of whether the Final Four of the NCAA will be cancelled, as opposed to postponed or transferred in locale — and decide if we're going to pay out $75 million the next day if it *is* cancelled, how much we should be willing to receive today to take care of that. There are all kinds of people to whom that probably wouldn't be interesting.

And since my dad wouldn't let me become a bookmaker, I went into investments. [He laughs.]

UNREALISTIC EXPECTATIONS IS AN UNNECESSARY EVIL — A TERRIBLE MISTAKE THAT WE TRY TO AVOID.

We know *something*'s going wrong *some*place at Berkshire.

Shareholder: Apart from the catastrophic insurance events or Armageddon scenarios, what are your greatest fears with regard to the operations of Berkshire Hathaway?

Buffett: Well, we don't worry about the economics of the businesses we have. We've got a very diverse group. By and large, they're very good businesses. By and large, they're run by some of the best managers in the country. But we worry about something going wrong.... We've got 180,000 people out there. So I'll guarantee you something *is* going wrong someplace as we talk. That's just the nature of it. However, what you hope is that it's relatively unimportant or that we catch it. But that's something that we *know* will happen.

The idea is to minimize bad behavior, not *incentivize* it.

Buffett: We try to have a culture — and I think we *do* have one — that minimizes that. It's very important, in our view, to have the right incentives. And many places, we think, have incentives that aren't so good.

When I get on an airplane — and we own the company, like NetJets — the last thing in the world I want to tell the pilot is that I'm running late and I hope that we can get to New York a little faster. I mean, that is dumb to incent a pilot — who may be worried that somehow you'll affect his job or something — to get in a hurry about the takeoff or the checklist or whatever it may be. And companies do that time after time in their compensation plans — or in other ways where they incent people, in our view at least, to do the wrong things.

If our goal was to report smooth earnings, we could do it....

Buffett: That doesn't mean nothing wrong will happen under *any* circumstances. But you should not have a system, for example, that causes people to worry about quarterly earnings.

For example, our managers do not submit budgets to Omaha. In fact, I have no idea what we're going to earn next quarter. I don't put any implicit body language out there, or anything of the sort, to our managers that I'm hoping to earn X dollars per share in the quarter — because in the insurance business, particularly, if you write long-tail business, you can basically report any numbers that you want to for a short period of time.

We've got $45 billion of loss reserves. Well, who *knows* whether the right figure is $45 billion or $46 or $44? And if the desire is to report some given number in a given quarter, instead of saying $45 billion, you can say $44-3/4 billion or something of the sort.

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

That's not an incentive we want our managers to have.

Buffett: So we have no incentives in terms of how people are paid or in terms of the fact that they just don't want to let me down. Let's assume at the start of the year that I asked everybody to submit budgets — and then I went out on Wall Street and preached a bunch of numbers. Even if their compensation didn't depend on it, the managers would feel, "We don't want to let Warren down on this, so we'll take an optimistic view of reserves" — which is easy to do at the end of the quarter — "so he won't look like a jerk in front of Wall Street."

So we try to avoid that sort of thing. But even then, that is what we worry about. Charlie?

We just don't *need* the evil of unreasonable expectations.

Munger: If you stop to think about it, the history of much of what we don't like in modern corporate capitalism comes from an unreasonable expectation, communicated from headquarters, that corporate earnings have to go up with no volatility and great regularity.

That kind of an expectation from headquarters is not just the kissing cousin of evil, it's the blood brother of evil. And we don't *need* that blood brother in our headquarters.

That's a terrible mistake that we'll try to avoid.

Buffett: Businesses do not meet expectations quarter after quarter and year after year. It just isn't in the *nature* of businesses to do that. In our view, people that predict precisely what the future will be are either kidding investors or they're kidding themselves — or they're kidding both.

We've been around cultures, and sometimes we've even been on the board, where the ego of the CEO became very involved in meeting predictions which were *impossible*, really, over time. Everybody in the organization knew what these predictions were — because they were very public about it. They knew that their CEO was going to look bad if they weren't met. And that can lead to a lot of bad things.

Well, you get enough bad things anyway. But setting up a system that exerts financial pressure, psychological pressure, or both, on the people around you to do things that they probably really don't even *want* to do in order to avoid disappointing you — I think that that's a terrible mistake. And we'll try to avoid it.

One thing we're *not* worried about — making money.

Buffett: We don't worry about this place making money. We'll make money. And if we don't, it's my fault. That's not the problem. The problem right now, in addition to the one we just talked about, is deploying capital — and that's my job, too. I haven't done a very good job of that recently. But with a little luck — and a different kind of market situation — we will get a chance to do that....

RETAINING EARNINGS *HAS* BEEN THE RIGHT ANSWER.
BUT THAT DOESN'T MEAN IT ALWAYS WILL BE.

It's not about taxes, but returns on retained earnings.

Shareholder: With taxes today at 15% on dividends, how do you feel about declaring a dividend?

Buffett: Well, there's no question about the fact that dividends are lightly treated now for taxation purposes. But we've always said — and it's been true, to this point, at least — that even if there had been *no* tax on dividends, we would have followed an identical dividend policy. And that's because the test with us is whether we think we can retain a dollar and have it be worth in present value terms *more* than a dollar. If we can't do that, we should distribute any money that we can't utilize on that basis.

If we can't reinvest right, we *should* pay out large sums.

Buffett: And when the cash piles up like it has currently, you can say it's pretty dumb to hold billions of dollars when the rate of return was less than 1% after tax last year — and what are you doing for shareholders with that? And I would say that the burden of proof will certainly shift if within a few years we can't use a lot more money intelligently.

But if the time comes where we feel the present value of the earnings we retain is not greater than a dollar — and it *could* come, and, in fact, it's more likely to come when you get large like we are — then we should have a dividend. And we should not only have a dividend policy that's X% of earnings, but we should pay out very substantial sums.

With time, the burden of proof will shift to us.

Buffett: The test is whether the money can be used effectively within the business. So far, it has been. That doesn't mean it was yesterday or the day before. But so far, it's produced more than a dollar's worth of market value for every dollar retained.

Our directors meet Monday — and that'll be discussed. And if we sit here a couple of years from now and we haven't successfully deployed more cash, then I think that the burden of proof will have shifted dramatically to us to explain why we'd be retaining earnings at that point.

OUR CRITERIA FOR BOARD MEMBERSHIP IS DIFFERENT.
AND OUR APPROACH DOESN'T SEEM TO BE SPREADING.

Corporate America isn't emulating our approach to boards.

Shareholder: Recently, we have seen a number of corporate boards take forceful actions — Hewlett-Packard and Boeing, for example. We've also seen board members from WorldCom pay large amounts to personally settle lawsuits. Morgan Stanley is embroiled in a bitter battle, largely based on divergent views of how to govern the firm. What responsibilities do directors have in this new environment — and what do you look for in your directors?

Buffett: Charlie, why don't you take that one first?

Munger: Well, we are completely out of step with modern practices on directors. The modern practice is to have one from each diversity category — and to have a whole lot of people who *need*, more or less, the $100,000 or $200,000 per year that they're paid for being a director. And people think this makes the system better.

At Berkshire, all the directors are rich, and underpaid, and they own a lot of stock in Berkshire — and they're all very smart. And they don't get any liability insurance

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BERKSHIRE HATHAWAY'S
WARREN BUFFETT & CHARLIE MUNGER
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provided by Berkshire. So we've been waiting for our system to spread, [Buffett laughs] but we seem to be losing.

Dealing with mediocrity is a difficult problem for boards.

Buffett: It's a tough job at times to be a director. The *real* problem that you can face — and may often face — is when you're dealing with mediocrity. If you have a baseball team and you have a player on your team who's a .240 hitter, that .240 hitter in the Majors is still a pretty good baseball player. But if your job is to have a winning team, you get rid of him — and find somebody that can bat .280 or .290 and field just as well. In business, the tough part is to get rid of someone who's a notch or two above mediocrity, but not the best one that could be found.

However, when people meet every couple of months and come from different parts of the country — and they have the normal social instincts — they don't like to have rump meetings or sort of talk behind people's backs. So it's very difficult in a group — particularly if it's a group like Charlie described where the directors' fees for a significant number of them are important to their well-being, and they'd love to be recommended for another board and add *another* $100,000 a year to their income — for someone to lead a charge all of a sudden at a regular meeting or to try to arrange a rump meeting of some sort to say, "We think the guy at the head of the table is no good."

So dealing with mediocrity — or, like I say, a notch above it — is a difficult problem if you're a board member.

You have to save your bullets. And even then....

Buffett: We believe independence is a state of mind. It's a willingness, but not the eagerness, to challenge the ideas of others. And if you see a merger that doesn't make sense — and Charlie and I have seen a *lot* of 'em... And we've been on boards — and sometimes we've spoken up, and sometimes we haven't spoken up. But you feel that the group around you, in terms of social behavior, can only tolerate a certain amount of obnoxiousness on your part. So you have to ration it out. You save yourself for big ones. It's not necessarily an easy equation.

Certainly, of the major acquisitions I've seen proposed, I wouldn't do a significant percentage of 'em myself. On the other hand, would I try to overrule somebody else? Well, I probably wouldn't get the votes anyway — and it's a very difficult thing to do. You occasionally fire a bullet if you think it's important enough — but usually it doesn't do any good.

I think that we have the best board in the country.

Buffett: We have a group where every one of 'em has significant money invested in Berkshire. They all bought their shares in the market just like you did. I've been on all these boards, and they keep handing me things. I've had shares of this one and that one that were given to me, options, matching charitable contributions, or whatever — all *kinds* of things. But we have real owners on our board.

And what they make for being board members is really inconsequential, [chuckling] as I get reminded occasionally, compared to their investment. And they're friends of mine — and they're *very* smart. I mean, they are handpicked in terms of business brainpower and quality of human being. I think that we have the best board in the country.

There's no group I'd rather have in charge of Berkshire....

Buffett: But from the perspective of the people who want to make their evaluations by checklists, either in terms of diversity or in terms of supposed independence — although I don't know how anybody that's getting half of their income from board memberships can be independent — we may not stack up so well.

But it's the kind of board that I want to have knowing that if I die tonight, virtually everything I have goes to a foundation. I want my foundation to have as much money over the years to spend as possible. And there's no group of people I'd rather have in charge of the decisions subsequent to my death than the people who we've got on our board.

DIRECTORS SHOULD ACT LIKE THEY OWN THE PLACE,
AND BE WILLING TO LEAVE THE BOARD AT ANY TIME.

We listen closely to Bill Gates, but then decide ourselves.

Shareholder: It's traditionally been your philosophy not to invest in technology companies. But now that you have Bill Gates on your board, do you feel a little pressured? [There's a smattering of laughter among the shareholders.]

Buffett: All *kinds* of pressure. You can't imagine what he's insisting on. [He cracks up.]

No, the answer is that Charlie and I in managing Berkshire try to put money in things that we understand. And when I say "understand", I mean where we think we know in a reasonable way what the economics will look like in five or 10 or 20 years.

And although Bill is a lot smarter about a whole lot of things than I am, it's still Charlie and I who have the responsibility for managing the money. So we'll stick within what we consider to be our circle of competence. And the fact that somebody else's circle is wider or different — well, that's the way the world is.

But any idea Bill has, believe me, I will listen to — because not only is Bill a smart manager, he's also a smart *investor*. I think, actually, our ideas on investment overlap to quite an extent. But I still wish I'd bought a little Microsoft when I first met him. [He laughs.] Charlie?

Standard board policy today leaves much to be desired....

Munger: I think what has happened at Berkshire is wonderfully for the good. And I think we have a perfectly marvelous board. What makes me sad, as I said earlier, is I don't see more of the same practice followed elsewhere. A director getting — and *needing* — $150,000 a year from a company is not an independent director. That director automatically becomes an *inside* director. And so much new governance intervention is typical government intervention — it says that it's doing one thing, while it's actually doing another.

Buffett: Yeah. I've been on 19 boards. And I've never seen a director on any of the 19, where the director's fees were important to them, object to an acquisition proposal or a CEO's compensation. It's just never happened in my experience.

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BERKSHIRE HATHAWAY'S
WARREN BUFFETT & CHARLIE MUNGER
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They frequently do not behave as they would if they owned the place. And basically, we want people who behave as if they owned the place.

One qualification should be the willingness to resign.

Munger: The correct system is the Elihu Root system. Elihu Root, who had three different cabinet appointments, if I remember right, said no man was fit to hold public office who wasn't perfectly willing to leave it at any time. And if Elihu Root didn't approve of something the government asked him to do, he could always go back and be the most sought-after lawyer in the world. He had an identity to go back to — so he didn't need the government's salary.

Well, I think that also ought to be more the test in corporate directorships. Is a director really fit to make tough calls who isn't perfectly willing to *leave* the office at any time? My answer is no.

I hope the ASPCA isn't listening....

Buffett: One of our directors has been removed twice from compensation committees of other corporations because he had the temerity to actually question whether the compensation arrangement being suggested was the appropriate one.

As I've said before, when they put someone on the comp committee of American corporations, they're looking for Chihuahuas, not Great Danes and Dobermans.

Munger: [Chuckling] Yeah.

Buffett: And I hope I'm not insulting any of my friends that are on comp committees. [Buffett laughs.]

Munger: No. You're insulting the dogs. [The audience roars with laughter.]

A recent CEO survey only confirmed my suspicions....

Buffett: Oh, incidentally, it was mentioned about Bill Gates becoming a director. I've got a little survey here conducted by PriceWaterhouse and the *Financial Times*.... They asked CEOs around the world if they could pick anybody from history or today to join their company's board, who would they choose? And I'm happy to report that Bill came in #2.

Actually, #3 was Winston Churchill. Carlos Ghosn came in fourth. Jesus came in fifth. Napoleon Bonaparte was sixth. And I won't give you the rest of the list.

Munger: Who was #1?

Buffett: Well, #1 was Jack Welch — I knew you'd ask. But we didn't *ask* Jack, we asked Bill. Actually, I thought this was quite an interesting list — because I think many of the CEOs of the world would prefer people that are dead to be on their board. [Audience laughs.]

Shareholder: On that note, maybe a merger of some sort between Berkshire and Microsoft is in the works.

Buffett: I keep hinting, but it doesn't do any good.... [He laughs.]

THE ULTIMATE OUTCOME OF OUR TRADE DEFICITS?
PREDICTING *WHAT* WILL HAPPEN IS EASIER THAN *WHEN*.

Most economists expect a soft landing. Not Volcker and I....

Shareholder: In your annual report, you mentioned how the current account deficit or the trade deficit has to eventually come to an end. But in your report, you were reluctant to forecast *how* it would come down from $2 billion a day. Would you nevertheless be willing to share some of your thoughts on how it might come down?

Buffett: Well, that really is the $64 billion question.... Incidentally, Charlie's not as on board on this as I am — so it's important that you listen to him on this, too. However, it does seem to me that with a trade deficit of something around $618 billion, and an even larger current account deficit — rich as we are and strong as this country is — that *something* will happen that will change that in a major way at some point. And the longer that it goes before changing, the more likely it is that something fairly significant happens.

Meanwhile, most economists and most observers would still say some kind of a soft landing is possible. They'd even say it's *likely*. To my mind, they never quite explain what the soft landing is. They just say, "It's likely to be a soft landing. It could be something different, but we still think it'll be a soft landing." But I don't know what a soft landing is exactly in the sense of how the numbers come down quite significantly.

If they don't come down, the current account deficit means we're transferring more and more wealth abroad and that, in addition to our trade deficit, at some point, we'll have a very significant deficit in terms of the net investment position that the rest of the world holds on us. So it becomes a compounding effect.

I do recommend you read an April 10th op-ed piece in *The Washington Post* by Paul Volcker. He's expressed himself some on this. And he gets into the question of whether it can be a soft landing or not and expresses some real apprehension about whether a soft landing *is* the likely result.

I think more assets are on a hair trigger than ever before.

Buffett: In the kind of world we live in, I think as high a percentage of the assets of the world — whether they be foreign exchange contracts, stocks, bonds, junk bonds or whatever — is on what I would call a "hair trigger" now as has ever existed. In other words, I think there are more people than ever before that go to bed at night with a position in foreign exchange or bonds or a carry trade or stocks or whatever — and that some event that could happen overnight would cause them to want to change that position in the next 24 hours. I think that it's the highest, perhaps, in history.

Somebody's referred to it as the "electronic herd". People can give vent to decisions involving billions and billions and billions of dollars with virtually the press of a key. I think that electronic herd is at an all-time *high*. And I think some exogenous event, and we'll *have* them — it was almost Long-Term Capital Management in 1998 — could very well cause some kind of stampede by that herd.

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And lots of money on a hair trigger = potential trouble.

Buffett: So the creation of lots of new financial instruments and the piling up of huge amounts by intermediaries, or agency activities in terms of money management, increases the possibility of more explosive outcomes on any given day than might have been the case some years back when I was selling utility stocks, 100 shares at a time, to people in Omaha. That money was not on a hair-trigger.

But as you turn it over to fund managers who think their job is to beat the S&P on a short-term basis, you are getting very short time horizons on *huge* amounts of money. And those people may think they're operating independently in one sense, but they're responding to the same stimuli. And just as they did in the fall of 1998, they can all try to head for the exits at the same time....

If you're the rest of the world though, you can't get rid of dollars. If you're sitting in Japan or China or someplace and you own a lot of U.S. government bonds and you sell 'em to somebody in the U.S., the result will be that you get U.S. dollars. So you still have U.S. assets. If you sell 'em to somebody in France, you've now got euros, but they've got the U.S. government bonds. So the U.S. bonds remain in existence — but you can have people trying to head for the door very quickly with them under certain circumstances.

[Editor's note: Of course, that's a double-edged sword — with one man's hair trigger representing another's more-efficient-than-ever-before market. In fact, some might point to that kind of efficiency as one justification for a lower-than-usual risk premium and historically high levels of debt as well as part and parcel of the greater challenge faced today by Munger and Buffett to successfully invest Berkshire's retained earnings.]

Predicting *what* will happen is much easier than *when*.

Buffett: In the second paragraph of his op-ed piece, Volcker said, "Yet under the placid surface, there are disturbing trends, huge imbalances, disequilibrium, risks, call them what you will. All together, the circumstances seem to me as dangerous and intractable" — and I'd emphasize intractable — "as any I can remember. And I can remember quite a lot." Well, Paul Volcker *can* remember quite a lot. And I agree with him.

I have no idea on timing whatsoever. In economics, it's far easier to tell *what* will happen than *when* it will happen. You can know a bubble is developing, but one of the things you don't know is how big it will get — for example, as happened five years ago in the market. When it comes to predicting timing, I've never been successful at it — so I don't try to do it.

Predicting what will happen, I think, is a much easier sort of thing.

It's not an easy issue to explain, but it's an important one.

Buffett: And I'd say that what is going on in terms of trade policy is going to have very important consequences. It was not addressed in the last presidential campaign by either candidate in any meaningful way at all. Now if you were standing up in front of the American people, and someone was giving you three minutes to explain this whole situation, when 90% of your audience couldn't define "current account" — well, you know, it's not an easy game. But it's an important one.

OUR SYSTEM CAN WITHSTAND A LOT OF ABUSE, BUT EVENTUALLY OUR CHILDREN WILL PAY.

I do think that our system will *bear* a lot of abuse.

Buffett: Now Charlie is less enthusiastic about Berkshire's foreign exchange position — *somewhat* — than I am, so I want to yield the floor here for a significant period of time while he gives you the other view.

Munger: Well, if anything, I'm a little more repelled than you are by the lack of virtue in the way our nation uses consumer credit, and the way we run the public finances. And I have a feeling that eventually, a lack of virtue is going to hurt us.

Where we differ is that I agree with Adam Smith that a great civilization has a lot of ruin in it — and that it'll bear a lot of abuse. So while I think there are dangers in the current situation that make it unwise for anybody to swing for the fences, I don't think we have a certainty that the system won't stand a *lot* more of the kind of abuse it's getting now.

Buffett: What do you think the end will be?

Munger: Bad.

Buffett: [Laughing] I knew I could count on him.

We can sell a little bit of the farm every day for a long time.

Buffett: We are truly in this country like an incredibly — and I mean *incredibly* — rich family that owns, say, metaphorically, millions of acres of land. They can't see — they can't travel — to the outer reaches of their domain. Nevertheless, they sit on the front porch and wait for the produce to come in from this vast holding. And even when they get it all, they still want to consume about 6% more than everything that's been produced on the farm.

And they have the *ability* to do that by simply selling off a little piece of the farm every day and every year that they can't even see. So they don't feel any poorer at the end of the day, or at the end of the year — because as far as their eyesight can see, they still own everything that God ever created. And they can sell those little pieces or they can mortgage 'em. They can send IOUs to these people that are giving them the extra goods to consume.

We are a very, very, very rich family. We produce a whole lot, but we consume a little bit more than we produce. So we trade away a little bit of the farm — or put a little bit of a mortgage on it — every day.

It can go on a long time, but our children will pay....

Buffett: And the rest of the world is happy to take a little piece of our farm, or take a mortgage on it, because it's such a terrific asset — and we've behaved so well over the years. So they're willing to work a little harder to send us something so we can consume a little bit more than we produce.

It's been going on awhile, but it's accelerated a lot in the last few years. As a result, more and more, the rest of the world is owning part of us. And we're going to have to

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service that ownership — either through interest (if they took it in IOUs) or in some other way.

It can go on a long time. But if it goes on a long time, the world will own a good bit of us — and our children will be paying one way or another for the fact that we got to consume more than we produced....

I DON'T THINK IT BODES WELL FOR THE DOLLAR — OR A VERY STABLE SITUATION IN THE FUTURE.

It's hard to think of an outcome involving a rising dollar.

Buffett: You've obviously had *some* less interest in the rest of the world accepting dollars, demonstrated by the fact that the dollar's declined somewhat in value in the last few years. The investment in us is always going to be equal to the overconsumption. It's an equation. But if people get a little less enthused about one side of the equation, it gets reflected in the pricing mechanism. And the world has demonstrated a diminishing enthusiasm for dollars in the last few years as they get flooded with 'em — because we send a net $2 billion out every day, whether we like it or not, and whether *they* like it or not.

The question is, does that reach some tipping point at some point, or does some exogenous event come about that causes people to want to rush for the exits? Who knows? All I know is that I have a hard time thinking of any outcome from this that involves an appreciating dollar. But as Charlie will point out in just a second, there have been times when we've been surprised. Charlie?

Others disagree....

Munger: Well, the counter-argument is: what does it matter if the foreigners own 10% more of the U.S. if, at that time, the total wealth of the U.S. is 30% higher than it is now? And so people who have that point of view just roll with it.

And some of them think that if we didn't manufacture *anything* in the United States and just sat here running hedge funds, we'd have a wonderful economy — because it comports with their Republican principles....

I don't think a tribute-paying scenario is particularly stable.

Buffett: But back in the late 18th century, obviously, the idea of taxation without representation caused a certain amount of trouble. And ownership of this country by the rest of the world would be seen as a form of taxation, I think, 20 years from now by the people who resided here.

If instead of fighting the Revolutionary War, we'd simply made a deal with England and said, "We'll give you 3% or 5% of our national product forever if you let us be free — we'll just send the royalty over every day." — that might have looked like a good alternative to war in 1776. But I don't think that subsequent generations would have reacted well. Something would have happened over time.

I have a feeling that the idea of America paying tribute to the rest of the world because of the overconsumption patterns of a previous generation isn't a particularly stable scenario. And that's why we have only $21 billion in foreign exchange contracts. By the way, Charlie might have a little less, or maybe none, if he were running it entirely — and I might have somewhat more if I didn't know that I'd have him sitting up here next to me next year.... [He chortles.]

HOW WILL DEFICITS/EASY MONEY/ HIGH ASSET PRICE IMBALANCES UNWIND?

I'm not a pessimist. I expect our progress to continue....

Buffett: That said, I'm not an Armageddon-type at *all* on the U.S. economy.... Absent something happening in the terrorism field, I think that citizens of the U.S., on balance, will live better 10 years from now than they do at present — and better 20 years from now than they will then.

I do think we're following policies that are unwise. But we've done that plenty of times throughout our history. Peter Lynch said, "Buy a business that's so good that an idiot can run it — because sooner or later, one will." Well, we've got a country that's so good that we can have policies that are counterproductive — and we'll still come out okay.

Just think of what we've had over the years — Warren Harding, Chester Arthur. [He chuckles.] We've had a *lot* of things in this country — for example, we had a civil war, all kinds of things — over the years. But society has marched forward, with some fits and starts, but still at a very significant clip. The real GDP per capita is 7 times what it was 100 years ago in the U.S. Just think of that — one century in the human pageant had a 7-fold increase in GDP per capita. It's *remarkable*.

[Editor's note: In effect, that's been real GDP growth per capita of nearly 2% per year — another example, among many, of the power of compound interest and why it's considered by many to be the 8th wonder of the world. (I know that our lenders would agree.)]

I'm not pessimistic about the U.S. at *all*.

Buffett: So I acknowledge consumer debt doing what it's done, and the trade deficit being what it is. And I think that those things — particularly the trade deficit — should be addressed, and promptly. However, I don't think that they pull down the whole place. They may create *very* severe dislocations in financial markets from time to time.

But that's been the history of this country. We have had very dramatic things happen in financial markets over the years — and the country survives, despite that. And there's *likely* to be great opportunity in those dislocations.

So I'm not pessimistic about the U.S. at *all*. I can't imagine any place that I would rather be. However, when you ask me about the two most likely outcomes, I think the *eventual* outcome is that the country does fine. But I think that there's a significant possibility that you do have some chaotic financial markets at one time or another. However, again, we've had 'em historically....

IF A THING'S NOT WORTH DOING, IT'S NOT WORTH DOING WELL.

Currency speculation is a tough game. So is investing....

Shareholder: Given the U.S. trade deficit and its implications on the future value of the dollar, do you think an individual or a business owner here in the U.S. should

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be concerned about the purchasing power of his future dollar earnings or savings, and diversify his or her investments in non-dollar-based securities?

Buffett: I think it's very tough for individuals to either select individual stocks, select individual times to enter the market, or select currencies. I think that's a game that they tend to get interested in at the wrong time. There's some adverse selection in terms of when people who do not follow stocks carefully get interested in stocks.

[Editor's note: Of course, there's a great deal of this phenomenon in most, if not all, investment asset classes.]

The best investment for most people is in them*selves*.

Buffett: I think the best investment most people can make is in themselves. When I talk to students, in many cases, I would be glad to pay them $100,000 cash up front for 10% of their future earnings. So if I'm willing to pay $100,000 for 10% of 'em, I'm valuing the present value of the whole person's earning potential at $1 million — just in terms of their capital value standing there in front of me.

So anything you do to develop your own abilities, or your own business, will probably be more productive than starting to think about individually making commitments into foreign exchange. If you have a good business in this country earning money in dollars, you'll do okay. You may live in a world 20 years from now where a couple percent of the GDP is going to service the debts and the ownership that we've created now by running these deficits. But you'll do fine in America. So I wouldn't worry about that much. Charlie?

Asset allocation is not our game. Finding bargains is.

Munger: Well, if you look at Berkshire, you'll find that it really doesn't do much conventional asset allocation into categories. We are looking for opportunities — and we don't much care what category they're in. And we *certainly* don't want to have our search for opportunities governed by some predetermined, artificial bunch of categories.

In this sense, we're totally out of step with modern investment management. But we think they're wrong.

Buffett: And incidentally, we have 80% of our money or more — *well* over 80% — tied to this country and to the dollar. So it's not like we've left the country or anything of the sort.

Munger: When have you done a big asset allocation strategy?

Buffett: Never.

[Editor's note: Of course, some would suggest that Buffett was doing asset allocation when he went to cash and short-term securities in the late 1960s and again, more recently, with his big bet on a declining U.S. dollar. But he would no doubt argue that the first was not based on his macro view, but rather an inability to find bargains — and that his current bet against the U.S. dollar is, in effect, a hedge given such a high percentage of his assets are dollar-based.]

Our asset mix is bargain driven — by company, not class.

Buffett: We end up with peculiar asset mixes. If the junk bond thing had gone on a little longer, instead of having $7 billion in there, we might've had $30 billion in. But we were doing that simply based on the fact that it was *screaming* at us.

And we do the same thing with equities. For many years, we had more than the net worth of Berkshire in equity positions. But they were cheap.

[Editor's note: The search for bargains may distinguish Buffett and Munger from most on Wall Street more than you might think. Sequoia Fund's late, great Bill Ruane told a story about a conversation he heard between a group of institutional analysts at a food company conference in the mid-'80s that spotlights the difference as well as any:

One analyst observed, "I understand that there's this very smart guy out in Omaha, Warren Buffett, who's been buying General Foods."

"Yeah, I saw that, too," chimed in another. "What do you make of that?"

"I don't know. Maybe it's cheap," replied the first.

That was probably with the stock in the $40s. But Ruane said there probably wasn't a buy recommendation from a single major institutional firm at the time.

And yet it was probably obvious to any damned fool who was paying attention at the time — even your editor — that the company was worth 50% of sales at the very least. (Philip Morris had already paid *80%* of sales for Kraft.) Well, of course, within two or three years, General Foods was acquired by Philip Morris (now Altria Group) at almost exactly 50% of sales — or $120 per share.

In effect, Buffett was looking for bargains. Wall Street was apparently looking for something else at the time — presumably the maximum possible commission volume.]

Why Ben Franklin turned the mantle over to Charlie....

Munger: And I want you to remember one of my favorite sayings as you do this asset allocation: If a thing's not worth doing at all, it's not worth doing well.

Buffett: [He chuckles.] You can see why Ben Franklin turned the mantle over to Charlie.

YOU CAN LEARN A LOT ABOUT BUSINESSES
JUST BY WATCHING THEIR PRICING DECISIONS.

The impact of high commodity prices? It depends....

[Oak Value's] Matt Sauer: Many businesses are reporting rising costs and surcharges on such inputs as fuel, metals and wood. They are often unable to pass along these costs to their consumers. If commodities stabilize at price levels above those of the past decade, will corporate margins be compromised into the future?

Buffett: Well, that's a great question — and I'd say that that would depend very much on the industry you're talking about. But in our carpet business, for example, we've just been hit time after time — as I mentioned in the annual report — with raw material increases, because there's a big petroleum derivative factor there.

(continued on next page)

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

And we have lagged in terms of being able to put through those increases to our customers simply because we want to protect Nebraska's Furniture Mart for those who have ordered for a reasonable period of time. So that's squeezed margins in carpet. And we use lots of natural gas at Johns Manville and Acme Brick — and that's tended to squeeze margins some.

So there's been a lot of inflation in basic materials — for example, steel has been off the chart. But I think over time, the businesses with strong competitive positions manage to pass through increases in raw material costs, just as they pass through increases in labor costs.

Long term, higher oil prices are a tax on the consumer.

Buffett: But you get these temporary situations where sometimes costs are increasing faster than you can pass 'em through. When we import 10 million barrels or more of oil a day, if we're paying $20 or so more per barrel than we were a year or two ago, that's $200 million a day. That higher cost for oil is a tax. But it's probably more of a tax on the American consumer than on American business — because the American business will probably be able to pass through most of those raw material cost increases.

That said, I think profit margins are more likely to decline.

Buffett: Corporate profits as a percentage of GDP are right at the all-time high — leaving out a few aberrational periods. And if I had to bet on the direction of corporate profits as a percentage of GDP over the next five years, I would bet they would go down somewhat — but that's because they're at this *very* high level.

Interestingly enough, while corporate profits as a percentage of GDP are at this very high level, corporate taxes as a percentage of total taxes raised in America are very close to an all-time low. So American business has managed to pull off a situation where they're making extremely good profits and paying, historically, a very small percentage of the total tax bill in this country. And I'm not sure whether that could or should or will continue.

But it's a very, very favorable period right now for corporate America. But that's nothing to get bullish about — because you might expect something of a reversion to the mean.

[Editor's note: An expectation which has also been expressed recently (in no uncertain terms) by GMO's Jeremy Grantham and Century Management's Arnie Van Den Berg.]

SEE'S PRICING POWER WAS OBVIOUS —
AND NEWSPAPERS' (AND BEER'S) *USED* TO BE.

We like businesses with untapped pricing power.

Buffett: Charlie?

Munger: Well, I can't add to that, but I can restate it. It's hard to know just which companies can pass through the increases in costs that come from higher commodity prices — and it's also *important* to know.

Buffett: We like buying businesses where we feel that there's some untapped pricing power. We haven't been able to do much of that lately. But back in 1972, when we bought See's Candy, I think they were selling it at an average price of around $1.95 a pound.

And they were selling 16 million pounds of candy a year, making $4 million pretax. And we finally settled on a $25 million purchase price — which I would have very foolishly refused to budge on, and as a result would have cost us a lot of money.

But one of the questions we asked ourselves — and we thought the answer was obvious — was, "If we raised the price 10¢ a pound, would sales fall off a cliff?" And of course the answer — in our view, at least — was, "no". There was some untapped pricing power in the product.

And newspapers *used* to have pricing power....

Buffett: It's not a great business when you have to have a prayer session before you raise your prices a penny. You're in a tough business then. And I would say you can almost measure the strength of a business over time by the agony its managers go through in determining whether a price increase can be sustained.

Frankly, a good example of that is the newspaper business right now — because 30 years ago the local daily had an absolute lock on the economics of the community, because it had the megaphone through which sellers had to talk if they were going to get their message across to their audience. At that time, both circulation and advertising rate increases were something that were almost a big yawn to most publishers. They did it annually. They didn't worry about whether Sears, Wal-Mart, Penney's or whoever would pull their advertising. They didn't worry that people would drop their subscriptions to the paper. And they went merrily along increasing prices.

And they increased 'em when newsprint went up, and they increased 'em when newsprint went down. And it *worked*. They got these very fat profit margins. And it looked like about as strong a business as you could imagine.

But the world has changed for newspapers.

Buffett: Now publishers *agonize* over rate increases — both in advertising and circulation — because they worry about driving away advertisers into other media, and they worry that when people get a 20¢ circulation price increase per month or whatever it may be, they'll decide to drop it. And when they drop it, they don't usually take it up again. So that world has changed.

And you could recognize the change in that world simply if you could get inside the mind of the publisher in terms of how they felt about price increases. You can learn a lot about the durability of the economics of a business by observing the price behavior.

And it may be changing in the beer business....

Buffett: We were talking about the beer business. It's moved up in price every year, but there've been some rollbacks in certain areas in the last year — which means that it's getting a little bit more difficult to increase prices, even though they increase them at rates below inflation. That's not a good sign for the economics of the business....

(continued on next page)

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

THE NYSE SHOULD BE AN EXEMPLAR, NOT A CASINO. FOR-PROFIT NYSE WON'T BE AS GOOD FOR INVESTORS.

I prefer the Exchange of yesterday....

Shareholder: As someone who visited the New York Stock Exchange at a very early age, and who's been touting its merits over the years, could you comment a little bit on what you think of the shenanigans that have occurred?

Buffett: The New York Stock Exchange ... has done a very good job over centuries. It's one of the most important institutions in the world. But the enemy of investment performance is activity. And the creator of profit in a profit-minded Exchange *is* activity.

So I personally would rather not have an exchange that wants to increase its earnings per share annually and, thus, is motivated to encourage people to trade more actively to create more income for itself. That will not, in my view, be good for the American investor. So the Exchange of yesterday may be better for the American investor than the Exchange of tomorrow....

It shouldn't be against the long-term interests of investors.

Buffett: The profit of an exchange — the profit of the people working on it — in a sense is the frictional cost of capitalism. That's coming out of the earnings of the businesses. And IBM or GM or General Electric will not earn more money because their stock turns over more frequently — but a for-profit exchange *will* earn more money. And I do not like the idea of the Exchange getting on the side that's against the long-term interests of investors. Charlie?

The NYSE should be an exemplar. We've lost our way....

Munger: Well, on this one, I feel the same as you do — only much more strongly. I think we have lost our way when people like the governors of the Stock Exchange and the CEO fail to realize that they had a duty to the rest of us to act as exemplars of the right behaviors. Once your activity is that freighted with public significance, I think you've got a duty to create the right *appearances*. You have a duty as an exemplar.

You don't want your first grade teacher to be fornicating on the floor or drinking booze in the classroom. Similarly, I don't think you want your stock exchange to be all over the headlines because of its wretched excess. And I certainly don't think that you want to turn the country's major stock exchange into even more of a casino than it is already.

I think we have *totally* lost our way on this stuff. [Audience applauds.] And I agree with Warren that it ought to be a public institution that cares deeply about its duties as an exemplar.

Buffett: I wish I'd gone to first grade where he did. [Buffett chortles. Audience quickly breaks out in laughter, followed by Buffett and Munger doing the same.]

[Editor's note: In a speech Munger gave on June 21, 2004 at Stanford University to a group of senior executives and directors of publicly-traded companies, he expanded on this notion of business leaders as exemplars:

"One of the things that's been horribly underdone is the concept where the military equivalent is conduct unbecoming an officer. When you rise to a certain point in a civilization, you ought to have a duty to behave as an exemplar. When is the last time you heard in a boardroom, 'Is this consistent with our duties as exemplars?' I mean, the very *word* has an antique ring to it — 'exemplar'. But that's exactly what is horribly lacking.

"And everybody can see that that's what's required. The military concept of conduct unbecoming an officer is an important one. Your duty is to not cause resentment and envy and a lot of other things. You have a big duty as an exemplar."]

POOR CHARLIE'S ALMANACK IS A SENSATIONAL BOOK. IT WILL TEACH YOU A WHOLE LOT ABOUT LIFE.

Peter Kaufman has made it easy for you.

Shareholder: Could Charlie Munger create a curriculum, or a reading list, which he believes would lead to his concept of worldly wisdom?...

Munger: Well, of course, Peter Kaufman has tried to do that in that book that he stitched together out of my old speeches — plus a lot else. And I didn't want to do it. But he went and saw Warren — and Warren got enthusiastic. Warren was the one who suggested this ridiculous name: *Poor Charlie's Almanack*. And between the two of them, they got me to do it. But the whole idea of doing it was just the motivation you're talking about.

I think if you assimilate everything in that simple book, you'll know a lot more than about 95% of your compatriots. And it's not that hard to do. So Peter Kaufman has made it easy for you.

Poor Charlie's Almanack is a sensational book.

Buffett: I couldn't be more enthusiastic about what you suggested — and it's been done. It's a sensational book. Anybody that reads it is going to learn a whole lot about life. And to get you to read it, I'll tell you that you'll even learn something about making money. [He laughs.]

Incidentally, we have *Poor Charlie's Almanack* next door in the exhibition hall. It's an absolutely terrific book. And I think it's going to be a huge seller long after most books have been forgotten. It's Charlie at his best — and Charlie's at his best *most* of the time. It's a real gem.

On the subject of education....

Shareholder: Speaking of education, can you share with us any thoughts about the various ideas that have been suggested to reform education and improve literacy?

Buffett: Well, my friend Bill Ruane, who I believe is here, is doing something extraordinary in terms of a program he has teaching kids to read. In fact, journalists who are here should seek Bill out and learn something about the story of what he's done in the last 10 years in terms of moving reading abilities — and kids' *enthusiasm* for reading, which is more important. I talked about our managers — that the important thing is that they have a passion for their business. Well, a passion for reading *can*

(continued on next page)

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

be developed. And Bill has shown that in his programs.

I think he first started them in Harlem. He sort of adopted a block and went from there....

[Editor's note: For more on Ruane's extraordinary accomplishments — both on and off the investment field — please turn to pages 63 and 64.]

GEICO'S BEEN A GREAT INVESTMENT, BUT ANOTHER ONE WAS EVEN BETTER.

Two investments that provided Buffett with huge returns....

Shareholder: What's been the single best investment of your careers — and why do you consider it to be the best (excluding Berkshire Hathaway itself)?

Buffett: Well, probably the best investment, if you're talking about business, was getting Charlie as a partner. And he works cheap, too. [Buffett laughs.]

You can't measure it by dollar terms, because obviously we're doing bigger things now than early on. But See's was an *enormously* important part of our success. It doesn't contribute a huge percentage of our net income now, but it provided income that let us buy other things in the past. And it taught us a lot of lessons about business — all kinds of things.

It's hard to beat the first half of our GEICO investment....

Buffett: In terms of what it's done already, and where it's going to go over time, the single best investment was probably the first half of GEICO, which we purchased for $40 million. Now the second half cost us $2 billion. I'm glad I didn't buy it in *thirds*. [He laughs.] But that $40 million for half the company will turn out very well.

Some of our businesses have growth potential and some don't. However, we don't require growth potential if a business makes good money and we can use that money to buy other businesses. One of the advantages of the Berkshire system is we have a tax-efficient and kind of frictionless way of moving money to the best opportunities.

But GEICO still has enormous possibilities for internal growth.

The single most important piece of advice I give students....

Buffett: Incidentally, I watched that movie — and I kept touting the American Express card. But here is our GEICO card, which I'm sure all of you are eligible for. And I don't advise people using credit cards to revolve, but the truth is that people *do*. So use a GEICO card if you're going to behave in an irrational way.

If you're going to charge anything, I still advise you to pay off your account before it starts revolving. I think it's a *terrible* mistake for people to get hooked on revolving credit at high interest rates. That's the first thing I tell students — if they don't remember anything else that I say, just don't fool around with charge cards and run up balances that keep getting larger and larger.

But GEICO has well over 6 million customers now. We entered New Jersey last year — and we're adding very rapidly there. It's a great, great business model. And it's run by a superb human being and businessman, Tony Nicely. And I think that the company still has huge potential. But I love 'em all.

And don't forget Ajit Jain....

Munger: But GEICO, after all, cost $2 billion for the second half — and a significant number of tens of millions for the first half.

Now the search expenses that brought us Ajit Jain — now *there* was an investment that really paid a dividend. I can think of no high-return investment that we've ever made that was better than *that* one. [Audience applauds.]

And I think that's a good life lesson — in other words, getting the right people into your system can frequently be more important than anything else.

IT'S A STRETCH TO CALL WHAT WE DO "OVERSIGHT". OUR SUCCESSORS CAN DO NOTHING JUST AS WELL.

We just find great players and let 'em play.

Shareholder: I think it's rare for diverse collections of businesses to be successful. An important part of Berkshire's success has been your skillful oversight of your subsidiaries. What advice would you give your successor in managing our diverse portfolio of businesses?...

Munger: Our success at Berkshire hasn't come from our oversight of the subsidiary companies. It's come from our *lack* of oversight of the subsidiary companies. And I think our successors will be able to provide the same wonderful lack of oversight that we have provided.... [Audience laughs.]

Buffett: We haven't succeeded because we have some great, complicated systems or magic formulas we apply or anything of the sort. What we have is just simplicity itself. We take people who know how to play their game very well — and we let 'em play....

So far, so good. And it should work for a very long time.

Buffett: It doesn't require some great business insight or anything like that in terms of whoever's running this place to keep that kind of machine in motion. It's not complicated.... I don't think it will be the most difficult job in the world to keep this engine going down the tracks at 90 miles an hour. I mean, it isn't like they'll have to create a system. They'll *inherit* it.

Munger: I think that the Berkshire system will work very well after we're gone....

Buffett: Yeah, I think that we've got something here that'll work for a very, very, very long time.

—OID

As always, the preceding has been reviewed and lightly edited by Warren Buffett, Charlie Munger (and *OID*) and printed with their permission.

A MEMORIAL & CELEBRATION OF THE LIFE OF SEQUOIA FUND'S WILLIAM J. RUANE

On Wednesday, November 2nd, family, associates and friends gathered at St. Paul's Church in New York in order to remember and honor the late, great Bill Ruane — who passed away on October 4th. Among those speaking about Ruane in the service — A Memorial & Celebration of the life of William J. Ruane — were daughters Paige and Lili, original partner and long-time friend Denis Kelleher, and long-time friends Linc Cornell and Thomas Murphy.

The recollections which follow were delivered by Murphy and included some thoughts about Ruane provided to Murphy by Warren Buffett for that service.

TOM MURPHY: THE RECORD IS VERY CLEAR — BILL RUANE WAS AN ANGEL AMONG MEN.

I think what Warren Buffett wrote captures Bill best....

Tom Murphy: Bill Ruane was a man who excelled at many things. He built an immensely successful company. He was a committed philanthropist. And he was a man who was deeply devoted to his family. This morning, I would like to talk about something *else* that he did well — and that was being a friend.

I met Bill in 1947 at Harvard Business School. And I was fortunate to have him as a friend for 57 years. In 1970, Bill introduced me to his good friend, Warren Buffett, and the three of us spent a lot of time together over the years.

In thinking about what I would say this morning, I asked Warren for some thoughts, as well. What he wrote so captured Bill that I thought I would begin with that.

It was futile to try to do as much for Bill as he did for us.

Murphy: Warren wrote, and I quote:

[Warren Buffett:] "I first met Bill in Ben Graham's class more than 54 years ago. There were 25 to 30 people in the class, and we met only once a week. So almost all of the names of my fellow students have faded from memory, but Bill stood out as an exceptional mind and an exceptional human being.

"We hit it off immediately, and began a friendship that grew stronger every year. One of the great joys of our friendship is the ripple effect. Many of Bill's best friends became mine, as well. The reverse was also true. This ever-enlarging group of shared friends enhanced the lives of *both* of us in a wide variety of ways — trips together, laughs together, and mind-blowing experiences together.

"All of us had one common experience — [that] it was futile to try to do as much for Bill as he did for us. He simply had no desire for the books to be balanced. Instead, he delighted in thinking of a new way to help or entertain me, my family, or his other friends before we had a chance to reciprocate for his last act of generosity."

In philanthropy, he never sought recognition, only results.

Murphy: Warren points out in his letter that the circle of those who benefitted from Bill extended far beyond Bill's friends. Warren said, and I continue quoting:

[Buffett:] "When I wound up my partnership at the end of 1969, as a personal favor to me, Bill formed the Sequoia Fund in order to handle many of my partners who were at a loss as to what to do next. It was not at a time of his choosing. And both he and I felt that prices were high, and that opportunities were few. We were right. And Bill suffered for five years with the burden he had taken on.

"Now, 35 years later, his stewardship has paid off in a huge way — and I often get thanked by friends and members of my family for steering them to Bill.

"And when good fortune came to Bill, after the difficulties of the early '70s, he spent that fortune in ways that were both intelligent and imaginative to help the less fortunate. In philanthropy, he never sought recognition; he only sought results.

"Kay Graham, who time after time thanked me for introducing her to Bill, had it right. She called him a saint — and he most assuredly was."

Murphy: I certainly agree with Kay Graham and Warren about that.

He had an unwavering commitment to helping poor kids....

Murphy: My personal relationship with Bill evolved over the last few years because of my connections to Save The Children, and Bill's desire to teach children how to read. Let me give you one example of how Bill operated:

I invited a group of friends to join our table at the Save The Children annual dinner. Bill and Joy came. And Bill took home the annual report. The next week, he called to tell me that he had read the report cover to cover. In it, he saw another opportunity to help children.

Bill had an unwavering commitment to building a better life for poor children. For him, education — in particular, the ability to read — was the pathway to a positive future. Bill decided to help Save The Children educate children in some of the most poor, most remote, rural locations in this country — places like Appalachia, and the Mississippi River Delta. He became a generous supporter of Save The Children's rural literacy programs. He gave them major contributions to fund programs in several of the neediest states. Typical of Bill, he checked on the children's progress, and regularly made suggestions on how we could improve the programs.

Those programs have made a real difference in the lives of thousands of children in need. And all of this was self-generated by Bill from picking up an annual report at a dinner.

The record is very clear....

Murphy: The better I got to know Bill, the more that I realized just how special he was. He was unassuming, approachable and easy to like — the eternal optimist who had no sharp edges. And he was committed, always, to helping others. Bill was simply a wonderful guy.

Over the past year, Bill and I visited quite often on the phone. As I look back, I started making those calls thinking I would pump him up, or take his mind off things. The fact is, that's what Bill ended up doing for me.

Shakespeare could have been writing about Bill when he wrote, "Now cracks a noble heart. Good night, sweet prince, and flights of angels sing thee to thy rest." — because the record is very clear. Bill Ruane was an angel among men.

—OID

BOB GOLDFARB, DAVID POPPE AND TERENCE PARE, SEQUOIA FUND

"Ruane, Cunniff & Goldfarb mourns the passing of our beloved founder, William J. Ruane, a great money manager, a greater friend and the softest touch that Wall Street has known....

"Bill was an unusual capitalist, as he cared deeply about building up the funds entrusted to him by his clients, but very little about compounding his own. Bill looked for perfection in businesses and could wait patiently, sometimes for years, until he found the right stocks at the right prices. But if he had a cool eye for the market, he kept a warm heart for people. He wanted to improve the world around him and, in his energetic way, launched a number of entrepreneurial philanthropies. He cared deeply about education and mental health issues and took personal interest in people he helped, especially children. He derived satisfaction from reading annual reports, but he took true delight reading the improving report cards of youngsters he'd sent to school on scholarships. He could bend your ear on the subject of the capacity of disadvantaged children to learn. Then he'd smile and buy you a beer. He took his work seriously, but not himself.

"Yeats wrote of the choice between perfection of the work or of the life. Bill was the rare man who never had to make that choice. He was exuberant, an optimist, and happy in the way that only a truly good man can be. He built a firm that was more like a second family, which grew over the years with new members astonished at their good fortune to have arrived in such a comfortable home. He respected every employee, rewarded hard work handsomely and endeavored always to strengthen the fabric of the firm.

"He was without guile, with no trace of meanness in him. He insisted that there be nothing mean in the way that the firm did business. The slogan, 'First Class Business in a First Class Way' may be borrowed, but Bill proved that possession is nine-tenths of the law. He leaves us a precious legacy, which we treasure: a commitment to do right by clients, by employees, and by our own best selves."

A Memorial and Celebration of the life of William J. Ruane — November 2, 2005

Dear Subscriber,

All of us at *OID* were shocked and saddened to learn of Bill Ruane's passing. What always stood out most to us was his extraordinary humility. We'll never forget how he generously agreed to be one of our first speakers at the Harvard Business School Club Breakfast of Champions series. At that event, he talked about his good fortune to be in the money management business, because otherwise, he said, he would have been the world's worst engineer. And he used to say that there was really no difference between him and Warren Buffett — "other than $X billion of net worth and 100 points on the I.Q. scale". To us, he represented the living incarnation of the word "gentleman". It was truly an honor and privilege to have known him.

We thought that one of the best ways that we could pay our respects to Bill would be to include some recollections from two of his oldest and best friends — Tom Murphy and Warren Buffett — that Murphy delivered at Ruane's November 2nd memorial service (see page 63).

Going from the sublime to the ridiculous, a saying to which we've long ascribed is that "a man's reach should exceed his grasp". But when we published our last edition, we had not intended to become Exhibit A in the counterargument against that proposition. However, we're sad to say, it appears we've managed to do exactly that.

Still, while being overly particular does have its costs, we'd like to believe it has its benefits, too. For example:

•Bill Miller of Legg Mason Value Trust fame talks about why he's so much more optimistic than most, and some of the areas where he's finding the best values today.

•Greenlight Capital's David Einhorn talks about an idea in what may be the most out-of-favor sector in today's market and why he believes that pessimism is overdone.

•Longleaf's Mason Hawkins talks about what's enabled his firm's flagship fund to go from over 26% cash as of year end 2004 to *zero* percent cash at December 31st, and why they're excited about their prospective returns.

•And last, but never least, Berkshire Hathaway's Warren Buffett and Charlie Munger share some of their perspectives on a wide variety of topics — including why they're finding it so hard to find intelligent things to do.

As for our next edition, rather than jinx it, let us simply say that we hope we'll be sharing it with you sooner (insert heartfelt prayer here) than we've all come to expect.

In the meantime, happy hunting.

Until next edition,

Henry J. Emerson

Your Editor

P.S. Thank you for your patience and your support.

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