

# Outstanding Investor Digest

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

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December 31, 1999

O/D MAILBAG: BAUPOST FUND'S SETH KLARMAN &  
FAIRHOLME CAPITAL'S BRUCE BERKOWITZ  
"WITH SO MANY CHOOSING NOT TO THINK,  
IT'S A GREAT TIME TO BE A VALUE INVESTOR."

In their latest letters, Seth Klarmen of Baupost Fund and Bruce Berkowitz of Fairholme Capital seem to be reading from the same page. Both are amazed at the virtual disconnect between underlying values and stock prices in today's two-tiered market. And both are particularly excited about the bargains they're finding today.

We hope you find their letters and some of the ideas that they include as interesting and valuable as we do.

(continued on page 2)

LONGLEAF PARTNERS FUNDS'  
MASON HAWKINS, C.T. FITZPATRICK & STALEY CATES  
"BOUTS OF MARKET FEAR AND COMPANY SHORTFALLS  
HAVE CREATED COMPELLING OPPORTUNITIES."

Accounts managed by Southeastern Asset Management, the advisor to Longleaf Partners Funds, handily outperformed just about any index you might want to consider during the 19 years ended December 31, 1998 — earning a compound return of 19.5% per year versus 17.7% and 14.8% per year for the S&P 500 and the Ibbotson Small Company Index,

(continued on page 14)

WESCO FINANCIAL'S CHARLIE MUNGER &  
BERKSHIRE HATHAWAY'S WARREN BUFFETT  
"WITH THIS MUCH MANIA, PROMOTION AND UPROAR,  
MUCH OF IT WILL PROVE TO BE FOOLISHNESS."

Wesco Financial Chairman Charlie Munger is credited by his partner at Berkshire Hathaway, Warren Buffett, with opening his eyes to the virtues of buying excellent businesses and being the second greatest influence on him (after Ben Graham) investment-wise, among other things.

Munger's comments at previous annual meetings of 80.1%-owned Berkshire subsidiary Wesco Financial have been replete with piercing and witty insights regarding

(continued on page 26)

ENTERPRISE FUNDS'  
MARIO GABELLI & BILL WITTER  
"BETTER PROSPECTS + VERY ATTRACTIVE VALUATIONS  
= AN EXPLOSIVE UPSIDE FOR THE RUSSELL 2000."

Enterprise Small Co. Growth Fund portfolio manager Bill Witter and small cap portfolios managed by Enterprise Small Co. Value Fund's portfolio manager, Mario Gabelli, have handily outperformed the small cap indices during the three years, five years and ten years ended 12/31/98. For example, equity-oriented, tax exempt accounts managed by Witter and small cap accounts managed by Gabelli earned a compound annual return of 16.1% and 15.6%, respectively, versus 12.9% for the Russell 2000 during that 10-year period.

(continued on page 63)

**OID MAILBAG:**  
**FAIRHOLME CAPITAL'S BRUCE BERKOWITZ**  
 (cont'd from page 1)

HE WHO LAUGHS LAST LAUGHS BEST.  
 AND WE EXPECT TO BE LAUGHING AGAIN.

These have been frustrating times. But we're optimistic...

"Graham and Dodd [value] investors are people who place a very high value on having the last laugh. In exchange for the privilege, they miss out on a lot of laughs in between."

Michael Lewis, author of *The New New Thing*, a chronicle of the start up of new technology companies associated with Jim Clark, one of the founders of Netscape Communications.

**Bruce Berkowitz:** The last 18 months have not been fun. We have watched our companies perform as businesses and languish as stocks. During the same time, extreme popularity has been conferred on technology companies — many with short or mediocre operating histories.

We empathize with any frustration you have over the short-term price behavior of our companies (as owners of the same securities, we should).

However, we want to remind you why we're excited about the future:

- Our companies are quality businesses with proven histories.
- Our companies are selling at bargain prices.
- Our companies are run by successful managers who are significant shareowners.
- Our companies and their managers respect their fellow shareowners.
- Our companies use conservative accounting.

There's a disconnect between our stocks and our companies.

**Berkowitz:** The recent price performance of our companies does not reflect their business performance. Stock price declines are "mark-to-market" declines, not permanent losses.... We believe the intrinsic value of our companies has increased, not decreased, over the last year. And the longer it takes their value to be recognized, the larger our future profits will be.

Furthermore, if Mr. Market continues to insist on placing low prices on our companies, we will buy more. This is how we've made lots of money in the past.

Dreams have temporarily displaced analysis.

**Berkowitz:** Watching the high-tech fireworks unfold has caused us to miss a lot of laughs in the last two years. Dreams have temporarily displaced analysis. But, eventually, numeracy will return. The high-tech gold rush is a dangerous game which we've been unwilling to play.

However, we own terrific companies at bargain prices. So we expect to laugh again.

[Editor's note: FPA Paramount's Bill Sams tells us much the same thing. He says it's much more fun being a growth investor than a value investor. He says growth investors are happy about their stocks most of the time —

until the bloom comes off the rose, whereas value investors are miserable most of the time until their companies finally clean up their messes and the clouds finally lift.

Therefore, he suggests, value investors should factor the expense of periodic psychoanalysis into their process.]

OFTEN BEING A VALUE INVESTOR ISN'T EASY,  
 BUT IT'S USUALLY REWARDING (EVENTUALLY).

Our approach has yielded large profits without large risks.

**Berkowitz:** The entire history of Fairholme and its investment managers is intertwined with the concepts of intrinsic value and margin of safety. We define intrinsic value as the present value of free cash generated by a corporation over time or the value that would be received should the company liquidate its assets and distribute the proceeds to shareholders. We define margin of safety as the discount from intrinsic value at which we can purchase part of a company for you.

In the past, holding tightly to these concepts has allowed us to make large profits without large risks in ... Berkshire Hathaway, Wells Fargo, Household International, Fund American, Freddie Mac and MBIA.

Frustrating times often signify opportunity — e.g., Wells.

**Berkowitz:** However, there have been times when our performance lagged badly. In 1991, for example, we began buying Wells Fargo at between \$52 and \$78 per share and watched it trade down or sideways for nearly two years. It would have been easy to become discouraged. Instead, we bought more. In fact, during this period, we made many purchases.

However, when the Company merged with Norwest [on 11/2/98], the last sale was \$374. (Wells split 10 for 1 after the Norwest merger ... and the merged company has since traded as high as the equivalent of \$498 per share.)

[Editor's note: At year end, Wells Fargo traded at the equivalent of \$400± per share (on a pre-split basis).

Of course, long-time OID subscribers (and editors) gratefully recall Berkowitz pounding the table for Wells in our November 11, 1991 edition with the stock trading in the mid-\$60s and again in our November 25, 1992 edition with the stock back down once more to the mid-\$60s.]

Employing our strategy isn't easy patience-wise.

**Berkowitz:** We want to be greedy when most are fearful and fearful when most are greedy. In virtually every case where we've had wonderful investment success, we bought quality businesses during times of distress and low valuations. In many examples our initial purchases showed losses — and we averaged down. Eventually, we wound up with large positions which rose to multiples of our purchase price.

However, this strategy is not an easy one to employ. It requires patience, more patience — and, sometimes, even more than that. It requires a commitment to dig deep into the business and to understand the business as well as the managers running the company.

But we're committed to this strategy and won't stray from our circle of competence because many are profiting from other strategies which we believe have high risk.

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**OID MAILBAG:**  
**FAIRHOLME CAPITAL'S BRUCE BERKOWITZ**  
 (cont'd from preceding page)

**TECHNOLOGY BUSTS ARE NOT A THING OF THE PAST.  
 TODAY'S HI TECH VALUATIONS CAN'T BE SUSTAINED.**

**Profits and competitive analysis don't seem to matter.**

**Berkowitz:** We are not strangers to new technologies and their potential impact on the world. In our business, we make extensive use of technology. Yet, whenever we've looked at some of these companies as potential investments, we've found a huge gulf between the valuations of the companies providing these new technologies and the value of their products and services. At present, the only thing that seems to matter is what these companies do rather than how much money they make or whether or not they face serious competition.

...There are good businesses in the technology sector run by honest and talented managers. But in our view these possess no margin of safety. We question whether they will ever generate the significant profits needed to justify their current market prices. That we felt this way a year ago makes us even more unwilling to take these risks with your money or ours.

**They're untested companies at unsustainable valuations.**

**Berkowitz:** In our view, it's illogical for us to compare our companies to ventures whose competitive advantages, if any, may not persist. Our companies have proven their worth by successfully facing many competitive challenges and varied economic conditions. Most of the popular newcomers have yet to experience even so much as a single economic downturn.

Of the internet companies that went public this year, about one-third paid more in investment banking fees than they booked in revenue during the previous twelve months. A group of 133 internet companies which have recently come public have a combined market value approaching \$500 billion — or more than 30 times revenues — and combined losses of more than \$3 billion.

These are extraordinary figures. And in our opinion, these valuations cannot be sustained.

**There will be a shakeout. And we might even profit from it.**

**Berkowitz:** In prior letters, we have discussed our concerns about the poor quality of earnings where companies have issued large numbers of stock options, written off research and development expenses, and undertaken extensive restructuring charges. Rest assured that there will ultimately be a shakeout in this area in which poor companies fall by the wayside and in which long-term competitive advantages become clear. In fact, one day, we may even wind up owning a great technology company at the right price.

*(continued in next column)*

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We recently sent you an article describing the experience that followed the purchase of speculative securities during prior technological boom periods involving automobiles and aviation. Over the years, there have been other stock market excesses in specific market sectors such as radio in the 1920s, uranium in the 1960s, oil in the late 1970s, biotech in the 1980s and, now, technology in the 1990s. Despite participating in rapidly growing industries that changed society in major ways, many of these new companies wound up failing completely — leaving shareholders with nothing.

**And technology busts are not a thing of the distant past.**

**Berkowitz:** Don't think that this has only happened in the distant past. A company called Iridium was formed only a few years ago to provide satellite telephone service worldwide. The company's major backer was Motorola — the well known and deep-pocketed semiconductor and cellular phone manufacturer. It had excellent technology, no direct competition, and the right backers. So how could it lose? Yet, not long ago, the company filed for bankruptcy — and the Bloomberg news service recently reported that common stockholders are expected to receive nothing.

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**SO FAR, GEN RE HAS HURT BERKSHIRE'S RESULTS.  
 BUT WE KNOW WHY. AND THIS, TOO, SHALL PASS.**

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**In our view, the future (of our holdings) looks bright.**

**Berkowitz:** We own the same investments you own. Our goal in managing money for you is simple: to create and increase your wealth and ours while avoiding permanent losses. Our investment criteria have not changed. In prior investments, these criteria have earned us high returns. And we see no reason why our existing investments should not prove as rewarding. In our view, the future looks bright.

We hold major positions in Berkshire Hathaway, Household International, and Mercury General. Mercury, in particular, now appears to be an extraordinary bargain. These are companies with excellent businesses with fabulous histories of shareholder returns. They use conservative accounting that typically understates income and balance sheet strength. They're run by talented and honest managers. They generate real cash earnings to benefit owners. And they're currently bargain-priced.

We've also provided a brief note on Leucadia National which is paying an additional distribution at year-end.

**Berkshire Hathaway's earnings have always been volatile.**

**Berkowitz:** Throughout its history, the quarterly earnings of Berkshire Hathaway have always been volatile. There are several reasons for that volatility — among them being the variability in short-term insurance profits, the uncertain timing of the realization of capital gains and the costs of growth that Berkshire tolerates for future benefit. In addition, the company treats shareholders as co-owners, reporting results as honestly as accounting allows without any attempt to smooth quarterly results.

**And earnings were hurt by several non-recurring events.**

**Berkowitz:** Berkshire's reported earnings for the  
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**FAIRHOLME CAPITAL'S BRUCE BERKOWITZ**  
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third quarter of 1999 were below our expectations due to continued underwriting losses at Gen Re. So far this year, Gen Re has recorded the worst underwriting results in the company's recent history. However, we think the overall results were affected by some one-time factors.

- Stock option plans were converted to cash incentives at significant cost.
- Under Berkshire, Gen Re appears to have adopted more conservative policies regarding the recognition of profit.
- Gen Re appears to be reducing costs substantially, immediately expensing these efforts rather than capitalizing them or reporting the often-used "restructuring charge".

Plus, we see signs of a recovery in reinsurance.

**Berkowitz:** However, the nature of insurance, particularly reinsurance, is to have poor quarters followed by great quarters. In other words, its profits are lumpy. And we've seen signs recently that reinsurance rates are starting to rise and Gen Re is refusing marginal business much as Berkshire's other reinsurance units have behaved over the years.

In any case, given Gen Re's long history of profitable operation and sizeable float generation, we see little evidence to suggest that its recent results represent any serious threat to the long-run economics of this business.

**GEICO'S GROWTH LOWERS BERKSHIRE'S EARNINGS, BUT IT'S CHOSEN TO INVEST IN GEICO'S GROWTH.**

The faster GEICO grows, the worse its reported earnings.

**Berkowitz:** There is another very important factor currently affecting Berkshire's short-term earnings. Berkshire has chosen to have certain of its businesses grow rapidly. It is tolerating lower short-term earnings for significantly higher future profits. Among the subsidiaries in this position are GEICO, FlightSafety, and Executive Jet.

We know that the cost to acquire new business in the auto insurance sector can be 25-30¢ in losses per \$1 of premium in the first year. But in the second or third year of the policy's renewal, the same customer will generate a profit of close to 10 cents per \$1 of premiums. Therefore, \$1 billion of new business can cost \$300 million in foregone profit at the same time \$4 billion of old business earns \$400 million — yielding a net profit of \$100 million. At its current premium level of roughly \$5 billion, GEICO is foregoing roughly \$250-\$300 million of reported profits to grow at its current rate.

But remember Berkshire's chosen to invest in its growth.

**Berkowitz:** The current decision to grow despite reporting hundreds of millions less in profits is quite possibly reducing Berkshire's market value by \$5 billion. On the day growth slows, reported profits will start to skyrocket. In five years, Berkshire's valuation could suddenly increase by \$15 billion — or \$10,000 per share — attributable to GEICO's more visible earnings alone.

And remember that Berkshire has chosen to invest in

GEICO's growth by foregoing the higher profits generated by a mature business. Certainly, the company would not be investing in that growth without the expectation of considerably higher future profits. These characteristics make Berkshire's current reported profits considerably less than its economic profits.

And Berkshire's float is increasing quite nicely, thank you.

**Berkowitz:** With the exception of the shoe segment (H.H. Brown, Lowell, and Dexter), the rest of the businesses owned by Berkshire are performing well. The company has close to \$20,000 per share in cash and bonds and continues to generate sizeable amounts of cash. The major equity holdings have increased in value since the end of September by close to \$3,000 per Class A equivalent share. And during the latest quarter, Berkshire's float grew by close to \$2 billion.

**EVEN IF ITS HOLDINGS ARE OVERVALUED,  
 BERKSHIRE HATHAWAY IS CHEAP....**

With Berkshire comes \$8,000/share of operating companies.

**Berkowitz:** During the quarter, Berkshire Hathaway committed to invest approximately \$2.5 billion by announcing the acquisition of a well-known regional furniture retailer in New England and a large electric utility holding company. These pending acquisitions, along with investments made in the other operating companies, are rarely considered when people look at Berkshire. We estimate their current value to exceed \$12 billion (including recent purchases) — or about \$8000 per share.

Even if its holdings are overpriced, Berkshire is cheap....

**Berkowitz:** Below is a chart laying out our current valuation of Berkshire. We've tried to be conservative in our presentation. Note that the low end of our valuation range incorporates a value for Berkshire's stock holdings more than \$10 billion below their current market value. In effect, by placing a lower than market value on its largest investments, we've priced in a decline of about 40% from current market prices for the major holdings of Berkshire.

In our opinion, this worst-case view should remove investor concern about the effect of a stock market decline on Berkshire's intrinsic value. And keep in mind that a significant stock market decline would also provide enormous opportunities for Berkshire which holds large cash and bond positions and which consistently generates large amounts of free cash which must be invested.

[Editor's note: Fairholme Capital's analysis — which arrives at a valuation range for Berkshire of between \$62,000 and \$73,000 per share — is detailed on page 5.

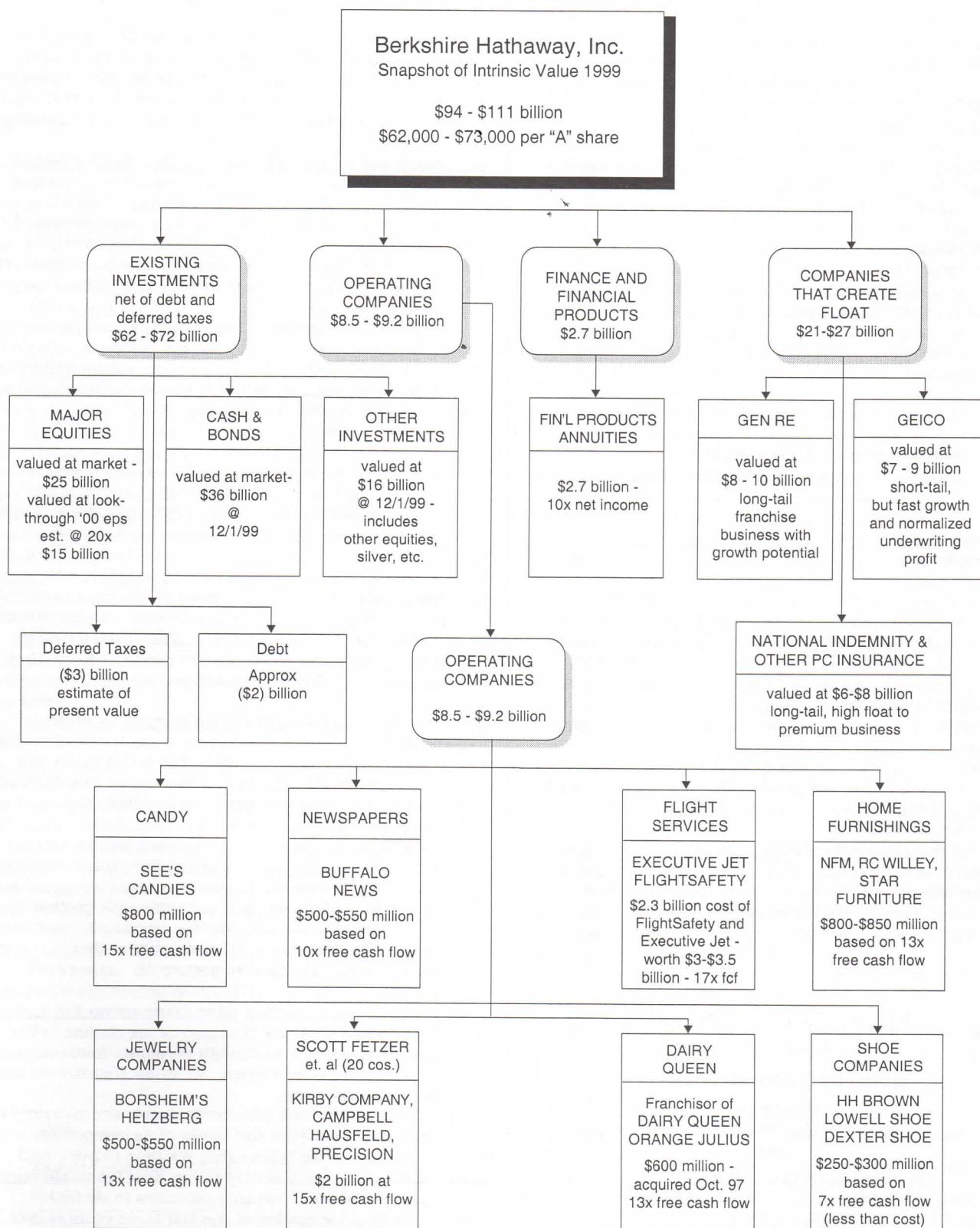
Incidentally, the analysis does not incorporate the impact of Berkshire's acquisition of MidAmerican Energy or Jordan's Furniture. However, Berkowitz informs us that the impact of those acquisitions would be to slightly increase Fairholme's estimate of Berkshire's value per share.]

Berkshire's an extraordinary company at an ordinary price.

**Berkowitz:** It's worth reviewing some of the history of Berkshire — which is clearly one of the most unusual and rewarding businesses created during the last 50 years. [If you look at a chart of the growth of Berkshire's book value

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**OID MAILBAG:**  
**FAIRHOLME CAPITAL'S BRUCE BERKOWITZ**  
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Source: Fairholme Capital Management

(Mailbag continued on next page)

**OID MAILBAG:**  
**FAIRHOLME CAPITAL'S BRUCE BERKOWITZ**  
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and stock price over the last 15 years relative to the S&P 500, you can readily see that Berkshire's business strategy has produced incredible rewards for its shareholders. Should Berkshire's future be even half as attractive as its past, we'll do very well.

In previous letters, we have explained in some detail how we believe Berkshire's business model functions. Through the generation of low cost float, Berkshire creates funds available for investment that leverage its returns on shareholders' equity.

Berkshire is an extraordinary company selling at a very ordinary price. It has tremendous resources and exceptional management. If the company continues to create low-cost float and generate modest after-tax returns of 10% on its investments over time as we expect (far below its historical experience), we'll earn high returns from current prices.

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HOUSEHOLD'S STOCK HAS DISAPPOINTED,  
 BUT ITS BUSINESS CONTINUES TO DO FINE.

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The stock isn't performing, but the business is doing fine.

**Berkowitz:** Household continues to generate stellar quarterly results. Its revenues are growing, its profits growing faster and credit quality remains high. The company has delivered on virtually every promise it's made over the last four years. Management (as well as ourselves) is highly disappointed at the performance of its stock. But every indication we have says that Household's business is continuing to perform to expectations.

Household has a long history as a profitable lender to the asset-poor consumer. It serves a segment of the population for which borrowing is a necessity, not a choice, and has done so since the 1880s. This is a business with staying power and the proven ability to grow.

And with these results, its stock shouldn't be languishing.

**Berkowitz:** During the latest quarter, Household's core receivables grew by \$2.4 billion. All of its product lines grew in the quarter with the strongest growth occurring in home equity loans. Quarterly branch-originated growth

(continued in next column)

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was the best in the company's history. Household's net interest margin widened to 8.4%. During the quarter its fee income rose 9.5%. And expenses as a percentage of revenues reached record lows — improving to 32% compared to 37% a year ago.

Cash basis EPS for the quarter rose 25% to \$.90 per share from \$.72 per share for the third quarter of 1998. And its return on equity reached 25.3% for the quarter and 22.2% for the year-to-date. These are not the results of a company whose stock price you'd expect to be languishing.

One way or another, Household's stock is headed higher....

**Berkowitz:** In April of 1998, we wrote to you about Wells Fargo and the fact that the stock price had been stagnant. In that letter, we said "If Wells does not succeed [after the acquisition of First Interstate], then another institution may buy them." Several months later, Norwest acquired Wells. We now believe that Household is in a similar position.

Household continues to repurchase shares in significant amounts. Last quarter, the company acquired nearly nine million shares at an average price of \$40.55. We expect these repurchases to continue at current prices. The current stock price is a bargain.

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AN EXTRAORDINARY BARGAIN WE'RE EXCITED ABOUT —  
 THE BEST UNDERWRITER, A SUPER FUTURE & A P/E OF 6.5.

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At 6.5+ times 2000 earnings, it's an extraordinary bargain.

**Berkowitz:** At its current price of \$22 per share, Mercury General's shaping up as an extraordinary bargain. It's now trading at approximately 8 times 1999 earnings — and possibly as low as 6.5 times estimated 2000 earnings. Very simply, we're excited about this company.

Bad news for auto insurers is usually good for Mercury.

**Berkowitz:** As more and more stress has surfaced in the auto insurance business, Wall Street has cast a pall over the industry. And Mercury's stock price has declined substantially since we first began to purchase shares nearly six months ago.

We've seen significant earnings disappointments. Mercury's results last quarter were slightly below our expectations. However, we believe Mercury's strengths far overshadow one mildly weak, but significantly profitable, quarter — especially considering that previously, bad news for Mercury's competition has been a signal that Mercury's growth was about to accelerate.

Price cutting is over. In fact, price hikes are on the way.

**Berkowitz:** We know that part of the decline in the stock price has nothing to do with corporate fundamentals, but with investor tax strategies. We know that there's been tax loss selling pressure.

But when the stock of a terrific insurance company is knocked down because of the losses of its competitors and tax-related selling, we believe that it's time to buy. And accordingly, we've been adding to our position in Mercury.

Furthermore, our research indicates to us that industry-wide price cutting of the last three years is over.

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**OID MAILBAG:**  
**FAIRHOLME CAPITAL'S BRUCE BERKOWITZ**  
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We continue to see signs that the auto insurance industry is on the verge of *raising* prices. Several companies — among them Safeco and Progressive — have announced their intention to file for rate increases or already sought higher prices.

Mercury remains the best underwriter among its peers.

**Berkowitz:** In our view, consistent underwriting profits are the hallmark of a well-run insurance company. And Mercury remains the best underwriter among its peers. In other words, it's consistently earned profits selling insurance before adding earnings on investments created by the insurance sales.

Below is a [table] of the Earned Premiums, Net Worth, and Net Earnings of Mercury for the last 10 years.

Over the past decade, its net worth has grown 20%/year.

**Berkowitz:** Note that the 1994 decline occurred as a result of the Northridge earthquake in California and that the 1999 decline occurred as rate cuts which were put into place 18 months ago flowed through the income statement.

Over the last decade, Mercury has increased its earned premiums by about 11% annually and its net profits by roughly 16% annually. Its net worth has grown close to 20% per year during the same period — during which time its return on equity has averaged close to 20%.

Mercury's well run. And its excess capital won't be wasted.

**Berkowitz:** It seems like almost every time we learn something new about Mercury, it reinforces our view that the company's well run, positioned properly and ready, willing and able to capitalize on opportunities in its markets.

Furthermore, George Joseph's operating Mercury with at least \$300 million of excess capital on his balance sheet. Over the next two years, we expect a significant portion of this capital to be used to repurchase shares and expand the business of Mercury to other geographic locations — including a continuation of its recent efforts in Florida and Texas. We expect Mercury to succeed in becoming a nationally known insurer over the next decade — mirroring its success in California where its market share has increased every year for the past 10 years.

We expect to see its stock price back above \$70....

**Berkowitz:** Only about 18 months ago, Mercury's common stock traded north of \$70 per share. At its current price of less than \$22, Mercury conservatively

appears to be selling for less than 8 times 2000 earnings despite its significant growth prospects. And it sells at a modest premium to book value — which we think is itself conservatively stated.

It has a dividend yield of about 4% — and we believe its dividend will be increased next year. And we continue to buy with the expectation that we'll see its share price back above \$70 within a reasonable time.

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WHAT'S TO LIKE ABOUT LEUCADIA? SHARE BUYBACKS, INCREASED INSURANCE ACTIVITY AND SMART MGMT.

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It's ramped up insurance activity & kept up share buybacks.

**Berkowitz:** Leucadia appears to have stepped up its level of business activity in recent months as it purchased a sub-prime automobile lender and increased its interest in MK Gold, a diversified mining company.

The company continues to repurchase shares around the \$21 per share level (equating to \$33 before the extraordinary distribution) and has announced that it will pay another partial liquidating payment at year-end of \$1.58 per share. These distributions have sharply reduced our total dollar investment in Leucadia, but will positively impact future returns.

In Joe Steinberg and Ian Cumming we trust.

**Berkowitz:** The investing environment of the last couple of years has been quite unfriendly to Leucadia's historical strategy of purchasing businesses with temporary problems or large contingent liabilities. Consequently, the company elected to distribute a sizeable portion of its huge cash position, which resulted from the sale of Colonial Penn Insurance to General Electric.

Nevertheless, Leucadia still has one of the best records in American business for creating wealth. We still believe that Joe Steinberg and Ian Cumming will create additional value for us.

We remain confident about the future of our investments.

**Berkowitz:** Finally, despite our recent frustration, we remain confident about the future of our investments.... We've examined our companies in detail and cannot possibly give justice to our knowledge in a few brief pages. As fellow owners, we want you to understand why we're comfortable owning our companies and why we feel we feel excited about their future performance.

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(Mailbag continued on next page)

10 Years of Mercury General

(All \$)	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999E
Earned Premiums	472.4	477.3	473.5	455.5	474.1	529.3	616.3	754.7	1,031	1,121	1,300
Net Worth	176.5	219.4	277.2	353.7	450.3	457.2	565.2	641.2	799.6	917.4	1,020
Net Earnings	33.8	51.5	65.5	83.3	96.2	66.3	90.3	105.8	156.3	177.5	148.0

**OID MAILBAG:**  
**BAUPOST FUND'S SETH KLARMAN**  
 (cont'd from page 1)

**OPPORTUNITIES AS ATTRACTIVE AS ANY WE'VE SEEN AND UNPRECEDENTED (UNWARRANTED) EXTREMES.**

Opportunities as attractive as any we've seen this decade.

**Seth Klarmen:** The Baupost Fund completed its year ended October 31, 1999 with a gain of 8.29%. This result, while profitable, is disappointing to us, especially coming on the heels of last year's decline. We remain determined in our pursuit of good absolute returns with limited downside risk.

The valuation extremes of today's market have resulted in opportunities as attractive as any that we've come across in the past decade. We believe that the extremely compelling valuation of our current holdings\* augurs well for strong investment results with limited risk in the months and years ahead....

Ironically, we got hurt because we didn't speculate....

**Klarmen:** Simply put, we're navigating through an unprecedented market environment where fundamental analysis has been thrown out the window and logic has been turned on its head. We underperformed in 1999 not because we *abandoned* our strict investment criteria, but because we *adhered* to them; not because we *ignored* fundamental analysis, but because we *practiced* it; not because we *shunned* value, but because we *sought* it; and not because we *speculated*, but because we refused to speculate. Ironically, we got hurt by *not* speculating in the U.S. stock market.

Avoiding the crowd is essential for long-term success.

**Klarmen:** Occasionally we're asked whether it would make sense to modify our investment strategy to perform better in today's financial climate. Our answer, as you might guess, is: "No!" It would be easy for us to capitulate to the runaway bull market in growth and tech stocks — and foolhardy and irresponsible and unconscionable.

It's always easiest to run with the herd. At times, it takes a deep reservoir of courage and conviction to stand apart from it. Yet distancing yourself from the crowd is an essential component of long-term investment success.

Baupost has employed a value approach to investing because it is, above all, risk averse and focused on preserving capital over the long run. This approach demands discipline and patience. Discipline is required to buy only bargains and sell fully-priced holdings and to avoid becoming swept up in the enthusiasm of the herd. Patience is required to wait for just the right opportunities, avoiding the pressure to make investments that don't meet the most stringent criteria of quality and undervaluation — and then to hold on, allowing an investment sufficient time to come to fruition.

Market's full of unprecedented (& unwarranted) extremes....

**Klarmen:** The stalwart performers of today's market trade at higher valuations than any of the bull market favorites of yesteryear. The major stock market indices are,

by virtually all measures, extremely overvalued. Never before have companies that have strung together growth for a few years (or quarters) in earnings (or sales) been valued at such high multiples.

And never before has the gap between the in-favor few and the out-of-favor many been so great. A few hundred in-favor growth stocks lift the market averages while thousands of out-of-favor companies trade at bear market valuations. The disparity between the market favorites and everything else has never been greater.

**INVESTORS ARE DUMPING THEIR CHEAP STOCKS TO TRY THEIR LUCK IN THE HIGH-TECH STOCK CASINO.**

Don't be fooled. The indices haven't been representative....

**Klarmen:** It is not just *our* portfolio which has lagged. A recent article in the *Wall Street Journal* explained that although the Nasdaq 100 Index is up over 74% year to date, the average Nasdaq stock is actually down on the year. Just about every day on the New York Stock Exchange, there are more stocks making new lows for the year than new highs, usually many times more, even though the major market indices are all at or near record high levels.

Indeed, on Friday, December 3rd — by no means an unrepresentative day — the Dow Jones Industrial Average surged 247 points, the S&P 500 Index jumped 1.7% (to a record level), and the Nasdaq 100 Index rallied 2% (also to a new high). Yet, on that same day, only 99 stocks on the New York Stock Exchange made new highs for the year, while 200 posted new yearly lows!

On December 10th, all three indices once again rose sharply. On the New York Stock Exchange, however, only 85 stocks made new highs, while 339 hit new lows. Then, on December 15th, the Dow, the S&P and the Nasdaq indices all rose sharply. But that same day, a mere 49 NYSE stocks made new highs while a whopping 455 posted new lows.

Investors are cashing in their stocks to buy casino chips.

**Klarmen:** It's hard to imagine a worse environment in which to assess the merits of a value investing approach (nor, ironically, a more favorable environment in which to practice it).

The gravitational force of the Internet and technology stock bubble is exerting a strong pull on investors' assets. Money is being drained from other sectors of the market into these strongly performing sectors causing share prices of more mundane companies not merely to underperform, but actually to decline.

Like a gambler withdrawing his or her savings for a trip to Las Vegas, investors are literally dumping their conservative shareholdings at giveaway prices in order to try their luck at the technology stock casino. The effect is a wild skewing of investment performance. For example, from January 1st through December 13th, 1999, the technology-heavy Nasdaq 100 Index rose 74.8% versus 15.2% for the more balanced S&P 500 Index.

One explanation — the increasing popularity of indexing.

**Klarmen:** There are several unusual forces at work in the U.S. stock market and in major stock markets worldwide which are important to understand. First, there's been a

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**BAUPOST FUND'S SETH KLARMAN**  
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decade-long increase in indexing activity, where more and more money is either overtly or tacitly invested to mirror the performance of market indices, especially the S&P 500. The view is that investors on average can't beat the market (a tautology since they *are* the market). So they shouldn't even bother to try — especially given that trying will result in transaction costs and management fees and could itself result in market underperformance.

Many investors have found these arguments persuasive, especially in combination with a steady stream of academic arguments trumpeting the merits of owning stocks over the long-term compared to other asset classes.

Of course, it's actually been a self-fulfilling prophecy....

**Klarman:** Finally, there's been a protracted, in effect self-fulfilling prophecy at work, as inflows into the indices lift their components at a faster rate than most other stocks — thus leaving the impression that an indexing strategy could actually outperform over time. For example, the recent inclusion of Yahoo, Inc. into the S&P 500 Index caused a 67 point (24%) one-day gain and a one-week \$19.1 billion valuation enhancement to Yahoo's already generous market capitalization....

WHAT INVESTORS WANT, THEY'LL GET —  
 UNTIL THE CHICKENS COME HOME TO ROOST.

Today's investment mentality is bizarre....

**Klarman:** A second factor contributing to today's lofty market valuation is the cult of growth and momentum investment strategies — a bizarre emphasis on the trend of a company's results rather than on the absolute level of its performance. To this way of thinking, no price is too high to pay for a company that is rapidly growing and there is no price worth paying for a company that is not.

I heard about a recent business school discussion where an entire class of students expressed a preference to own Microsoft (at 60 times earnings and 20 times revenues) rather than General Motors (at less than 10 times earnings). One student indicated he wouldn't buy General Motors at one half or even one fourth of its current price. The professor asked if there were any price at which he might prefer General Motors. The student started to reply in the negative, hesitated, and then allowed that he might take it were it offered for free. This so perfectly captures today's investment mentality.

What investors want, investors get. Managers see to it.

**Klarman:** Investors are particularly enamored with companies which are able to post long records of unflagging earnings growth. Companies which do so achieve very

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high stock prices which, in turn, generously reward stock-option-laden management teams. As a result, there is no shortage of companies which always "make their numbers". The stakes are enormous, providing tens or even hundreds of millions of dollars to corporate executives who achieve consistent growth in reported results and little or nothing to those who do not (whose stocks consequently plummet and generally fail to recover).

Since businesses simply aren't as steady or consistent as Wall Street number crunchers demand, there's enormous pressure on managements to smooth their results and pull the occasional rabbit out of a hat to deliver the desired quarterly outcomes. There are elements of a conspiracy to all this, as managements and shareholders both benefit from good reported results.

But overstated earnings will one day be reversed....

**Klarman:** A great many companies meet or exceed estimates only with a great deal of accounting legerdemain: write-ups and write-downs, changes in accounting procedures, modifications to actuarial assumptions, one time charges or gains and other forms of chicanery. And there is little incentive for the market cheerleaders on the sell side of Wall Street to bring these goings-on to light.

Such practices render the stock market even more overvalued than commonly recognized, because many of today's dubious accounting practices would almost certainly be reversed in an adverse market environment, with much lower multiples applied to the resultant lower reported earnings.

RELATIVE PERFORMANCE IS A SLIPPERY SLOPE.  
 PEER PRESSURE SUSTAINS AND FUELS THE BUBBLE.

The Internet has spawned a gigantic stock market bubble.

**Klarman:** The third factor impacting today's stock market is the Internet. While we have no doubt that this extraordinary technology is changing and will continue to change our lives in important and unimaginable ways, it has spawned a gigantic stock market bubble among investors who wish to connect their investment fortunes to their excitement about this technology.

At the root of all financial bubbles is a good idea carried to excess. The Internet is an extraordinary idea; how fitting, then, is the magnitude of the excess. Hundreds upon hundreds of Internet-related companies have come public and achieved valuations well into the billions of dollars — a great many possessing little more than a business plan. Very few of these companies are currently profitable — and it is our belief that most of them never will be.

The level of speculative activity is at a fevered pitch....

**Klarman:** The excitement of the Internet, the well publicized successes of investors who jumped in early on the Internet stock bandwagon and the greed element in human nature have combined to create a market culture of day-trading — a low cost, convenient alternative to casino gambling that has to date, unlike Las Vegas, delivered a positive sum experience. The level of speculative activity is at a fevered pitch and people are changing their lives around to participate. Some have quit their jobs to day-trade.

Venture capitalists are fighting to throw money at

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each successive hot deal. Many have raised their fees and taken in gigantic sums of new capital. Business school and college students are rushing to write business plans that routinely get funded for millions of dollars. Traditional businesses are being raided for managerial talent by Internet companies using the lure of vast quantities of stock options as bait. Stories are everywhere of mere mortals who became multimillionaires overnight either working at or investing minor sums in Internet companies.

Don't just stand there. Join the party....

**Klarman:** The explosive performance of Internet stocks has infected many professional investors who are typically judged by their investment performance relative to their industry peers. Relative performance is a slippery slope — and when a few investors holding Internet stocks outperform their peers, it becomes increasingly difficult for everyone else to avoid them. This sustains and even fuels the bubble despite the absence of investment fundamentals.

Performance-driven hedge funds, relative-performance-oriented mutual funds and even some "value investors" have capitulated. Among the ten largest holdings of one prominent "value investor" are big stakes in Microsoft, IBM, Cisco Systems, America Online and Amazon.com. The first three trade at an average P/E ratio of over 69. America Online trades at 378 times earnings, while Amazon.com "suffers" large operating losses which the stock market values highly.

Needless to say, this "value investor" has significantly outperformed his less imaginative peers.

The fault lies in our wiring, not in our stars.

**Klarman:** The tendency of investors to follow the market's momentum and bet on whatever has worked recently is accompanied by antipathy to whatever hasn't. Underperforming market sectors and asset classes are generally experiencing fund outflows, exacerbating the downward trend.

Historically, out-of-favor investments have typically performed best in the periods immediately following their underperformance, while those that have done well almost always follow their success by lagging badly. Human nature makes it unlikely for most investors to benefit from these predictive factors; the memory of most investors only

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incorporates what has been successful most recently.

The rich get richer and the poor poorer — in the short run.

**Klarman:** Small and mid-capitalization stocks — and especially those at the lower end of the valuation range — have underperformed dreadfully for years as money has gone into larger capitalization stocks. Some of this has been due to indexing; some is explained by momentum. Many institutional investors manage sums so vast that only the few hundred largest capitalization stocks could possibly absorb a meaningful portion of their capital.

And the underperformance of small and mid-cap money managers has caused investors to withdraw funds from them in search of better relative performance. Client redemptions then force these managers to sell shares to raise cash regardless of the valuation of what they're forced to sell. Thus it is that the undervalued securities become even more so — even as the overvalued do the same.

IT'S AN ENORMOUS OPPORTUNITY IN THE MAKING  
— AN OPPORTUNITY WE'RE CURRENTLY EXPLOITING.

But extraordinary discounts = enormous opportunity.

**Klarman:** But we're actually cheered by the current environment (although not by its impact on our results) because we believe it represents an enormous opportunity in the making — an opportunity which we are currently in the process of exploiting.

Right now, we're able to purchase high-quality assets and businesses in the form of small to medium cap stocks at their cheapest valuation levels in a decade or more. Many are selling at or below fifty cents on the dollar of underlying value — an extraordinary level of discount. Significantly, we believe these bargains are upon us precisely because of the speculative activity surrounding the Internet, which has siphoned enormous sums of money out of more mundane investments.

And we're not talking about dogs. Quite the contrary....

**Klarman:** It's important to emphasize that we're not describing a portfolio of cats and dogs — highly competitive or declining businesses, poor quality assets or the likely losers in the Internet economy. Rather, our portfolio has been assembled through rigorous fundamental analysis, one investment at a time, bottom up. We typically pass on dozens of prospective investments for every one we make.

Most companies in our portfolio, in addition to compelling undervaluation, have strong market positions, significant barriers to entry, substantial free cash flow and catalysts in place to assist in the realization of their underlying value. Almost all of them have managements who own significant amounts of stock personally. Even if these smaller stocks never return to investor favor, we expect to earn good returns from our fractional ownership in the underlying businesses.

We expect strong performance — absolutely and relatively.

**Klarman:** Over time, we're confident that the market for these stocks will recover as overstimulated investors refocus on risk as well as on return. This should result in a period of strong absolute performance and even better relative results.

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As we emphasized in our Semi-Annual Letter to shareholders, our goal is to generate good absolute returns with limited downside risk over time. A portfolio of deeply undervalued, carefully chosen securities — many with catalysts in place for the realization of underlying value — is the most reliable way we know of to achieve this goal.

**WITH SO MANY CHOOSING NOT TO THINK,  
 IT'S A GREAT TIME TO BE A VALUE INVESTOR.**

Investors don't even seem to be looking where we are....

**Klarman:** Our search for investment opportunity is always guided by fundamental analysis and valuation. We employ no rigid formulas, believing that the flexible pursuit of opportunity improves one's prospects for good returns with limited risk. We strive to be intellectually honest at all times, maintaining a willingness to change our minds when we're wrong.

Given the competitiveness of the investment business, we believe it's important in every investment to have an edge — an advantage over the herd. This edge could be a willingness to take a long-term perspective in a market with a short-term orientation, a tolerance of complexity when others crave simplicity or the absence of constraints which impede the ability of others to act or force them to act in uneconomic ways.

For many of our holdings today, we believe the market has become increasingly inefficient, as investors have simply decided not even to look at small cap stocks outside of the high technology industries.

To members of the herd, leaving the beaten path seems risky.

**Klarman:** Frequently, we attempt to profit by providing liquidity to urgent sellers. Financial markets act as allocators of capital, but they function much more efficiently when things are going well than when they're not.

When an industry, asset class, security type or geographical region is out of favor, profitable opportunities can be available to those who have cash and the expertise and willingness to deploy it. These opportunities superficially appear to be risky — since investing where capital is exiting is by definition unpopular. Since most investors derive comfort from consensus, many would not even identify such areas as rich with opportunity.

Don't mistake a lower stock price for a bargain.

**Klarman:** But the investment challenge of providing liquidity to out-of-favor asset classes is more complex than simply identifying areas that others are avoiding. First, it's important to never be blindly contrarian, betting that whatever is out of favor will be restored. Often investments are disfavored for good reason — and investors must consider the possibility that recovery may not occur.

Second, it's important to gauge the psychology of other investors. How far along is the current trend? What are the forces driving it? And how much further may it have to go? Being too early is tantamount to being wrong. So contrarians are well advised to develop an

understanding of the psychology of the sellers.

Finally, valuation is extremely important in reducing risk. Investors must never mistake an investment that is down in price for one that is bargain-priced; undervaluation is determined only by a security's price compared to its underlying value.

Our holdings are cheaper & better than they've been in years.

**Klarman:** Despite two consecutive disappointing years, we remain enthusiastic about our prospects going forward and continue to invest virtually all of our liquid net worths in various Baupost portfolios. We choose to eat home cooking not only out of habit, not only because we should and not only so we can tell you that we do, but also because we have a great deal of confidence in our strategy.

Our portfolio contains greater undervaluation and higher quality investments than we have owned in years. We are continuing to scoop up extraordinary bargains amidst this crazy market. And we look forward to an upcoming period of profitable value realization....

PORFOLIO REPORTS estimates the following were The Baupost Fund's largest equity purchases during the 6 months ended 10/31/99:

1. TENNECO INC
2. HUDSON CITY BANCORP INC
3. STEWART ENTERPRISES CL A
4. CAPITOL FEDERAL FINL
5. LNR PROPERTY CORP
6. TELECOM ITALIA SPA SAVINGS
7. HARCOURT GENERAL INC
8. WALTER INDs INC
9. APPLIED POWER CL A
10. SAAB AB B

We're frequently waiting for great opportunities to arrive.

**Klarman:** We have no mandate other than the risk averse investment of capital under our direction. We need not be fully invested and frequently hold significant cash balances waiting for truly great opportunities to come along.

As part of our risk management, we've never leveraged our portfolios. We do not bet the ranch on any single investment; few positions have exceeded 5% of assets in recent years. We do not generally engage in the short sale of overvalued securities, believing that short-selling could effectively increase — not decrease — portfolio risk in certain kinds of markets.

This is a wonderful time to be a long-term investor....

**Klarman:** With so many investors choosing not to think about their investing (indexing), failing to analyze the fundamentals of their holdings (momentum investors) and having an extremely short-term time horizon (almost everyone else), this is a wonderful time to be a long-term value investor.

Always keep in mind that stocks are perpetuities — with no maturity date. While we frequently invest in stocks with a catalyst for value realization in order to create a portfolio of limited duration, we nevertheless buy only when we're prepared to hold for the long-term. Very

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few investors would choose to hold their current portfolios if they thought the stock market might be closed for trading for the next five years; since we're investing and not speculating, we would be comfortable with our portfolio under such conditions.

A NUMBER OF SPINOFFS ARE ORPHANED  
 — AND TRADING AT GIVEAWAY PRICES.

We continue to see a strong flow of opportunities in the U.S.

**Klarman:** To help you understand how we're positioned today, we've broken down our current portfolio into categories as shown below:

The Baupost Fund Portfolio Breakdown (at 10/31/99)	
Cash and Cash Equivalents	32.2%
U.S. Equities	41.9%
Western European Equities	11.5%
Emerging Market Investments	5.0%
Liquidations	6.5%
Distressed Debt Investments	2.3%
Market Hedges	0.2%
<u>Other</u>	<u>0.4%</u>
Total Portfolio	100.0%

As you can see, we continue to hold substantial cash. Most of our common stock investments are in the U.S., where we continue to see a strong flow of opportunities. A significant percentage of our investments have either partial or full catalysts in place for the realization of underlying value....

A number of spinoffs are selling at giveaway prices.

**Klarman:** Among today's most attractive pockets of opportunity are corporate spinoffs — which initially come under selling pressure in even the best of markets. Currently, a number of spinoffs are truly orphaned securities trading at giveaway prices.

We've not seen a branded consumer firm so cheap in years.

**Klarman:** For example, we recently purchased shares of both of the recently separated subsidiaries of Tenneco. The larger company, Pactiv Corporation, manufactures Baggies food storage bags and Hefty trash bags and has leading market share in a myriad of other plastic packaging products.

Due to indiscriminate post-spinoff selling pressure, the shares have slumped to around 10 times currently depressed, after-tax earnings and about 5.5 times pretax cash flow. The earnings should grow from a combination of cost reductions, asset redeployments, bolt-on acquisitions, volume growth and expected lower raw materials prices.

Management recently received significant stock options as part of a new incentive plan to better align their interests with those of shareholders. They've also been buying stock personally. It's been many years since a

branded consumer products business fell through the cracks to trade at such a compelling valuation.

One that's been particularly brutalized — at 4X earnings.

**Klarman:** We're also buying shares of the Tenneco Automotive spinoff. This company manufactures Monroe shock absorbers and Walker mufflers, and is the market share leader in nearly all of its products and markets. It currently trades at roughly four times after-tax earnings. Its shares have been particularly brutalized as a result of its deletion from the S&P 500 Index.

Tenneco pre-spinoff traded at a market capitalization of several billion dollars. The highly leveraged Tenneco Automotive spinoff — still under extreme selling pressure — trades at a market capitalization barely in excess of \$200 million. Selling pressure's turned this market leader into a micro-cap stock, forcing many holders to exit because it no longer meets their size criteria. In effect, there is now a class of shareholders who must sell a stock simply because it trades at a depressed market valuation.

Harcourt General sells at roughly half of its asset value.

**Klarman:** Harcourt General recently spun off most of its interest in Neiman Marcus — allowing it to become a pure play in the publishing and computer-based learning and training businesses. In the current turbulent market, we believe investors have failed to focus on the low valuation and high-quality, strongly growing businesses within Harcourt. Currently, trading at a several year low, the shares trade for less than 12 times cash earnings (earnings plus goodwill amortization) and for roughly half of our estimate of the company's asset value.

The company is expected to grow earnings 12-15% annually and recently reported strong quarterly results. Harcourt's management has most of their net worths invested in the company (which they control) and has committed to take additional actions as warranted to cause the company's share price to more fully reflect underlying business value.

At 5 times cash flow, this one's actively buying back shares.

**Klarman:** Chemfirst, a specialty chemical company, came public several years ago as a spinoff. Despite the company's strong position in the fast growing electronics chemicals market, the shares trade at around five times estimated cash flow. Business results are strong and the management owns a substantial interest in the company.

Also, the company's actively buying back its shares. We believe that the company will eventually be acquired in the chemical industry's consolidation.

Strong returns, share buybacks and a deep discount....

**Klarman:** We own several investments in the real estate area including shares in LNR Corporation — a spinoff a few years ago from a respected homebuilding firm. This company's essentially an opportunistic investor in a variety of real estate assets, with a bias toward purchasing underperforming or out of favor properties and then turning them around and selling them.

They've achieved consistently strong returns over time, and the underlying value of the company's assets is close to twice the current market price of the shares. We expect underlying value to grow at a healthy rate for the

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**BAUPOST FUND'S SETH KLARMAN**  
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foreseeable future. Management owns approximately 30% of the company's shares and the company's been repurchasing substantial amounts of its own stock at the current price.

**Octel is in a sunset industry. But at 3 times earnings....**

**Klarman:** Octel was spun-off from Great Lakes Chemical Corporation in 1998 and has not succeeded in attracting investor interest. It's the world's dominant producer and marketer of worldwide TEL, a fuel additive that makes gasoline "leaded." This has been called a "sunset industry" because leaded gasoline is being phased out all over the world. In the meantime, however, it's a high margin business that requires almost no ongoing investment.

Having recently consolidated its position so that it controls over 90% of the worldwide TEL market, Octel's currently buying back about 10% of its stock per year.

There are two primary risks — that the phase-out goes much more quickly than the 15-20% annual decline that management anticipates or that the company's abundant cash flow is squandered on foolish acquisitions rather than being used to pay down debt and buy in stock. However, at 3 times its current after-tax earnings, its valuation more than compensates for these risks.

**THESE AREN'T SPINOFFS, BUT THEIR PRICE IS RIGHT — SINGLE-DIGIT MULTIPLES OF DEPRESSED EARNINGS.****And here we go again with thrifts....**

**Klarman:** We've recently become more active investors in thrift conversions. Thrifts at one time had a large dedicated community of investors. However, after a period of overvaluation and poor stock performance, this is no longer the case. While there are generally no short-term catalysts for value realization in this area, stock repurchases are accretive to shareholder value and industry consolidation seems likely to continue at a healthy pace.

In short, the opportunity to buy significantly overcapitalized, conservatively managed thrifts at 50-75% of book value and at reasonable multiples of earnings offer a low-risk investment with significant return potential.

**At Stewart, there's a lot to like — price-wise and otherwise.**

**Klarman:** We own shares in Stewart Enterprises, a funeral home and cemetery company which currently trades at about 6 times after-tax earnings per share. The death care industry has come under pressure as a result of overpriced acquisitions, excessive levels of debt, a recent, temporary decline in the death rate and increased competition in some regional markets.

However, all of the public companies in this industry are trading at extremely depressed levels. And Stewart has some of the best properties in the industry. The company has recently repurchased its stock around current levels and insiders have added to their holdings. Also, a new management team is expected to reorient the company to maximize its free cash flow generation.

**Excellent prospects, a strong market position & a P/E of 8.**

**Klarman:** UCAR is the world's leading manufacturer of graphite electrodes which are used in steel production. The company came under a cloud a few years ago when the industry admitted to price fixing. And results were then adversely affected by the Asian crisis last year.

Management announced a sweeping cost-cutting plan which has been implemented faster than expected. And earnings are expected to grow strongly over the next few years as a result of lower expense levels, stronger demand, and possible price increases from current depressed levels. Also, the company's announced a potentially lucrative product development and supply agreement with Ballard Power Systems — developers of a new fuel cell technology.

However, despite the company's excellent prospects and its strong market position, UCAR's shares trade at only about 8 times estimated 2000 earnings.

**Chargeurs trades at 7 times depressed earnings.**

**Klarman:** Chargeurs is a French company which processes and trades in wool and produces fabrics, interlinings and protective films. The market leader in virtually every segment in which it operates, it generates substantial free cash flow from its operations. Management is proactive in taking measures to maximize shareholder value including a securitization program to reduce volatility and risk in the trading business and the repurchase of a large number of shares.

Some segments of the business have suffered as a result of the Asian crisis and are only now beginning to recover. Even on its depressed results, however, the market values the company at only about 7 times earnings. Small cap companies in mundane businesses are out of favor in France, too.

**At Saab, there's a lot to like business-wise and price-wise.**

**Klarman:** Saab, a Swedish defense company primarily focused on aircraft, space and training systems is currently valued at only about 7 times earnings. This valuation does not take into account growth opportunities available from the expansion of Saab's fighter aircraft program into the export market. And the company recently received its first export order — validating our investment thesis.

Management is also pursuing value creation through the monetization of its civilian aircraft lease portfolio. Last month, Saab agreed to purchase Celsius, another Swedish defense contractor, in a deal that enhances value by about 20% after cost-savings and revenue synergies.

Although the European defense market is undergoing rapid consolidation, Saab — as one of the smallest remaining independent players — is below the radar screen of most investors.

**We're disappointed, but we remain confident and optimistic.**

**Klarman:** The last two years have been difficult ones for The Baupost Fund. We're disappointed, but not disillusioned. And we remain confident that a fundamentally-driven, disciplined value approach will deliver good results with limited risk over time. We appreciate your patience and support and look forward to a period of improved performance.

—OID

**LONGLEAF PARTNERS FUNDS' CONFERENCE CALL**  
**MASON HAWKINS, C.T. FITZPATRICK & STALEY CATES**  
 (cont'd from page 1)

respectively, during that same period.

From a stock-picking perspective (their equities-only returns before fees), their performance was more impressive still — 21.0% per year compounded over the same period. (All figures provided by Southeastern Asset Management)

In our December 31, 1998 edition, we told you that founder Mason Hawkins and some of his key associates were downright excited about some of the opportunities that they'd been finding and buying.

Well, this year, it's déjà vu all over again. With flagship fund Longleaf Partners and Longleaf Realty Fund both down more than 15% during the second half of 1999, Hawkins and several of his key associates — Staley Cates, C.T. Fitzpatrick and Lee Harper — sounded as excited about the securities that they were finding and buying as we've ever heard them. Therefore, naturally, we wanted to share their thoughts with you.

The excerpts which follow were excepted from their remarks and from their answers to shareholder questions during their most recent client conference call — which occurred in late October. We hope that you find some of their ideas and insights as intriguing as we do.

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**STOCK PRICE DECLINES AREN'T A DISADVANTAGE.  
RATHER THEY'RE AN OPPORTUNITY TO BUY MORE.**

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For the true investor, price fluctuations are an opportunity.

**Hawkins:** We feel very fortunate to have intelligent, long-term partners who understand that increased price volatility produces very salutary benefits for the patient and disciplined long-term value buyer.

We'd like to quote some of Ben Graham's comments from *The Intelligent Investor* about price volatility. We've taken some of his quotes from Chapter 8 and put them together. As Graham states:

"As long as the earnings power of his holdings remains satisfactory, the investor can give as little attention as he pleases to the vagaries of the stock market. More than that, at times he can use these vagaries to play the master game of buying low and selling high."

"The investor who permits himself to be stampeded or unduly worried by the unjustified market declines in his holdings is perversely transforming his basic advantage into a basic disadvantage. Price fluctuations have only one significant meaning for the true investor. They provide him with an opportunity to buy wisely when prices fall sharply and to sell wisely when they advance a great deal."

We've certainly taken advantage of the opportunity....

**Hawkins:** Recent bouts of market fear coupled with specific company shortfalls from consensus quarterly earnings [estimates] have enabled us, we think, to buy wisely in compelling investment opportunities ... [and make] significant progress in our domestic portfolios. We've added to existing holdings that we know very well ...

at attractive prices. We acquired several new positions at prices below 60% of our conservative appraisals. And these investments have decreased the levels of low-yielding cash reserves that we held in each of our funds....

Our corporate values per share as well as our ownership in certain businesses increased as many of our corporate partners moved to repurchase shares aggressively. This progress has lowered our funds' composite price-to-value ratios and increased our implied future returns. And we've recently added materially to our own personal stakes in each of the Longleaf funds....

**PRICE TO VALUE? CHECK. GROWING VALUES? CHECK.  
AGGRESSIVE SHARE REPURCHASES? CHECK....**

How have stocks done? Well, pick your index....

**Hawkins:** If you look at macro figures pertaining to the S&P 500, you draw a completely different conclusion than you do if you look at the Value Line Index. During the 10 years ended June 30th, the S&P compounded at 18.8%. For the 10 years ended June 30th, the Value Line Index compounded at 6.0%. So if you'd been invested in the average company in America over the last 10 years through the Value Line 1,700 largest companies, you would have clipped about a 6% compounding rate. That is about half of what we would have earned if we had just parked our money in a long bond over that same 10-year period.

If you'd invested in very, very large companies as indicated by the S&P 500 over the last decade, you did quite well. But the average company in America has done significantly less well in that same 10-year period.

As for the NASDAQ, the five largest companies in that index accounted for over 100% of its returns in 1998. So there's very disparate information out there as it relates to investing in equities.

That said, we couldn't care less. But hooray for volatility.

**Hawkins:** All of that is just commented on — because we're not driven by *any* of it. We're not index buyers of the Value Line, the S&P 500 or the NASDAQ. We're long-term investors seeking tremendous value at a discount in the hopes that we can find a few companies that will give us great compounding, deferral of taxes and a good, net after-tax return over the long run. And in an environment like today where we've had this great amount of increased volatility, we're beginning to find companies that really meet our requirements and our qualification criteria.

What a difference a quarter makes....

**Hawkins:** Today, all of the four Longleaf Funds are extremely well positioned with one of the lowest composite price-to-value ratios ever amongst the four funds.... They're in the 50% range plus or minus a few percent. We own businesses with excellent competitive positions. Many of our corporate partners, as we've said, are buying back their shares — and doing so quite aggressively. And we have a meaningful stake in what we consider to be our *best* ideas. Finally, we're fully invested — unlike the last time that we visited with you in July. As of June 30th, Longleaf Partners Fund had 31% of its assets in cash. Longleaf Small Cap Fund and Longleaf International Fund both had 13% of their assets in cash reserves. And Longleaf Realty Fund had roughly 4% of its footings in cash equivalents.

*(continued on next page)*

**LONGLEAF PARTNERS FUNDS' CONFERENCE CALL**  
**MASON HAWKINS, C.T. FITZPATRICK & STALEY CATES**  
 (cont'd from preceding page)

Today, we have essentially put that money to work in long-term equity stakes that we believe will give us much, much higher returns than the 4-5% we were earning on those cash balances.

It's déjà vu all over again — we hope....

**Hawkins:** It's also interesting to note that as we make this call today, it's very much identical to the call that we made October of 1998. We'd had a market that really declined very significantly in 1998. And we were able to take our cash reserves and put them to work in very discounted individual businesses.

And the subsequent returns were substantial. I think the 12-month return third quarter to third quarter 1999 versus 1998 were 22% or so for Longleaf Partners Fund, and about 20% for Longleaf Small Cap Fund. Of course, we had a great year with Longleaf International Fund. And even the 12-month return on Longleaf Realty Fund was quite acceptable — up 2% during a time when the NAREIT and the other realty index were down pretty substantially.

So we view this environment that we're in today as one that is very, very interesting.

As far as we're concerned, all our stars are in alignment....

**Hawkins:** So we'd like to just say in summary that we own a lot of investments that are [trading] at half of our appraisals. And those corporate values are growing nicely through the retention of free cash flow.

Those values are also growing very nicely on a per share basis because corporate managements across the board are aggressively retiring shares in the companies that we own. So the denominators of these intrinsic values are going south. That's building our value per share and our free cash flow per share and it's building our percentage ownership in these very competitively entrenched businesses. So all of that works to build on our compounding long term.

And to highlight everything that we've said, as we told you, we've been aggressive buyers of all four of our funds in the last three months since we visited with you last....

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**WMI'S PROBLEMS ARE FIXABLE AND SHORT TERM,  
 WHEREAS ITS INTRINSIC VALUE IS FOREVER.**

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As WMI's price has fallen, we've kept building our stake.

**Hawkins:** We want to talk a little bit about one of the reasons why our performance was in negative territory in the third quarter in Longleaf Partners Fund because there's been a lot written and said about one of our significant investments — and that's Waste Management.

(continued in next column)

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Waste Management accounted for about half of our decline in the third quarter.

Again, we want to tell you that we think that decline is not indicative of the intrinsic value of the business. And we want to just give you some of the basic logic behind our commitment to Waste Management and our decision to increase our stake in that company as the price declined. We've committed, as we've indicated, a meaningful amount of our capital to Waste Management....

There's a lot to like....

**Hawkins:** The company has the best landfill and collection assets in the industry — virtually impossible to replicate in today's environmentally conscious society.

Waste Management is the dominant operator in almost all its regional markets. The industry's economics are improving as supply remains relatively limited and demand continues to grow. The industry has become an oligopoly of sorts with most markets having only one primary competitor, therefore creating what we consider to be an environment for firm pricing.

Significant cost and revenue opportunities remain from the merger of the old Waste Management with the USA Waste Company. We think the net cash earnings of Waste Management over the next 12 months will be about \$2.50 per share and that the free cash flow per share can exceed \$4.50 sometime in the next three years.

And its problems are both fixable and short term in nature.

**Hawkins:** Two problems remain: Its board is currently trying to find the kind of CEO who'll be able to capture these revenue and cost opportunities. And we think they're being very diligent in this process and that shortly we'll find out that we have a very capable manager who will not only operate intelligently, but also invest our free cash wisely.

[Editor's note: Maurice Myers, the former chairman of Yellow Corp. (the parent of trucking company Yellow Freight) has been named the new CEO of Waste Management — their sixth since May 1996.]

The second problem is one that relates to accounting and MIS [management and information systems]. That problem also is both fixable and short term in nature. And we believe the company is making good progress there given its announcement to bring in the individual from Perot Systems who was responsible for the GM conversion to an up-to-date MIS system.

So to date, [although] our performance has been affected by the decline of Waste Management, we've used that decline to our advantage to build our position. Problems remain to be addressed — both at the management level and at the accounting and systems level. However, we believe that both of those issues will be resolved in short order — and that the company can then go on the offensive to building even more value per share for us as long-term owners.

**WE DON'T VIEW WASTE MANAGEMENT AS A MISTAKE.  
 AND LONG-TERM, WE THINK IT'S AN OPPORTUNITY.**

Waste Management was once a very successful position.

**Shareholder:** Nobody's perfect. And we all want to

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**LONGLEAF PARTNERS FUNDS' CONFERENCE CALL**  
**MASON HAWKINS, C.T. FITZPATRICK & STALEY CATES**  
 (cont'd from preceding page)

learn from our mistakes — all of us. Is there anything that you've learned about your own internal processes — your buy discipline, your sell discipline, etc. — that you'd modify after this entire Waste Management experience?

**Hawkins:** I'd like to do a review of our experience at Waste Management with you, if I could.

**Shareholder:** Sure.

**Hawkins:** You remember they had major accounting issues before when Waste Management was on its own — and its stock melted down from \$40 to the low \$20s. Well, we took a major stake at that point. And that investment was very successful.

The company then merged with USA Waste to solve a management issue. Waste Management's board brought in USA Waste in order to get John Drury and Rod Proto. It was unanimously viewed by Wall Street as a good solution.... It went up into the high \$50s.

Looking in the rear view mirror, Waste Management was a very successful investment at that juncture. And we had about 5% of our assets committed to it at the end of the second quarter when the company's stock was trading at \$54 per share. At that point, it got to our appraisal. And we were in the throes of cutting our position back.

Task of putting the companies together was too much....

**Hawkins:** But [then] CEO John Drury had to admit through his doctors that he could not come back to the company because of his brain cancer. All of the management responsibilities then went to Rod Proto. And in our view, those management responsibilities were too significant for this one person to handle in terms of putting two companies together, two accounting systems together and two cultures together — what have you. They've been very challenged by the issues of USA Waste being combined with the old Waste Management.

A number of other issues have come up subsequently. And clearly, some of them are substantive....

We don't feel like Waste Management is a mistake.

**Hawkins:** However, the case that remains is that here's a company with the best landfills in the country, in an industry where the competition has really shrunk to two major companies. Browning Ferris and Allied have combined into a single company [Allied Waste]. And USA Waste and Waste Management have combined into the other [Waste Management].

Meanwhile, waste streams are growing. The supply of landfills is limited. And we believe as a long-term investor, a year from now we will look back and say that we have the best assets, great management, good systems and a very good earnings stream that will be highly rewarded in the equity market. So we don't feel like it's a mistake.

Without consternation, there wouldn't be opportunity.

**Hawkins:** It's a mistake in the short term. But it's also a long-term opportunity. The [roughly] 5% position that we had at the end of the second quarter has been added to as the stock has declined and our discount to

appraisal has increased.

We're at a short-term period here in a long-term game where our short-term results have been affected by one of our holdings. Those short-term results are the price that we pay to be long-term investors. And if you can't handle the short-term volatility in an equity portfolio, then you probably aren't going to add a lot of value over time.

We need mispricing in the equity markets in order to commit big dollars at big discounts to appraisal. And if we didn't have this consternation and this concern about short-term issues....

Wall Street liked Waste Management universally at \$54. There was not a single analyst that said it wasn't a great growth company and that it wasn't wonderful to own. And almost collectively, none of them like it at \$17....

In the short run, the market is a voting machine and in the long run it's a weighing machine — to quote Ben Graham. In June, it was voting in the greed mode. Today, it's voting in the fear mode — at the other extreme of the spectrum.

And that big swing — from love to hate, if you will — gives us the kind of opportunities that we seek and pursue in order to buy \$1 bills for 50¢. So even though this volatile stock price has affected our short-term results, we're highly convinced that it will add to our long-term compounding.

**ITS LANDFILLS ARE AN INCREDIBLY VALUABLE ASSET.  
 WE APPRECIATE THE OPPORTUNITY TO BUY MORE.**

WMI's landfills are incredibly valuable assets.

**Staley Cates:** I would throw out one more thing about that — which gets to the underlying value of the assets. The disproportionate amount of Waste Management's value lies in its landfills. It's not in its trucks that you see driving around or the dumpsters — which is just a really mediocre business that any of us could get into and try to be competitive in.

The value's in the landfills — which very few of us could get into even with a lot of capital because of environmental constraints, where supply is going down as the government shuts down municipal landfills that don't do it right, that don't have liners and that don't comply with EPA rules and so on. Those landfills are an *incredibly* valuable asset. And that's where the lion's share of Waste Management's value lies.

Allied and Waste Management together now have about two thirds of the part of our nation's landfill capacity that isn't municipal. That's one of the reasons why we don't have a problem waiting 12-18 months for the computer systems to merge, a good, new CEO to be named and all that type of thing — because the landfill value isn't changing anything like a stock price drop from \$54 to \$17.

**Hawkins:** And when Fresh Kills closes in New York, I can assure you that they're not going to let it pile up in Manhattan. They've got to put it somewhere. And that is only going to add to our earnings power long term.

To us, it's MediaOne revisited — a \$1 bill for 35-40¢.

**Hawkins:** The situation at Waste Management today is no different than the situation that we had two years ago in the cable TV business. Every analyst in New York said that cable TV was not of interest. And that's when we took

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**LONGLEAF PARTNERS FUNDS' CONFERENCE CALL**  
**MASON HAWKINS, C.T. FITZPATRICK & STALEY CATES**  
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a 9% or 10% stake in MediaOne. We bought that stake at \$21 or \$22 per share. The stock declined to \$17. And we had a conference call like this where everybody questioned that position. Two years hence, the stock's at \$70.

And it's not a question of clairvoyance. It was a question of valuing the business. Our appraisals are our anchor to windward. It's what everything depends on here. Again, the price tells you nothing about the company's underlying value. The price in the *long run* will tell you something about the long-term value of the business you own. But in the short run, the price is a very evanescent and changing phenomenon of supply and demand and greed and fear.

But if you didn't have that volatility — if you didn't have that swing of psychological demand and supply — you wouldn't get a chance to buy MediaOne at what was about 35% of appraisal. And you wouldn't have a chance to buy Waste Management today at what we consider to be about 35-40% of appraisal....

THE INSIDERS' HANDS ARE TIED.  
 FORTUNATELY, OURS AREN'T.

Are Waste Management insiders buying? No. They can't.

**Shareholder:** Some months ago, a questioner pointed out that a number of insiders were selling their shares of Waste Management at \$55 or \$60 per share. And I think your response was that they were being smart — because it had reached appraised value.

Given the huge price decline, have the insiders at Waste Management been buying back their shares as aggressively as they were being sold?

**Hawkins:** That's a very good question — and one that we would want to explore with them. Right now, insiders at Waste Management are not permitted to buy shares — and they haven't been permitted to buy shares, since, say, July because of underlying concerns about various issues. That freezes them out of being buyers at this juncture.

Given sufficient conviction, we can be pretty concentrated.

**Shareholder:** Your fax says that Waste Management now accounts for 14.6% of your portfolio. What is the maximum percentage that any individual equity will represent in Longleaf Partners Fund?

**Hawkins:** A couple of years ago, we went from the SEC to the IRS as our regulator of diversification. You have those two choices in our business as managers of mutual funds.

And by going to the IRS standard for diversification, technically we can have half our portfolio in 10 companies with no more than 5% in each of those. And then with respect to the other 50% of the assets, we could have as few as two holdings. So in effect, we could own as few as 12 companies — ten 5% stakes and two 25% stakes — without violating IRS standards for diversification.

I doubt that we'll ever get into a situation where we ever have enough confidence to have 25% of our portfolio committed to one company. However, it's possible under

IRS guidelines....

AS BUFFETT SAYS, MORE CONCENTRATION IS BETTER.  
 MARGIN OF SAFETY ISN'T ABOUT DIVERSIFICATION.

We did add aggressively to UCAR. But we were limited....

**Shareholder:** Obviously, you folks — and I think we as advisors — have a lot of conviction in your process. But when one company takes up 15% of your assets, haven't you introduced a lot of unsystematic risk into the equation that Graham might take issue with as far as the margin of safety and the value of diversification?

Secondly, one of the other holdings that you've had in your portfolio for about two years is UCAR International. That's a stock, I believe, that you purchased in the mid-\$30s that's had all kinds of management changes, [allegations of] price fixing and lawsuits. And yet that's a company that's fluctuated widely in value. How do you compare a situation like that, where the price has fluctuated down to as low as \$12-13, [to Waste Management]? Why not have doubled up on that and done the same thing if you have the same conviction in the fortunes of *that* company?

**Hawkins:** First of all, the values have not fluctuated

PORTRFOLIO REPORTS estimates the following were Longleaf Partners Fund's largest equity purchases during the quarter ended 9/30/99:

1. WASTE MGMT INC
2. GENERAL MOTORS CORP
3. GEORGIA-PACIFIC TIMBER GRP
4. TRICON GLOBAL RESTAURANTS
5. HILTON HOTELS CORP
6. TRIZECHAHN CORP
7. NIPPON FIRE & MARINE INS CO LTD
8. FDX CORP
9. YASUDA FIRE & MARINE INS CO LTD

that dramatically, but the prices have.... And ... we did add aggressively. There's a maximum stake we can have in UCAR.

**Cates:** They have a poison pill that we're right under.

Margin of safety is about price-to-value, not diversification.

**Hawkins:** Margin of safety pertains to what the business is worth versus what you pay. And the lower the price-to-value ratio, the greater the safety and the higher the potential return. So to the extent that we have 15% [of our assets] committed to a company that we believe is worth close to \$50 a share that sells at \$17, we believe very strongly — as would Dr. Graham or Warren Buffett — that we've lowered our price-to-value and, therefore, we've lowered our risk and improved our potential future return. It's an opportunity to buy more of the company at a lower price than we would have if the stock were higher.

If we had other equal opportunities in terms of price-to-value, competitiveness, endurance, lack of technological risk — what have you — it would be fine with us to have 10-15% of our assets in some other positions. You don't put 15% of your capital in something that's selling for what

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(cont'd from preceding page)**

it's worth. You only put 15% of your capital in something that is so discounted that you have a great probability of making a lot of money two or three years hence when the market begins to weigh the economics of that situation as opposed to voting on the basis of the psychological issues that are being voted on today.

We agree with Buffett — there's less risk in concentration.

**Cates:** And the large position isn't just due to that discount. It's due to the *quality*. Again, the quality of the landfill business is really hard to match — especially at this point in time. A quick look at *Solid Waste Digest* and what landfill pricing is doing right now will highlight that.

We constantly use, as you say, Graham's thoughts on margin of safety. However, we also use Buffett's thoughts on diversification — which is that there's less risk adding heavily to things you know very well than there is to having a greater number of things you *don't* know as well.

And we just think Waste Management is compelling. We know it really well. And it's incredibly high quality.

We wish we had been able to back up the truck on UCAR.

**Lee Harper:** You're right, too, that had we not had the limits on UCAR, we probably would have added [to that position] when the disparity got so big between its price and value after its price had dropped. And we would have benefited from that. This year, that stock has added a huge amount to our returns in Longleaf Partners Fund....

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WHY THE DISCONNECT IN REAL ESTATE?  
VERY SIMPLE — INVESTOR PSYCHOLOGY.

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

**Hawkins:** C.T. [Fitzpatrick] wanted to make a couple of comments about Longleaf Partners Realty because it's been the subject of a number of questions. It's also been the recipient of much of our personal cash flow into our four funds lately....

A disconnect between stock prices and underlying reality.

**C.T. Fitzpatrick:** As Mason said, many of you have asked, "What's going on with publicly traded real estate?" Earnings remain healthy throughout the industry. And the companies that we own are generally meeting or exceeding our expectations. Private market real estate values have moved north over the past couple of years. And fundamentals remain healthy throughout the industry with rents continuing to rise and stable occupancies. And very interestingly, new supply growth has actually declined from the peak levels reached last fall.

But over the same period of time, publicly traded real estate companies have languished. Their prices have declined rather dramatically.

Very simply, there's an excess of sellers and no buyers.

**Fitzpatrick:** So why the disconnect? Well, consider these statistics: Year to date, real estate mutual funds

have experienced more than \$500 million of net outflows. That's an average of almost \$13 million per week. In the latest week [for which that data is available], the outflow was \$19 million.

In contrast, the average equity mutual fund has had *inflows* of \$4.3 billion per week. Basically, two weeks of inflows into the average equity mutual fund is equal to the assets under management for the entire real estate mutual fund industry.

So what we have is an excess of sellers and no buyers. Prices are moving south not because of fundamentals, but because of selling pressure that's basically feeding on itself. So stock prices really aren't influenced right now by fundamentals or by values.

The disconnect isn't fun, but we like the opportunities.

**Fitzpatrick:** Our response to this environment is to focus on long-term returns and value creation at the companies we own. And based on these criteria, we're very pleased with the progress that our companies are making. Instead of being upset by this environment, although we admit that we are frustrated, we are grateful for the opportunities that we have — the *numerous* opportunities we have — in the publicly traded real estate world....

We continue to add to our stake in Longleaf Realty Fund. And as painful as it might be for some of you, we would encourage you to do the same....

POSSIBLE CATALYSTS IN OUR REAL ESTATE STOCKS?  
THEY'RE ALREADY IN MOTION AND ON THE WAY....

Catalysts to unlock value are already underway....

**Shareholder:** In Longleaf Partners Realty Fund, I know that you look at individual stocks and not so much at the real estate industry as a whole. However, given that that's somewhat dominating values right now, I wondered if you had any thoughts on a possible catalyst to break the stretch here where the market just doesn't like REITs?

**Fitzpatrick:** So what can turn things around? Well, we're seeing the following: Several companies have announced management-led LBOs [leveraged buyouts]. Also, private buyers are beginning to enter the market. These firms are paying prices well in excess of our appraisals — which suggests that the companies we own are even cheaper than we believe them to be.

While we wait, our values per share are building....

**Fitzpatrick:** A number of the companies that we own are selling off assets and using the proceeds to buy in their own shares. For example, Host Marriott just announced that it's selling the Boston Ritz Carlton at a price well in excess of our appraisal for the asset and is using the proceeds to repurchase its own stock.

Prime Group in Chicago, which is a company that we've highlighted in the past, is selling its largest asset at \$300 per square foot. At the same time, the company sells in the stock market at less than \$100 per square foot. And all of its leases are below market and have escalators.

There could be an external event — like people just waking up and realizing the values are a joke. But you also could have *internal* events. And we're seeing that ... in the case of the companies that I mentioned.... — and there

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are others. I should have also mentioned Newhall Land. Newhall Land announced recently that they were accelerating their asset disposition program with the goal of buying in 20% of their stock over the next 12 months. And they have bought roughly 20% of their stock in over the last two years.

So the companies themselves are taking steps. And ultimately, when it's realized, there'll be ... a lower denominator and we'll also have a healthy numerator. So while we wait, our values per share are building.

Besides share buybacks, there's LBOs and M&A.

**Fitzpatrick:** The other thing that could happen, and we're seeing some evidence of this as I mentioned, are buyout funds moving into the area — because you can pay prices well in excess of the current stock market prices for these companies and still derive very healthy returns to equity holders. The prices are just a joke. And it's only a matter of time before something happens either internally or externally to move price to value. Basically, nature abhors a vacuum. And that's what we have here — a vacuum.

**Hawkins:** Just to summarize C.T.'s comments, we've never seen share repurchasing pursued as aggressively by companies in the realty world as we're seeing today. Secondly, we're seeing a number of buyout funds being put together to take these companies private because the private values are obviously so much higher than the public values that are being ascribed to these companies in the equity market.

Thirdly, we're seeing a huge acceleration in merger and acquisition activity in the real estate world. There's great consolidation going on at very, very high prices that makes our appraisals seem conservative.

**FDX'S PRICE IS DISCOUNTED AND ITS CASE IS INTACT.  
THAT'S WHY THEY'RE GOING TO SHRINK THE SHARES.**

When internet hype got overdone, we trimmed our FDX.

**Shareholder:** In past conference calls, you've talked about the strength of a couple of your top holdings like Federal Express and Marriott. Could you speak to why they've struggled and your thoughts [about their prospects]

(continued in next column)

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who doesn't subscribe  
is making a big mistake."

WARREN BUFFETT, Chairman  
BERKSHIRE HATHAWAY

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moving forward?

**Cates:** That's a good question. Federal Express and Marriott are two companies that we feel wonderful about. And both hurt our performance in the third quarter.

Let me talk about FDX [Federal Express' parent] first. All this internet stuff, all this nonsense and hype — not that the internet is nonsense, but I just mean all the kind of excessive parts of it — have whipped FedEx around both for good and for bad. And last fall, things got euphoric — or maybe it was last winter. Everybody got so excited about its internet possibilities. And so its stock ran up.

And when the stock hit our appraisal, we trimmed back our position. We took some money off the table.

There's a great story, but it's not on the consumer side.

**Cates:** But more importantly, in terms of the fundamentals of the business, even then, Fred Smith and the rest of the company would come out and say, "Look, we're not an Amazon.com shipper. We're a huge, huge internet beneficiary. However, we're not that kind of an internet consumer-type business — door-to-door, residential stuff. It's more the business model of how business-to-business commerce changes."

Dell is a great example of that. As Dell ships all of its parts around rather than holding them in inventory, FedEx is the biggest beneficiary of that. And that's way, way more high powered [and important] to FedEx than, say, the consumer stuff.

When other investors figured it out, FDX got cheap.

**Cates:** So as a lot of this internet stuff backed off this summer and as FDX reported a quarter of mid-single-digit revenue growth in the U.S., the same people who'd gotten euphoric about it last winter kind of threw their arms up and said, "Gosh! This isn't an immediate, double-digit beneficiary of Amazon.com." Therefore, you saw it trade in line with some of the internet names that came down.

All of that's just such a tempest in a teapot. Again, it doesn't change the fundamental case — which is this huge business-to-business opportunity that's coming up.

FDX knows that its stock price decline has been overdone.

**Cates:** And not only do we firmly believe that, but a really interesting thing happened recently — which is that the company for the first time ever came out and announced a major share repurchase because they know what their shares are worth. And they know that the price has been discounted way, way below their value. Therefore, they're going to shrink the shares to take advantage of it. So over a long period of time, you'll see good volume numbers and great margin numbers. And you'll see that FDX is a true beneficiary of e-business.

So nothing's changed. Our investment rationale is the same as before. We actually added a little bit when it dipped down. And we're happy to own that one.

**HOTEL OVERBUILDING DOESN'T HURT MARRIOTT.  
TO THE CONTRARY, IT SPEEDS UP ITS GROWTH.**

At Marriott, what investors worry about is cause for glee.

**Cates:** As for Marriott — Marriott International as opposed to Host Marriott — that's the fee business. That

(continued on next page)

**LONGLEAF PARTNERS FUNDS' CONFERENCE CALL  
MASON HAWKINS, C.T. FITZPATRICK & STALEY CATES  
(cont'd from preceding page)**

one came down along with the hotel owners over these concerns about hotel overbuilding. Marriott International is a huge beneficiary of the very building that people are worried about — because a lot of that new supply consists of Marriott products where those hotel owners that are building with their own capital are going to pay Marriott International a fee off the top. So whether revpar is 2% or 4% kind of pales in comparison to a room growth of 10% paid for by other people's money who will then send Marriott a fee off the top. So Marriott International basically has mid-double digit earnings [growth] baked in the cake for the next couple of years.

**Share buybacks should make our values grow even faster.**

**Cates:** And like FedEx, Marriott International is a company that knows its own value even better than we do. So they're just taking advantage of it. And they're back buying their own shares in.

So the business case in both places is the same. If anything, our value per share is building even faster [now] because both companies are able to lower their denominator at a great price.

**We get to have our cake and eat it, too. And here's why:**

**Shareholder:** I believe Staley, who was talking about Marriott International, made a compelling case. But it seemed to me that the case for Marriott International, as he described it, was a negative case for Host Marriott. Would somebody comment on that please?

**Cates:** That's a great question — and very perceptive of you. The reason why I think we get to have our cake and eat it, too — in other words, why I'm excited about the new supply helping Marriott International while not fretting about what that new supply does to Host Marriott and Hilton — is that they're really different animals. The properties, especially the ones that Hilton owns, and the great majority of Host Marriott's Marriott [hotels] are CBD-type [central business district-type] hotels — which is not where a lot of this new construction is happening. And those properties are also not even in the same category of property where a lot of it's happening.

If you see mid-priced-type suburban hotels going up, those represent fees that will go to Marriott International, but they're not going to compete with a top-tier Marriott. And when I talk about Host Marriott's Marriott hotels, I'm leaving out Ritz Carlton because none of this stuff is going to hurt Ritz Carlton which is doing extremely well and which is a meaningful part of Host Marriott.

**NEW SUPPLY WON'T HURT HILTON OR TRIZECHAHN.  
WE'RE DIFFERENTIATING, BUT THE MARKET ISN'T....**

**Ditto for Hilton....**

**Cates:** In the case of Hilton, you not only have their top 10 hotels giving you two thirds of its cash flow — things like the Waldorf Astoria, Hilton Hawaiian Village, Palmer House and other true trophies — but they're about to also fold in Promus which they've bought. And we're

happy about the combination. So we get a fee stream coming from Hampton Inn and some of these other things where you like having the fee, but (as you've picked up on) you might not want to own the hard asset. So it's really a differentiation thing.

**The market's throwing out the baby with the bath water.**

**Cates:** To us, the mathematical proof's obvious. If you just look at the hotel group, you see that they're all down roughly the same amount. And they all sell at similar multiples. What that says is that the stock market isn't yet making a distinction between a Ritz Carlton that we own through Host Marriott and some mid-priced piece of junk in a suburban market.

That's why we see the supply [coming on and benefiting] Marriott International, but we're not sweating it a whole lot at Host Marriott and Hilton.

**Why are they selling a Ritz Carlton? The price was right....**

**Shareholder:** [As C.T. mentioned,] Host Marriott just announced the sale of a central business district [CBD] hotel in Boston — a Ritz Carlton. And they've said that the reason why they're selling it is to buy back their stock — at least, that's what they say. And it strikes me that it

PORFOLIO REPORTS estimates the following were Longleaf Partners Realty Fund's largest equity purchases during the quarter ended 9/30/99:

1. WASTE MGMT INC
2. TRIZECHAHN CORP
3. HILTON HOTELS CORP
4. FRANCHISE MORTGAGE ACCEPTANCE CO
5. MARRIOTT INTL INC

probably makes sense.

However, why a Ritz Carlton in downtown Boston? Given your comments, aren't there other properties that would be more appropriate for sale?

**Fitzpatrick:** Right. Well, I think they correctly put it on the table in terms of price and value the way that we do. And frankly, they sold that hotel for more than we think it's worth and, apparently, more than they think it's worth.

**Selling at a 6-7% cap rate and buying at 20% works well.**

**Fitzpatrick:** And if you can do that and then buy in your own stock at a huge discount to its intrinsic value — well, that works really well.

**Cates:** We may appraise that particular Ritz Carlton — just picking rough numbers — using [a cap rate of] 9%. If they can sell it at [an implied cap rate of] 6% or 7% and buy their shares back in the stock market at what amounts to [a cap rate of] 20%, literally — well, that's a good trade.

**TrizecHahn is extremely well positioned....**

**Shareholder:** I'd like to ask a question about an article that appeared in the September 16, 1999 issue of *Forbes Magazine* entitled "The Great Suburban Overbuild". It indicated ... that in suburbs of four metropolitan areas — Chicago, Dallas and two others — there was a tremendous amount of overbuilding of office buildings. And in the last page of the article, they listed a number of

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**LONGLEAF PARTNERS FUNDS' CONFERENCE CALL**  
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real-estate-related companies that they thought were especially vulnerable to the overbuilding that they claimed was going on. One of those companies was TrizecHahn. Do you have any opinion about that?

**Fitzpatrick:** Well, yes. TrizecHahn has very limited exposure to the areas you're talking about. Their office properties are almost exclusively in the CBDs [central business districts] where there's very little building going on. And their properties have below-market rents. In addition, the buildings that they bought in Texas were purchased around four or five years ago at prices per square foot that probably average between 25% and 40% of replacement cost.

So they are extremely well positioned because of the very intelligent way in which they entered those markets. They hadn't been buying in those markets for a number of years. [As to] the companies the article might refer to other than those we own, I can't speak to them. However, TrizecHahn is extremely well positioned.

And one last point: They have long-term leases in place at those buildings. So regardless of what happens to the market, they're going to continue to collect rent.

**Shareholder:** Do you know what their average vacancy rate is by any chance?

**Fitzpatrick:** I think the average vacancy rate in their office portfolio is about 8%. And in those markets, I believe that they are better than that. They're pretty much fully leased up in those markets. Good question.

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**OUR GM PURCHASE ISN'T A BET ON CARS AND TRUCKS.  
 WE'RE GETTING THOSE ASSETS FOR FREE — OR LESS.**

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With our GM, the car part cost us nothing — actually less.

**Shareholder:** You've put a lot of cash to work.... Has some of the cash gone to new securities instead of just adding to existing securities?

**Cates:** Maybe the largest one we've added to which we've outlined in the quarterly report is General Motors. [That purchase] is not a bet on cars and trucks. It's a bet on Hughes Electronics whose biggest asset is DirecTV — which we know very well from our cable holdings.

And the value of Hughes, which again is mostly made up of DirecTV, plus the value of GMAC, which is a very high quality finance company, is more than we've paid for GM. Plus, there's a lot of net cash. So we're getting the car and truck company for less than nothing. In effect, we're paying a negative number.

Even valuing vehicles very conservatively, GM's very cheap.

**Cates:** And we're valuing the car and truck company at less than what Chrysler sold for and for about two thirds of Ford's market cap even though it's bigger than both of 'em.

Our appraisal of the car and truck company is very low because we think that's a bad business. But even with an incredibly conservative value [on it, General Motors] is

still very cheap. The value growth will come from DirecTV.

And we very much like what we see management-wise.

**Cates:** And in terms of its management, it has what may be the best board of directors that we've ever seen. On GM's board is Bill Marriott, John Bryan from Sara Lee, Percy Barnevik from Investor A.B., George Fisher from Eastman Kodak and John Smale from P&G. And I could go on and on.

They've improved the operations of the car company. They've bought in tons of shares. They've spun out all of the different other pieces besides Hughes. And we think it's just a matter of time before they separate out Hughes. But for now, it makes sense to keep 'em together.

So that's kind of our main, new holding....

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**WE THINK WE'RE AS CLOSE TO NIRVANA  
 AS WE'VE BEEN IN THREE OR FOUR YEARS.**

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If we get three things right, there's nothing to worry about.

**Shareholder:** ...I was wondering what the mix was in your stocks now.... Is 75% of the portfolio dead cheap or is 60% of the portfolio dead cheap right now?

**Hawkins:** Well, we could give you a lot of statistics about the most recent quarter or the most recent year. But I don't think that would be as insightful as maybe our sharing our experience, say, over the last 30 years.

Clearly, our great wish would be to have the cheapest price-to-value ratio we could build with the best companies and the best managements. If you do that, then you just go to bed and you don't worry about when you get paid — because you have three things working on the compounding equation:

You have intelligent managers working for you building more free cash flow that gets retained.... Therefore, those values grow. Second, you have intelligent managers repurchasing shares when they're very cheap. And that builds intrinsic value per share even more.

A measly 12% per year earnings growth can go a long way.

**Hawkins:** Then, because your price-to-value composite ratio is so low, you have this gap between price and value closing — say, over the next five years. And the combination of the growth in value per share and the closing of the gap between price and value gives you a tremendous outcome.

For example, if you own a business whose value is growing 12% per year and you only paid 50¢ on the dollar for it — and if the price rises to reflect its underlying value in the fifth year — then you achieve a compound annual return of 29% per annum. And I might add that you've deferred your taxes for five years....

We think we're as close to nirvana as we've been in years.

**Hawkins:** That's nirvana — that's what we're shooting for. That's our goal. And we're as close to being able to put that into play today as we've been in three or four years.

**Shareholder:** Compounding at 29% per annum going forward...

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**Hawkins:** We hope ... that our values could grow at 10-12% per year. We hope because they're at half of value today that those values will close over the next five years to appraised value. And if we get both of those — if the values grow at 10-12% per year and the gap between price and value closes over that five year period — we're looking at very high returns. The sum of the two ... will give us a very good outcome.

We don't control when the market's going to "properly weigh" these businesses. But we do have great experience that when you buy them cheaply enough and they're run by honorable, capable people, you will get a good outcome. So our job is to make sure that the companies are competitively entrenched, that we're not paying more than, hopefully, half of value for them and that the managers are doing intelligent things for us as shareholders....

**Our holdings are unusually — almost uniformly — cheap.**

**Cates:** I don't know if this helps or not — because I don't think we can answer it exactly in the terms you ask. But one kind of blunt instrument would be that each fund — Longleaf Partners Fund and Longleaf Small Cap Fund — only have two names that are over 70¢ dollars.

**Shareholder:** That's what I wanted to know.

**Cates:** Which as you can imagine is rare. Usually, a few more names are closer to being a sell than that.

**Harper:** And just for perspective, in Longleaf Partners Realty Fund, there's *nothing* currently selling for over 70% of what it's worth — which attests to the value there. And in Longleaf Partners International Fund, there are only two or three names that are selling at 70% or more of what they're worth.

BAY VIEW CAPITAL'S STOCK PRICE IS A JOKE.  
 AND ITS MGM'T IS AMONG THE BEST WE'VE SEEN.

**A lot to like now at Bay View — and it's getting better....**

**Shareholder:** I wanted to ask you about one of your investments that you've owned for a long time in both Longleaf Partners Realty Fund and Longleaf Partners Small Cap Fund. It's Bay View Capital — which is a savings and loan that I think converted to a bank. Could you comment on it?

**Fitzpatrick:** Yeah. We won't tell you that Bay View Capital is the greatest business in the world — [because] it's not. But we have the best management team there clearly in the industry and, in our opinion, one of the best management teams in *any* industry.

They've aggressively repurchased their shares. Every company that they've ever bought they've stolen. They're closing on the transaction of a company that has much better economics than their core business — FMAC....

[Editor's note: The merger between Bay View Capital and Franchise Mortgage Acceptance Company (FMAC) has been completed.]

**Bay View's price is a joke today — and its value is growing.**

**Fitzpatrick:** Bay View sells for about a third [of the price] of all the comparables of California thrifts. Every transaction in the state of comparable companies has occurred at prices significantly higher than Bay View's current price. And Bay View has the largest market share of deposits in the Bay area that is not a major bank.

So it's a very attractive company. It would be a very attractive acquisition for any number of companies interested in California. And we have a management team that's highly motivated — not only to build value, but to have that value recognized. So, basically, we *love* it.

**Shareholder:** Do you think the acquisition you mentioned is accretive to earnings?

**Fitzpatrick:** It is very accretive to free cash flow. Because of GAAP accounting, it's not very accretive to earnings. But we look through that to the cash earnings. And on that basis, among others, Bay View's price is a joke.

**Berkshire is definitely cheap, only other ideas are more so.**

**Shareholder:** You mentioned Mr. Buffett earlier. Does Berkshire look attractively priced at these levels?

**Cates:** It's definitely more attractive than it's been in a long time. The \$64,000 question with Berkshire is basically how much do you pay up in order to get the greatest capital allocator around — because it's not going to go to a 60¢ dollar the way we traditionally demand. You've got to make the case that the value build is kind of your margin of safety there as opposed to a discount to NAV.

So it's definitely attractive. And it's in a range that probably offers a good, long-term return. However, in our price-to-value world, it's not as cheap as some other things that we like.

WE DON'T CHASE HIGH TECHS OR RUN FOR THE HILLS.  
 IT'S JUST A CASE-BY-CASE THING. TAKE PHILIPS....

**We don't mind owning high tech — especially if it's free.**

**Shareholder:** Do you ever see yourselves owning a tech stock — particularly in Longleaf Partners Fund?

**Cates:** We don't come at it that way from a macro standpoint.... We're agnostic about industry groups. So we wouldn't begin the answer by saying, "Yes, we want to own techs." or "No, we don't want to own techs."

Instead, the relevant part of our philosophy is that it has to be something that we understand. And that includes both the product and who competes with that particular company as well as the economics of that business. So that does tend to screen out certain things.

But I would highlight a few things that we have owned because both the circumstances and the price were right. One example was MediaOne — where we made 2-1/2 times our money. We bought cable very cheaply based only on the video opportunity and got the cable modem opportunity for free. It's now manifested itself in these huge multiples that the cable companies are now trading for. But they're maybe the biggest pipeline internet beneficiary we know of. And because we got that, I guess, for less than free, we were happy to be there — although that's something that may be hard for us to size up technologically.

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**LONGLEAF PARTNERS FUNDS' CONFERENCE CALL**  
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With Philips, we got high tech plus other stuff for free.

**Cates:** Another one would be Philips. Our cost in Philips is in the high \$30s. And at that price, their cash and marketable securities alone exceeded what we paid. So not only did we get the lighting and all of the Philips and Magnavox appliance businesses for free, but we got a huge semiconductor business for free. And we still own it. From our probably limited understanding of how it works, we like the business.

But because our understanding is limited, we value it *extremely conservatively — way below what similar companies trade for in the stock market*. But it's not a lynchpin of our case [for Philips]. And I have a hard time saying that had that company traded out there by itself in a vacuum that we would have bought it.

So it just has to be on our terms. And it's got to be in ideas that are cheap and understandable. But there's nothing that says we hate tech and don't want to own tech. And there's nothing that says that we feel like we're missing out explicitly — and, therefore, we've got to go *chase* tech stocks. It's just a case-by-case thing....

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**WE DON'T LIKE PAYING TAXES ANY MORE THAN YOU,  
BUT WE ALSO DON'T LIKE OVERVALUED STOCKS.**

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Microsoft may be your cup of tea, but it isn't ours.

**Shareholder:** In 1998, in Longleaf Partners, you made half of the benchmark that you chose — the S&P 500. That is, you were off 14% from the benchmark. And we had a large distribution. I fought off clients saying, "God, I've got to give the man on the hill all of this money in tax returns." But we're facing the same thing in 1999 — half of the S&P 500 return and a large distribution coming at us to take money out of our pockets. So the bottom line is that the client is looking at no significant relative total return. Yet the man on the hill gets *his* dollars....

**Hawkins:** The S&P 500 is ... shown as a measure of performance. However, it's not a benchmark that we shoot for. Our benchmark is inflation plus 10%. It's always been that. It's absolute returns looking at what the risks are in order to achieve those absolute returns.

And we would submit that those people who are interested in buying the S&P 500 right now at 28 times trailing earnings with the great weighting in Microsoft and all of the others that drive the S&P 500 are free to go pursue that if they think that makes sense.

If buying things that have a 3-1/2% earnings yield in industries that we can't understand with technology risk and all of the other things attendant, if that appeals to you — we would encourage you to pursue it. However, we're going to be mindful of what our values are and the risks that we take when we deploy our assets.

We'll sell a stock for any of four reasons....

**Hawkins:** Many of you have asked us when we sell a stock. And so we thought that we would talk a little bit

about that briefly — because it's a topic that comes up quite often in our conversations with our partners.

We sell a stock for one of four reasons: The first is that the [stock] price reaches our appraisal and no margin of safety of value over price remains. The second reason is when we can improve our risk/return profile substantially — for example, when we can replace a business selling at 80% of its worth with an equally attractive company at 40% of value.

The third thing that would cause us to sell a position is a case where the company's profitability becomes severely impaired because of threats to its competitive position. That doesn't happen very often — and hasn't happened except on one or two occasions during the last 24 years here at Southeastern. However, it would certainly be a reason that would cause us to rethink not only our long-term holding, but also to question whether the company could generate earnings power down the road.

The fourth thing that would cause us to sell a position would be that we no longer believe that management could build shareholder value and that efforts to find new corporate leadership would be either unsuccessful or too costly. And that, again, is something that we've not had to deal with often....

PORTFOLIO REPORTS estimates the following were Longleaf Partners Small Cap Fund's largest equity purchases during the quarter ended 9/30/99:

1. SAFETY-KLEEN CORP
2. ROMAC INTL INC
3. FLEMING COS INC
4. PEDIATRIX MEDICAL GRP INC
5. MONY GROUP INC
6. WISCONSIN CENTRAL TRANS CORP
7. BAY VIEW CAPITAL CORP
8. THOMAS INDs INC
9. US INDs INC
10. AMETEK INC

How long will we wait? As long as it takes.

**Hawkins:** Some of you have asked how long we'll wait for a stock's price to rise before we'll exit an investment. Well, a stock's price really tells us nothing about its underlying corporate value, nor does it indicate over a short period of time how we're executing. Asset values and the free cash flows that are produced from certain assets in the business determine a company's intrinsic value and, eventually, our investment outcome....

Our horizon is opportunity driven, not time driven. If the return opportunity remains significant based on the quality of the business, the actions of management and the price of the stock, we are very patient long-term investors for all of the obvious reasons — including the deferral of tax liabilities and because compounding works best when it's not realized [in the short-run].

And of course, we always encourage managements to build their long-term competitive advantage even if it means sacrificing their short-term, reported results....

Market made us an offer (two, actually) we couldn't resist.

**Hawkins:** As regards booking taxes, ... 95% of our  
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**LONGLEAF PARTNERS FUNDS' CONFERENCE CALL  
MASON HAWKINS, C.T. FITZPATRICK & STALEY CATES  
(cont'd from preceding page)**

realized gains [last year] were long term. We booked those tax liabilities because those stocks rose to our appraisals. News Corp., Seagram and MediaOne were tremendous investments for Longleaf Partners Fund. And had we not made the commitment to those, we would not have created the kind of long-term returns we realized.

We've taken those dollars that got fully valued in the equity market and we held on to the cash until we could find the next 50¢ dollar. And we're very convinced here that we've deployed that capital intelligently in very, very competitively entrenched businesses at half of their values with people who we think will manage the companies well and allocate the capital intelligently.

**There's a constant trade-off between turnover and value.**

**Hawkins:** We don't like paying taxes any more than you do. And I would submit that we have a whole lot more invested in Longleaf Partners Fund than your clients do. We want to defer our tax liabilities as far into the future as we can.... However, we also don't like owning equities that sell for more than they're worth. And there's a constant trade-off there.

There are three or four things that drive that decision: (1) When a business gets to full value, there's no margin of safety left. So you're subject to the vagaries of the market — the fear and greed that may prevail subsequently. Therefore, as a general rule, we want to sell 100¢ dollars. (2) We like to sell 'em *after* we've owned 'em for 12 months so we get the 20% tax treatment. And (3) we like the capital that comes from those 100¢ dollars when we can redeploy it in 50¢ price-to-value relationships.

That hopefully gives you some feel as to the reason why we've sold fully valued businesses and held the cash until we could redeploy it in cheap companies.

**ONE NAME HURT OUR RETURNS & OUR TAX SITUATION.  
BUT OUR RESPONSE? WE'VE BEEN BUYING MORE.**

**One name hurt our returns and, in effect, our tax situation.**

**Cates:** What it really boils down to is what do we do from here. Do we hold, sell or buy more? And why should you have faith ... in the context of being unhappy with what's happened? My advice would be to look through the mutual fund to what you really own. The building blocks are an even better indicator of what has happened and what's going to happen.

For example, take Waste Management. Our unrealized loss on Waste Management is why we have a flat total aggregate return which offsets those taxable gains that we harvested for logical reasons. So what it boils down to is that the reason that both your return is poor now as well as the fact that you have an unfavorable tax situation is Waste Management. And there are a couple of other names like that, but let's stick to that one.

**But when you look at the facts, it's very easy to have faith.**

**Cates:** So let's look through at Waste Management. It's down to \$17-1/2. And they're going to do \$3 of free cash flow now — even on all of these reduced expectations.

And we think a decent CEO gets that to \$4-1/2 or \$5.

So ... do you sell Waste here, do you hold it or do you add more? Well, here it is at a P/E of 6 — even before things are corrected. And we know we're stealing it because we know how much everybody hates it. Furthermore, we know what the future prospects are. And we know what the landfills are worth no matter what happens to the management systems and the computers in the next 12 months. Therefore, we would submit that Waste Management is something we should add to heavily. And that's why we've taken the position up.

That's really what this thing boils down to. The building blocks of your future returns are these names. And when we look through to these names and putting all of our own capital in these names, that's why it's not only an easy answer, but that's where our faith lies....

**What drives our purchases is price-to-composite value.**

**Hawkins:** As the largest investor across the board in the four Longleaf Funds, the thing that guides our aggressive purchase — or our *deferral* of purchase — of the Longleaf funds is simply the price-to-composite value.

Each month, we value each of our businesses. And each month we compare that valuation to the share price the market puts on those companies. And as the price to composite value ratios go down to this 50% of appraisal — as the four funds have done here in the last quarter — that drives our interest to own more of the very discounted businesses that we have in each of our four portfolios.

**We don't like the tax liability, but we love the discount.**

**Hawkins:** Therefore, in the third quarter, we were the most aggressive purchasers of the Longleaf Partners funds here — between our own capital, our retirement plan and our foundation — of any period in the last 12 months. And it was driven by this very steep discount of price to value.

And we clearly are aware that we will share some short-term tax obligations because of our aggressive recent purchases. However, we think that the opportunity of the discounted prices is substantially greater than the few cents per share that we'll have to ship to Washington as a result of our aggressive purchases....

**WE USE THE WORD "INVESTING" VERY CAREFULLY.  
AND WHAT'S GOING ON TODAY IS SOMETHING ELSE....**

**Just because you win a loser's game doesn't make it smart.**

**Shareholder:** I know that you don't like to comment on the general market. However, investing for growth at outrageous prices seems to be working better today than value investing or investing in growth at reasonable prices. And some of the worst portfolio managers in the industry seem to be doing better than the greatest managers.

Is that something you think will last for awhile?

**Cates:** Well, we share your frustration.... This may sound smart alecky, although I don't mean it that way. But if we walked out of the casinos in Tunica having won a lot at the blackjack table, we might say, "Gosh, this gambling thing isn't so bad after all. We won. And that's probably really a great way to make money."

But we know that's *not* the case — that on the margin, going forward, that would have nothing to do with our probabilities for success. Well, to me it's the same

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**LONGLEAF PARTNERS FUNDS' CONFERENCE CALL**  
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 (cont'd from preceding page)

[with investing today].

This is the way it always goes. Just pick your tulip bulb.

**Cates:** Go back to any historic market peak — and it doesn't have to be equities. It could be real estate in the late 1980s. Or it could be a foreign market like Japan in the late 1980s. Pick your tulip bulb. In all those cases, people who were trying to be rational felt like this as it hit the late stages.

All we can do is stick with our discipline and make sure that in a dangerous time like now, we're not setting ourselves up to lose a lot of permanent money....

It doesn't bother us to pass on things we don't understand.

**Hawkins:** ...When you look at it from the perspective of it being your money, it doesn't keep us up at night if somebody else is making some money on principles that we don't agree with. In fact, we're all *beneficiaries* of what's going on in Silicon Valley and with the internet. It's lowered the cost of production for some of our businesses. It's creates a lot more wealth in the system — [as he laughs] some of which may be ephemeral.

It really doesn't trouble us that somebody might have made a higher return in something that we're not capable of understanding, that we're not capable of valuing and that's certainly not trading at 60% of whatever number that we might speculate its value is all about.

So we're not nearly as frustrated as maybe some of our other shareholders might be because we're only going to play in the circle that we feel that we can understand. And we're not going to be purchasing things that might have just gone up because they went up. It doesn't trouble us that that's outside our sphere of operation.

You can't call much of what's going on today "investing".

**Hawkins:** For those who feel they need to put money into dot.coms when there's no revenue and no earnings because they've been going up, we wish them well. It's not for our capital. It's not for our families or our foundations or our retirement plans.

It really goes back to what Graham said: "An investment is something that promises safety of principal and an adequate return." And right now, I don't believe that you can apply the definition of an investment to what many are doing in the world of finance.

We use the word "investment" very carefully around here. We want to get our money back first — and we want to get a return on it second. Everything else that doesn't promise safety of principal and an adequate return by deduction is a speculation.

**WE'RE NOT PREDICTING DISASTER THIS TIME.  
BUT THESE THINGS HAVEN'T ENDED WELL BEFORE.**

When fortunes came easily, they've been lost that way, too.

**Hawkins:** It makes people happy at cocktail parties that they participated in a successful speculation. But do we want to go put literally billions of dollars into things that don't promise to give us our principal back and a

reasonable return?

If you go back and study the last hundred years, you'll see that there have been periodic bouts of greed that have drawn people's attention to things that were easy. And almost without exception, those magnetic periods have taken permanent capital away from them.

We're not prognosticating what will happen this time. But it clearly could be another period where people get disappointed.

We'd rather not own overvalued stocks insiders are selling.

**Cates:** And this relative stuff will do nothing but drive you crazy because whether you look at the unweighted average stock in the S&P or whether you look at the average stock in the Value Line (which is not market-cap weighted, although it's a bunch of large companies), the average stock has done poorly. So by definition, the S&P 500 doing real well — which is driving everybody crazy — is a function of a handful of companies like Microsoft doing *spectacularly* well.

But going forward, would you rather own the Microsofts of the world where the top guys tell you it's

PORFOLIO REPORTS estimates the following were Longleaf Partners International Fund's largest equity purchases during the quarter ended 9/30/99:

1. SAMPO INSURANCE CO LTD
2. SAFEWAY PLC
3. O&Y PROPERTIES CORP
4. NIPPON FIRE & MARINE INS CO LTD
5. BEMROSE CORP PLC
6. CANADIAN PACIFIC LTD
7. WISCONSIN CENTRAL TRANS CORP
8. ANGLOVAAL MINING LTD
9. NISSAN FIRE & MARINE INS CO LTD
10. DE BEERS CONS MINES ADR

overvalued and they're all selling tons of stock or our fund where every company but two are buying in substantial shares and screaming about how cheap they are?

And even if our returns aren't as high, our risk isn't either.

**Harper:** I think the focus is what is your return goal and how much risk do you have to take to get that? Here, we feel pretty good about the fact that a year ago, we had 55¢ dollars in these portfolios overall. And a year out from that, we have a 20% return booked.

So in one year, we got that kind of return — and with what we feel like was very little risk to get that kind of return. So if the S&P did better than we did, that's OK — because we don't feel like we took very much risk to get a great return.

**Hawkins:** Again, we always go back to what our absolute goals are. Compounding works best if you shoot for absolute returns. Inflation plus 10% has always been our bogey. And fortunately, over the last nearly 30 years, we've been able to do almost twice that.

There have always been periods where others did very well in worlds that we weren't comfortable participating in.

—OID

**WESCO FINANCIAL'S  
CHARLIE MUNGER**  
(cont'd from page 1)

business, investing and the human condition. For example, his comments at past annual meetings have included warnings about debacles to come in savings and loans, junk bonds and derivatives years before they arrived, much less entered the public consciousness.

For those reasons and more, we're very pleased to bring you excerpts from his comments at Wesco's most recent annual meeting — followed by excerpts from his comments and those of partner Warren Buffett at their latest Berkshire annual meeting which we didn't have room for in our last edition. As always, we highly recommend a careful reading (re-reading, etc.).

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A LITTLE BIT OF PONZI EVERYWHERE TODAY —  
THAT'S JUST HOW OUR CULTURE HAS EVOLVED.

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We leave incentives alone — except for cutting out options.

**Shareholder:** You and Warren have talked and written about stock options and your distaste for them. Might you say a little more about alternative incentive plans that companies could put in place for management and some of the things that you've done in [that area]?

**Munger:** We do not have some "one size fits all" management incentive plan. And many big companies do. With our extreme decentralization where we inherit various incentive plans that people are used to, our practice has been to leave the existing system in effect.

The one exception has been that we do stop issuing new stock options with the traditional corrupt accounting treatment that has prevailed in this country for 50 years that I can remember. In some cases, we've given management the same thing economically. But we do it in what we think is a more honest way where the true costs of it go through the earnings statement, etc. However, we have to change the way the plans are written and how they work to get the accounting treatment that correctly reflects reality.

Corrupt stock option accounting is not a new phenomenon.

**Munger:** The accounting treatment in America for stock options was the subject of a long study group at the Harvard Law School in 1947, I believe, when I was there. At that time, I concluded that accounting for stock options was corrupt, foolish and violated all engineering principles — and I learned to detest it.

And yet here I am 50+ years later — and what do we have but the same lousy, corrupt accounting which is the standard accounting practice of the world, the standard reporting practice of America, and one which is, by and large, also accepted in the business schools of America.

But now at least a little Ponzi pervades corporate America.

**Munger:** What's different now is that 50 years ago, options involved a very small percentage of the capitalization of American business. We hadn't raised the practice to an *art* form and run it to ridiculous extremes.

Take Cisco — which I have every reason to believe is a

wonderful company with wonderful products. But it's basically paid a bunch of employees — who, incidentally, are worth high compensation — with a big fraction of their total compensation year after year after year in the form of stock options. And it goes quite deep into the company.

So they've taken a whole lot of expense off the books. And even after adjusting for the dilution in earnings per share in accordance with accounting treatment, they're getting what amounts to a *mirage* of phony earnings on top of the very good earnings they're making selling software.

It operates a lot like a Ponzi scheme. And yet it's perfectly respectable. After all, the Ponzi scheme is attached to a respectable business — which Cisco is. And it only affects *part* of it — it's not *all* Ponzi scheme. It's just that there's a little Ponzi mixed up with the rest of Cisco. And that is the way that our culture has evolved.

People with a stake in the game continuing are everywhere.

**Munger:** And just like any chain letter scheme, if you try and end it, the people who are in the middle who are waiting for the new people to come in and boost them up don't want the game to *stop*. And the communities that are getting rich from having a bunch of Silicon Valley people prospering mightily with stock options — well, obviously, *they* don't want the game to stop.

So the minute Congress or anybody else talks about changing it just because it's unethical, lousy engineering and not good for civilization in the long pull, the people benefiting from the game rise in *wrath*. And they say it's as American as apple pie and it's what creates modern software — as if you couldn't create software *without* stock options.

He whose bread I eat, his song I sing....

**Munger:** At any rate, the Munger view has lost — and what I regard as the corrupt view has won. I do not think it is a good thing that a corrupt view of that kind gets accepted by the so-called "better people" — in other words, the business school professors, the business leaders, the accounting profession, etc.

Incidentally, the accounting profession has done what most professions will do. They'll pretend to have integrity and yet bend a lot with the adage: "Whose bread I eat, his song I sing."

And no partner at the big accounting firms can criticize it publicly — because they're afraid of being sued. But if you talk to them privately, they'll say, "We just can't do anything about it." I can't do anything about it.

You can't be in software without issuing stock options.

**Munger:** By the way, if I were a software company executive, I'd probably feel that to hold on to my employees, I'd need stock options, too — I'd have to join in the game. I'm not sure if I would or not. I think I might choose to *lose* rather than do it. But at least I understand people who are in that business. If they're going to be effective and successful in a tough, competitive world, they think they can't be a software company without issuing stock options when everyone else in their field is doing it.

But do the math — and some of you are quite mathematical. Just run through an example of taking, say, 12% or 14% of a company's total expenses off the books and then work them back into the earnings per share to see the dilution that occurs. And to make matters worse,

*(continued on next page)*

**WESCO FINANCIAL'S  
CHARLIE MUNGER**  
(cont'd from preceding page)

the phony part of the earnings get capitalized at a very high P/E ratio, etc. You will find that you have grafted a bit of a Ponzi scheme onto a culture that should have more integrity. Again, I do not think that's a good idea.

How do we structure our incentive plans. It depends....

**Munger:** As regards the details of our own incentive systems, they are *enormously* variant. In some cases where it doesn't take much capital to run the business — where it's earning 150% on capital or something like that — we just give the guy a share of the earnings. In other cases, where capital is more important, we generally have a heavy capital charge before computing the pool from which incentive bonuses are awarded.

One of the reasons that we've done so well....

**Munger:** One of Berkshire's non-secrets has been that we really love companies that have all their earnings at the end of the year in cash when sales are static. I had a friend in the construction equipment business years ago. That's a very tough business — big inventories and big receivables. And he told me, "No matter how well I run this business, at the end of every year all my profit is sitting in the yard." There was never any cash — just more used machines in the yard.

Generally, we *hate* that kind of a business. We'd like a business that is spewing out a lot of cash — and you can take the cash and buy a second business which spins out a lot of cash and then you can buy a third business. That's a Berkshire kind of business. But these noncash generators which show accounting profits, by and large, we don't like.

And one of the reasons Berkshire has done so well is that we had that aversion very early in our history. If you just use earnings — ignoring whether those earnings are in cash or whether they're in the yard so to speak — I think you get some very ridiculous valuations. Businesses that generate tons of cash are, by and large, much more valuable than businesses where all of the profit is always sitting out there in the yard in used equipment, in slow receivables or wherever else it is, so you never have any cash.

**PROGRESS IN TECHNOLOGY DESERVES LESS CREDIT  
AND PRACTICE-RELATED IMPROVEMENTS MORE.**

Technology has changed productivity less than you think.

**Shareholder:** You commented about the difference between businesses where you can touch the money that you earn and businesses where you can't touch it because you have to reinvest it in equipment, inventory, etc.

**Munger:** Yeah, it just goes into working capital — because the business has to stay in non-cash in order to  
(continued in next column)

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stay in place.

**Shareholder:** Everybody is writing about how crazy many of the P/Es are — and, undoubtedly, many are. But it's also true that because of computerization and more efficient machinery — whether due to computers or faster diffusion of efficient ideas — many companies are able to use less capital than before to do the same business. And then, of course, it's easier to *do* more.

There seems to be a debate today between people who see this and say, "Therefore, businesses are worth more," and people who compare today's P/Es to those prevailing in 1960 and prior to the Crash of 1972 — which were probably outrageous by any standard. Would you expand on your thoughts regarding that debate?

**Munger:** Regarding your general questions about how the technical revolution has changed productivity and so forth, I would say, "Less than you think." Here at Mutual Savings, we computed the savers' interest and so forth with community college students, and maybe some high school students, working at night. Louie Vincenti, as many of you old-timers will remember, wouldn't change to computers because the students with calculators did it way cheaper and in a very acceptable form. I think that Mutual Savings was the last savings and loan in California to throw out the students and the Frieden calculators.

And when Vincenti did finally throw them out, it wasn't because the computers would do it *cheaper*, but rather that they would do it *faster*. We had people waiting in line a little longer. So it was a service issue that caused old Mutual Savings to finally go to computers....

Practice improvements have been greater than most think.

**Munger:** I think that a lot of the modern revolution in manufacturing has been technology-driven. But a lot of it has just been better *practice* — very old fashioned blocking and tackling in manufacturing. And I think that *has* created considerable productivity improvements. Certainly, the technical changes have created improvements. But I think technology-related improvements have been smaller than most people think — and the practice improvements have had *larger* effects than most people think.

It's been quite brutal out there in terms of the way businesses are organized. All of these waves of downsizing, practice-revision, best practices, 5 sigma or 6 sigma quality standards — all of that's forced a lot of change in all kinds of places. It's been very hard on the people who've had to adjust to a less forgiving and more demanding atmosphere.

**REVOLUTIONARY CHANGE IS NOTHING NEW.  
BUT THAT CAN BE GOOD OR BAD FOR INVESTORS.**

What's most interesting is revolutionary change....

**Munger:** The technology, where it gets interesting to investors, is not just in improving the efficiency of the world from the way it was. If you have a bunch of airliners and someone makes them a little bigger — or they can go across oceans on two engines instead of three or take longer flights, etc. — that's improving the airline business to be sure. But it's just the normal technical improvement that a technologically advanced civilization is going to have.

But what interests people is a *total* change of climate. For instance, before the advent of air conditioning, the

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**WESCO FINANCIAL'S  
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(cont'd from preceding page)

whole South was a sleepy, tough place in which to live and not very intellectually advanced compared to colder places. Take Mississippi, rural Georgia or the bayous of Louisiana. It was not an advanced civilization. I was in North Carolina as an Air Force officer and there were three livery stables, for mules on the main drag — the main downtown street — in Goldsboro, North Carolina. It was a very sleepy, backward place.

But air conditioning came along and *revolutionized* the South. It changed the world dramatically in terms of where was a good place to be and so forth. And it changed the economics of manufacturing in a very interesting way.

I can revolutionize society, but do nothing for investors.

**Munger:** Of course, having the railroad instead of a tow path where you're towing a barge down a canal or using a wagon on an imperfect road represented a real revolution with truly dramatic change. And likewise, the advent of refrigeration totally changed the world. Then, of course, air conditioning is just a type of refrigeration.

Then along came radio where unlimited people could listen to the best comedians and the best orchestras and the best this and that. And then you had television. Into the house actually came talking motion pictures, in color, with great sound. Pretty soon you had the average TV set on in the average home something like seven hours a day — so old people and sick people's lives were made endurable just because that television set was available with a clicker. It revolutionized human life.

In the revolution, investors can find agony or ecstasy.

**Munger:** Yet early investors in railroads did terribly. And the early investors in the airline industry did terribly. So the civilization developed, but not for the investors.

TV on the other hand, by reason of the technology, created *gold* mines for people. There were a limited number of channels that could broadcast in any given community because of interference in the electromagnetic spectrum. It was logical for one television station in each community to join in a network with stations in other communities so that they could all jointly bid for fancy attractions from Hollywood, professional athletics or what have you.... So it was a natural oligopoly.

Networks made a lot of money. And everybody who bought a fair sized network television station made a lot of money. It was a wonderful thing where all people had to do was identify an obvious technological development with economic barriers that prevented it from getting miserably competitive — like airlines and railroads. And people just rode it up like so many ducks on a fast-rising pond.

**INTERNET IS A GOOD IDEA — AND REVOLUTIONARY.  
THAT'S WHY IT WILL SPAWN SUCH IMMENSE LOSSES.**

The internet will revolutionize the world, but not like TV.

**Munger:** Now you've got the radical concept of enormously increased computing power — and, on the way, what we think of as almost unlimited bandwidth right into the home. Well, that *again* revolutionizes the world.

I don't personally think it's as revolutionizing as the TV set was. You take what human beings actually do with their time on earth before they put 'em in boxes and stick 'em away for good: The TV set's had an *unbelievable* effect. It's had indirect effects on the great branded goods companies and so on. And it's hard for me to believe that the internet will quite match that — I don't care *how* efficient it gets.

It's not the bad ideas that do you in, but the good ones.

**Munger:** But this idea of unlimited bandwidth into the home and this vast increase in software made possible by vast increases in computing power on cheap chips — that *does* revolutionize the world. And people are just going *bananas* for it.

But the part of it that should cause one to be cautious is a phenomenon that Ben Graham talked about over and over again. He said, "It's not the *bad* ideas that do you in, it's the *good* ideas." And you may say, "That can't be so. That's paradoxical." What he meant was that if a thing is a bad idea, it's hard to overdo it. And you will recognize it as a bad idea, so it's not going to cause much investment trouble. But where there is a good idea with a core of essential and important truth, you can't ignore it. After all, it's a good idea with important truth in it causing big effects. And then it's so easy to overdo it. So the good ideas are a wonderful way to suffer terribly if you overdo them.

I think the internet will spawn immense losses.

**Munger:** And that kind of thing happens in markets. Take the good idea of better transportation, air conditioning and so forth. One of the results was a crazy boom in Florida real estate in the '20s. It was basically a good idea that there'd be a lot of development in Florida. It was totally correct. That's exactly what happened. However, that idea was very easy to *overdo* because once everybody started believing it, the prices started cascading upward and people started buying land just because prices were going up, etc.

Fast forward to today. Is the good idea of the internet like the Florida land boom of the '20s where there's a lot of opportunity to get in a lot of trouble as an investor because you overbelieve in a good idea? I would say the answer is yes. I think there will be *immense* losses taken from people getting overenthusiastic about the good idea of the technical revolution created by the internet and cheap computing.

New technology has great opportunities and great dangers.

**Munger:** I think it will also be true that it will do in some businesses — because that's what technology does. Suppose you had a wonderful horseshoe company — and in came this damn automobile. It wasn't a bit good for horseshoes, buggy whips, street sweeping and all kinds of businesses that depended on horses. So I think the internet will do in some people.

And you find every newspaper in America is thinking, "Can I protect my classified franchise from the technology that's coming?" Nobody knows the answer to that for sure.

So I think that this technology has its opportunities. But it also has its terrible dangers and ... huge chances that you can make mistakes by overbelieving and overdoing the good idea. The one nice thing about it is that if you like thinking, it's very interesting.

Now you may say, "I don't want to think. I just want to make a lot of money fast without taking any risk." Well,

*(continued on next page)*

**WESCO FINANCIAL'S  
CHARLIE MUNGER**  
(cont'd from preceding page)

I'm afraid I can't help you today....

The internet won't affect Wrigley much. That's good & bad.

**Shareholder:** I agree with you about the internet being like the Florida analogy. But I think the real issue ... is does the revolution that you've talking about make G.E., Wrigley, and all those companies more valuable because they're more efficient because of the new technology?

**Munger:** Well, I don't think Wrigley is more efficient because of new internet technology. I don't think we're going to change chewing gum very much. Now, whether it's more valuable because you can identify it as one business technology that's not going to change very much...

One of my favorite stories about Wrigley... Years ago, one of the Wrigleys was on some boat with somebody or other who remarked about what a wonderful business Wrigley had. This Wrigley said, "Well, it is a nice business. However, it was better when Grandfather controlled the world's supply of chickle."

WITH THIS MUCH MANIA, PROMOTION AND UPROAR,  
MUCH OF IT WILL PROVE TO BE FOOLISHNESS....

There are times when it's a good idea to lose money....

**Shareholder:** A Wall Street Journal article suggests profitability is a quaint, old-fashioned notion and that the modern growth business should go for market share and size and only worry about profits years and years later. I'd like to hear your thoughts on this revolutionary new theory.

**Munger:** Well as a matter of fact, it's not a revolutionary new theory. There are times when it is wise in business to reduce profits below zero in the short term in order to increase profits much later. And at GEICO today, Lou Simpson would tell you that the degree of advertising going on is such that we're harming today's profits from what they could easily be in order to help profits many years down the road. So it's not a new theory that under appropriate conditions, the smart thing to do is to lose money now to make more money later. That is frequently a good idea in business.

But today, that good idea is being carried to wild excess.

**Munger:** But like any other good idea in business — and like the Florida swamp land in the '20s — a good idea can be overdone. Whether or not the current internet mania is greatly overdoing that idea, I don't know. Certainly, the basic idea of getting efficiencies of scale from market share, etc. is a good idea.

But as I said, big trouble in life is often caused by good ideas carried to excess. It's not the bad ideas that do us in. Is this one being carried to excess? Well, I'd say it's highly probable that, in many instances, it is. However, I couldn't identify the specific instances. I just know that with this much mania and this much promotion and this much uproar and this much inherent unpredictability in human affairs, a lot that is going on will prove to be foolish. But, quite likely, big fortunes will be made by a few.

There was an outbreak of mass insanity in academia....

**Shareholder:** I think I'm starting with two strikes against me because I'm a professor of finance to start with — and I live on the bayous of Louisiana. [Munger laughs].

Whenever I go to a Berkshire meeting or come here — and this is my second time — I hear a lot about professors of finance being criticized. But we're always willing to change our views on whether or not markets are efficient. We just do our research and try to teach the best we can. And at times, we change our views. I hope that's taken as a positive because I sometimes get angry when everybody starts criticizing professors of finance. I think we do a good job trying to teach and do the research we can, although, of course, we make mistakes....

**Munger:** I certainly have nothing but commendation for any professor of finance who comes to a Wesco or Berkshire meeting. You're my kind of a professor of finance.

I create more of that animosity than Warren does. He's more tactful. But what happened with reference to your profession is there was an orthodoxy of what I call "hard-form efficient market theory". And it was an *insanity*. You can only describe it as a mass insanity.

And naturally, we got a little irritated with people who were prattling a mass insanity in an academic setting. We've got no problem at all with professors of finance who believe that markets are moderately efficient on average. The so-called "soft-form efficient market theory", I think, is a perfectly rational and useful concept. But it was the other group that dominated your profession for a long time.

If we've tarred you inadvertently with the brush that should have gone to them, why, I hereby apologize.

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NOT EVERYTHING WE DO FITS THE CLASSIC PROFILE  
— AND SOMETIMES THEY WORK OUT FINE ANYWAY.

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Allied Domecq's mgmt may be smarter than you think.

**Shareholder:** I'd like to ask about Warren's trip to England. It reminds me of the speculative bubble in Honolulu real estate where a Japanese was driven around in a limousine and pointed out houses he'd buy without seeing. Before long, whenever a limousine was sighted, the house's price would go up \$40,000 or \$50,000 even if he wasn't the one in it. And it was called the "Buffett Effect" when Marks & Spencer and other stocks went up.

Apparently, the news came out that his investment was in Allied Domecq. That surprised me for several reasons: First, I would not call its management distinguished. Second, it's within an industry that will probably be the next target after tobacco for class action litigation. In fact, with what economists call the socialization of the tobacco industry in the U.S., billions of dollars have been funded to lawyers who are looking for their next target.

So maybe I'm wrong about its management. But is this a cigar butt or is it the kind of business that ... you should buy because it can be run by anyone?

**Munger:** Well, I want to confess that I don't know that much about that particular investment. However, we like companies with strong brands. And we like companies that rationalize in various ways. And my guess is that based on what that company is doing, its management is

*(continued on next page)*

**WESCO FINANCIAL'S  
CHARLIE MUNGER**  
(cont'd from preceding page)

way smarter than you're giving them credit for being.

Not all of our investments fit the classic Buffett profile....

**Munger:** You may remember when Berkshire bought into General Dynamics. You could have said, "What the hell is Berkshire doing in a shrinking defense business?" Well, the guy who was then running it — nobody would sell him any companies and everybody wanted to buy companies at unprecedently high prices. So he just kept shrinking and buying in stock and one thing and another and rationalizing General Dynamics. And in due course, its stock outperformed that of most defense companies.

So we occasionally get into things that don't fit what you might call the classic Buffett profile yet which work out very well — such as General Dynamics. We also buy some things that don't work out very well. That's what keeps our life interesting.

But a company with strong brands that's doing some rational things... I haven't looked at it personally, but it wouldn't surprise me at all if it worked out very well.

As for the "Buffett Effect", that's just a price we have to pay.

**Munger:** Regarding the so-called "Buffett Effect" — well, we hate that copycat stuff. Being so famous that we get all of these followers is fun once or twice a year when a group of you people get together — many of you being old friends from old days. But having followers that speculate on what we're doing and rush into everything we're reported to be buying ... doesn't make our life easier as investors — and we don't like it. But it's a price that we have to pay for having lived a long time and having a good record....

I'VE ALMOST NEVER LOOKED AT WHAT LOU'S DOING  
— AND WARREN'S ABLE TO KEEP HIMSELF AMUSED.

Being enormously decentralized fits our temperaments....

**Shareholder:** In Omaha this year, Warren said he wasn't buying REITs, but that some of the subsidiaries — General Re or GEICO — could have been buying them. Yet the papers and press continue to talk about the interest of Berkshire in REITs. Also, I was happy to see Lou Simpson here at the meeting. But do these portfolio managers of General Re and GEICO in any way come to you and Warren for confirmation of the things they're doing — or are they totally independent?

**Munger:** By and large, my style in life is either to delegate completely or get too involved. I don't seem to have a good middle ground. Warren is better than I am at being partially involved, but only moderately better. Therefore, Berkshire is *enormously* decentralized. And that means that Lou Simpson is doing his own investing and the people in the European part of General Reinsurance are doing their own thing in their own way.

The rest of it's centralized in the way it's always been. But I know I don't even look — I've never looked — at what any subsidiary of General Reinsurance was doing. And I've almost never looked at what Lou Simpson is doing.

So it's quite possible that these pools of money that

are being independently managed might do something that we wouldn't even notice — particularly if it's small. And that would be much more true in my case than Warren's, who's more likely to watch investments in ever-loving detail.

Lou Simpson performs his millennial inspection of Wesco.

**Munger:** By the way, Lou Simpson, will you stand up — because it's a rare treat. This is the first annual meeting [of Wesco] that Lou's ever attended.

**Lou Simpson:** Charlie, I've only been a shareholder for about 17-18 years. So I thought maybe that it was time that I come inspect the management.

**Munger:** [Laughing] I see. Lou's been co-chairman of GEICO for a long, long time. And during his tenure there, GEICO has had a perfectly wonderful history — not only in the investment of the company assets, but also in running its insurance operations. It's continued to flourish — indeed, it's flourished even faster after Berkshire bought all of GEICO instead of merely being a very large shareholder.

An occasional cigar-butt investment keeps Warren amused.

**Munger:** Now that said, and Lou being introduced, I'll answer your question about REITs. I think what Warren said was that the part of Berkshire he was running — with me watching with very moderate participation — is not buying REITs and that he doesn't know or recall what Lou Simpson or General Re's sub-subsidiaries are doing.

The confusion arose from the fact that Warren personally bought a few blocks of REIT shares. And that's what drew some press attention. REIT shares do not get a tax-advantaged treatment for the dividends they pay. So they're way more suitable for individual shareholders than they are for corporate shareholders. And Warren has enough residue from his old cigar-butt personality that when people became disenchanted with the REITs and the market price went down to maybe a 20% discount from what the companies could be liquidated for, he bought a few shares with his personal money.

As you know, he doesn't draw any significant salary from Berkshire. And he has a wife who's very generous and needs a large cash flow and has her own private airplane courtesy of Netjets, etc., etc. And so it's nice that Warren has a few private assets with which to pick up cigar butts in memory of old times — if that's what keeps him amused. But that's how that all happened.

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WE HAVE NOTHING WHATSOEVER AGAINST ANALYSTS.  
IN FACT, WE LOVE GOOD OLD WHAT'S-HER-NAME.

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We welcome analysts. After all, why shouldn't we?

**Shareholder:** I understand that Berkshire Hathaway does not have much in the way of analyst coverage — ... and that Berkshire actually shies away from analysts and may not even talk to them. Could you comment on that?

**Munger:** Well, we're not anti-analyst. By and large, we don't like the system in which analysts are embedded. We think that the security analysts of the world are a bunch of very smart, hard working people — and that they know a lot about business. Therefore, we tend to welcome that part of the analyst tradition.

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**WESCO FINANCIAL'S  
CHARLIE MUNGER  
(cont'd from preceding page)**

And while we haven't had a lot of analyst coverage in the past, we expect to have a moderate amount of it in the future as a consequence of the General Re transaction. We welcome coverage. We think that's part of the system in which we operate — and why shouldn't we welcome it?

For example, we like that firm — what's it called?

**Munger:** What we don't do is tell analysts a bunch of stuff at little secret meetings of 30 or in secret phone calls while the ordinary shareholders learn about it way later. We release the quarterly reports over the internet — and everybody can have it at exactly the same time. So we're probably a little more rigorous than many companies in keeping the analysts equal with other people in terms of getting hard data instead of having any advantage in getting new information from us.

But if what they're looking for is not new information, but just help in getting a little insight into how we or our world really works, we welcome the analysts. And we like them. We like that analyst at — what is it — Paine Webber.

We especially like one analyst. I may even recognize her....

**Munger:** Yes, the lady in the red dress.... Will somebody give her a microphone? Oh, it is the analyst! Do you have a question? [Munger laughs.] Stand up and introduce yourself. Some of these people have never seen a security analyst.

Give her a microphone. I want to ask her a question. You weren't given hard data other people don't have, right?

**Alice Schroeder [of Paine Webber]:** No, not at all. In fact, I've been an analyst for years. And I've never been able to construct an earnings model for 30 years from start to finish before without asking a single question of the company. But the hard information that Berkshire supplies in the annual report, the 10-K and other sources is so extensive that you really don't need access to the company. It was very helpful to get insight into things such as how Executive Jet works — just to understand the business — because it was a business I'm not familiar with. But [Berkshire gave me] nothing at all that wasn't public.

**Munger:** But you found people were willing to give you time on that one, didn't you?

**Schroeder:** Yes, it was very helpful.

**Munger:** Basically, Berkshire loves education, and it loves people who like to learn. Now we can't spend all our time as an unpaid educator. But generally speaking, we see no reason... We've attracted one wonderful analyst. Why shouldn't we attract others?

Last time I looked, Paine Webber hadn't become non-profit.

**Shareholder:** Is it possible for you to make copies of Ms. Schroeder's report available to shareholders...?

**Munger:** Alice Schroeder can deliver her own reports. There's no reason why her hard work should be totally free to people. I presume Paine Webber's giving it to people they hope will, in some way, be able to help Paine Webber. So I leave that to you and Paine Webber.

**THE AUTO INSURANCE INDUSTRY WILL GET WORSE,  
BUT GEICO IS GETTING BETTER AND BETTER.**

The auto insurance area will get worse. But that's fine....

**Shareholder:** Back in the '70s, interest rates and inflation were going up — and it killed the cash flow of insurers. How would Berkshire be affected by that today? Also, AIG's entering the auto insurance area quite heavily with 20th Century. Do you have any comment on that?

**Munger:** Yeah, I don't think there's any question that the casualty insurance business is going to get worse — more competitive. And I think it's also true that the investment returns that the casualty insurance industry had over the last 15 years were way higher than the industry can possibly have over the next 15 years. So in two different ways, the casualty insurance industry is going to get worse — materially worse. I think that's as close to a sure thing as you're likely to get in business.

All that said, I think Berkshire is very well situated. Sure, our underwriting profits will go down at GEICO. And by the way, they'll go down partly because we're spending hundreds of millions of dollars advertising for new policyholders. And the advertising is being very well spent.

There's good news and bad news....

**Munger:** But I like our business compared to that of most other insurers. I think relative to other insurers that we've done better in the past — and I think we'll do better in the future. For the business as a whole, if you take the progress of our insurance operations as akin to operating a boat in a current, the current's going to work more strongly against us. On the other hand, I think that our boat is learning to go faster and avoid shoals and so forth better than it did in the past. So I think that we'll do better than the industry.

But you are absolutely right — the macro climate for casualty insurance is, at the moment, going against us.

**WE HAVE A DOUBLE ADVANTAGE IN INSURANCE.  
BUT MAXIMIZING GROWTH ISN'T ALWAYS BEST.**

We have an advantage over almost everybody else.

**Shareholder:** How should one value the untapped leverage in your insurance business? The obvious answer is to just take the basic numbers and use extrapolation. But ... with the industry in such dire straits in terms of overall returns, how should we look at that business...?

**Munger:** Well, it's the most important business we have. We have an advantage over almost everybody else. And if we're better at investing the money than the ordinary insurance company, we have a double advantage. Maybe that's all the advantage you're entitled to have. If you've got a way of getting more, please tell us about it — because we'd like to know it. But we do have an advantage.

What's really interesting about buying securities, however, is figuring out whether the advantages are enough to justify the price. And we've always left that question for you to solve.

The optimal strategy in every business isn't forced growth.

**Shareholder:** There are companies out there like AIG

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**WESCO FINANCIAL'S  
CHARLIE MUNGER**  
(cont'd from preceding page)

which is able to grow fast while underwriting at a profitable level — 100-103 — in this market. Your earnings would be so much higher if you did the same. I'm not saying the end gain would be the same because there may be more inherent risk in today's underwriting. But is there another way to look at this business?

**Munger:** That's a good question. We are not crazy. If we saw a way to balloon the insurance company with total safety — bigger and bigger and bigger and bigger — and never have the [combined ratio] above 101, would we do it? Of course we would.

But given the existing businesses we have and the position we're in, the natural business strategy is of a certain type for us as you look at the businesses one by one. By and large, that is how you manage a company like ours. You don't have some master concept from headquarters that you force on every business. Each business has its own nature.

Take See's Candies: People say, "My God! Look at all the money you're making. Why don't you have a store in every major city in the world?" Well, the answer is that it doesn't work that way. When you understand See's Candy, you understand we can't automatically make a lot of money by sticking a store in Paris and a store right in the middle of some well-established New England company's market. And we understand those issues company by company.

We try to adapt to the realities in each business we own.

**Munger:** That's our management system. And I think it's a good one because we're adapting to the reality in the individual business instead of forcing some concept from headquarters where it doesn't belong. I think that's been a source of enormous strength at Berkshire over the years.

You can assume that, company by company, we're making the decisions. And they're quite different. GEICO is being pushed hard while other companies are run in a quite different mode. There are businesses where the correct business strategy is slow liquidation — where anything else you might try to do would give you a worse result, not a better one.

Some people get out of modern business schools and say, "What kind of career would this be for me?" They try and force the reality of any business into their own mental structure — which emphasizes what the true "little me" really wants. And the result is a managerial disaster 99.9% of the time.

We try to adapt to the realities in the businesses we have and to give each the amount of expansion and push that is right for it. We have no way of saying to GEICO, "Be more like AIG." I like GEICO's business *better* than AIG's. It's not that AIG doesn't have a wonderful business, but I really like GEICO's better.

Is Kansas Bankers different than GEICO? Radically so....

**Shareholder:** I've noticed that the loss ratio of Kansas Bankers Surety over the last three years has run up from around 30% to about 60% last year. I'd like to understand that compared to, let's say, a casualty insurer like GEICO where the combined ratio generally approaches

100%. Is the insurance business different there?

**Munger:** Radically different.

**Shareholder:** OK. What about that trend — going from 30% up to 60% over three years?

**Munger:** Well, the answer to that is it doesn't matter. And again, it's a question of having the right model. Kansas Bankers Surety is in the fidelity bond business. That's a radically different business from the automobile liability business that, for instance, GEICO's in. There isn't much float in the Kansas Bankers business. And the main game there is to have a considerable underwriting profit.

Its business is also radically different than it used to be.

**Munger:** Because it was a small company operating on a stand-alone basis, it used to cede away about half of its premiums to others to eliminate catastrophe risk to itself. But once it got to be part of Berkshire which doesn't mind bumps in performance if aggregate performance is going to be way better, we stopped giving away all that insurance by reinsuring with other people. And that's going to change the ratios every which way.

But you're looking at Kansas Bankers where a large revision in policy was made for a good reason. And if you just take one look at certain numbers, then you get wrong answers. It's like taking the temperature of somebody who's got a piece of meat in his throat and is about to choke to death. You have to figure out in each situation what's really happening by looking at the right things.

**WHERE SHOULD GEICO FIRE ITS SILVER BULLET?  
THERE ARE CANDIDATES, BUT WE'RE NOT WORRIED.**

I'm not preoccupied with destroying our competitors.

**Shareholder:** I've often heard you and Warren talk about firing a silver bullet as a concept, but I've never heard you talk about the companies that *you'd* fire it at.

**Munger:** Warren sometimes talks about Andy Grove who asks: "Who's your most important competitor?" Grove says, "I'm in such a tough business that I have to think rationally about who's going to do me in. So I think about who do I want to hurt so I can survive?" And that's where that silver bullet concept came from.

I think it's important to know which competitor is most likely to do you in. And if that's what the concept means, then it's useful knowledge. I do not have the idea that I want to go around destroying competitors. I want to know who my most important competitors are, but I'm not into being so paranoid that I'm imagining doing them in.

Progressive and 20th Century are plenty tough.

**Shareholder:** Can you tell me which competitor you think is the greatest [threat to] GEICO — and why?

**Munger:** Well, that is different market by market. Right here in Southern California, for example, I'd say that 20th Century Insurance is the single toughest competitor.

But again, Lou Simpson's here. So Lou, why don't you take that one. You're so much better able to do that....

**Simpson:** I'm not getting paid for this, Charlie. But I agree with you — certainly, in Southern California — that 20th Century is an extremely tough competitor, primarily because they have the lowest cost. They have a general

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**WESCO FINANCIAL'S  
CHARLIE MUNGER**  
(cont'd from preceding page)

expense ratio of 10%. They're not growing very fast — mainly because they went outside their core business and insured a lot of homes in a very narrow geographic territory which happened to be hit by an earthquake.

Tony Nicely, the CEO of insurance operations for GEICO, has done an *extremely* good job. GEICO has prospered greatly since it was acquired by Berkshire. And if you were to ask Tony that question, I think he might say Progressive right now. Progressive is certainly very tough. They're growing fast. And they are getting into GEICO's sort of core business — which is preferred risk.

There are other competitors — including two sleeping giants.

**Simpson:** There are two competitors who are not that important right now that you have to worry about: one's AIG. In Southern California, for example, they're doing a creeping tender for 20th Century. I guess they own 60% today. And the other competitor is G.E. which recently got into the business by buying Colonial Penn. Those are two that ... could be real tough. I mean both of 'em have *extremely* deep pockets. And both of 'em are very anxious to get into the private passenger automobile business.

Then, I think the other two are the sleeping giants — State Farm and Allstate. Both are losing share right now. But potentially they're tough.

The fact that it's going to get tougher is just fine with us....

**Simpson:** Incidentally, the business is going to be a lot tougher, I would say, over the next five-plus years. And I think, as Charlie said, the results are likely to deteriorate — and probably have begun to deteriorate already.

**Munger:** By the way, I'm not a *bit* discouraged by that. I like what's happening at GEICO. The fact that it's getting tougher over the next 20 years may be helpful to us net. We're certainly not going to be the first one to feel pain.

And don't forget one direct writer — Mercury General.

**Munger:** I would argue there's another competitor in Southern California that we don't think of as a competitor so much because it uses agents instead of direct writing — and that's Mercury General. I would argue that Mercury General is run by one of the most brilliant men who ever entered the insurance business — George Joseph. He

*(continued in next column)*

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must be as old as I am, more or less. There's only one George Joseph. What he's done with an agency company is simply awesome. He has better figures than GEICO in some departments.

The guy is an absolute genius. He knows everything about that business. He's the kind that fixes everything as soon as it goes wrong. He understands incentive systems. And he was a former chess player, bridge champion and what have you. He's really a piece of work. He has equipment that's useful in doing the kind of work that he's chosen....

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YOU CAN EASE TOUGH PREDICTIONS BY PAYING UP.  
BUT THAT WON'T SOLVE ALL YOUR PROBLEMS EITHER.

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For the best returns, try what our early shareholders did....

**Shareholder:** Since value is about company returns, if I hold a business long enough, my return will mirror the company's return. So one of the key filters I should use is to find companies with a high return on assets. Then, the next issue is how long those returns can continue and what forces could stop or change it. And if I can't answer those questions, then I have to go on to the next one.

**Munger:** I'm not sure you *need* a question answered. You're doing very well.

**Shareholder:** So the timing issue is really [reduced or virtually eliminated] — because I ride out the macroeconomic swings and get rid of some frictional costs. Have I interpreted that correctly?

**Munger:** I would say pretty correctly, yes. Obviously, you can make even more money if you can find a company that is currently earning a very low return on capital — enabling you to buy it very cheaply — that subsequently transforms itself and earns a high return on capital. That's what early shareholders of Berkshire — who bought shares when it was a little textile company controlled by people not including Warren Buffett — did. That's the best of all.

Paying up doesn't solve all your problems either....

**Munger:** It's much simpler, of course, to find a company that *already* in its reported figures demonstrates that it knows how to earn a high return on equity. But the trouble with that is that by the time that is so clear, the price of the stock may be 3 or 4 times book or higher. And so that makes investing difficult again.

The one thing you left out of the equation was the quoted price in the market. Even if you could correctly identify a company which was going to earn a high return on equity for a long time ahead (and I frequently use the Wrigley Gum company as an example of such a company) that doesn't solve your problem — because now you have to figure out whether you really want to pay 45 times earnings or whatever it's selling for. And that involves making a prediction for a very long period of years in a changing world.

In the long run, it's earning power that counts.

**Shareholder:** What's the most important question that we should be asking you? And what do you think is more important — price-to-book ratio or P/E ratio?

**Munger:** If there *is* a general answer to that question,

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**WESCO FINANCIAL'S  
CHARLIE MUNGER**  
(cont'd from preceding page)

the P/E ratio at least reflects earning power more than book value does. And in the long run, it's earning power that counts. So certainly, *generally*, earnings are more important than book value. However, there are exceptions to every rule.

As to what would be the best question I should ask myself, that is really a smart question to ask. And I have used that trick many times in a long life. I recommend it to all of you. There's no reason this gentleman should have all the clever tricks to himself. But I think I will duck that question for a moment and let the questions go on. But I may come back to it.

**ONCE YOU KNOW SOMETHING'S A GOOD IDEA,  
WHY DO YOU HAVE TO TALK ABOUT IT?**

How did we decide to buy \$1 billion of Coke? We didn't....

**Shareholder:** I'm a Berkshire shareholder from Mississippi — where we're advancing the civilization.

**Munger:** Aided by air conditioning. And I was there before you *had* it. [Munger chuckles.]

**Shareholder:** I wanted to ask you about something that took place 10 years ago.... I've always been fascinated by the human side of your purchase of Coca-Cola. And you'll have to help me with these numbers, but as I recall, you invested about \$2 billion — which was about a third of the net worth of the insurance company. What was the conversation between you and Warren like? Did it take place over six months or one month? I could imagine some of us, if we had been you, going home and saying, "Honey, you're not going to believe this, but Warren wants to buy \$2 billion of Coke."

**Munger:** I wish we *had* bought \$2 billion. It was more like \$1 billion.

**Shareholder:** Tell us, if you would, though, how that conversation and how that process evolved.

**Munger:** That's a good question. Once you're able to figure out that something is a very intelligent investment, and you have plenty of money, the only problem is buying as much as you *can*. We tried to buy every single share of Coca-Cola we could buy without dramatically pushing the price up with our own purchases. That meant we could only account for 30% or something like that of the trading. And we bought every single share we could using that methodology — and without, I think, greatly changing the price from what it would otherwise have been — until we'd spent our \$1 billion.

Once you know it's a terrific bargain, who needs to talk?

**Munger:** And that was a *huge* mistake — because we should have kept on buying. And you people have to live with these mistakes. And it's in the nature of shareholders that you're pleased with the \$1 billion we did buy instead of displeased by the second billion that we didn't. But the truth of the matter is that our great miss there was the error of omission. We should have bought more.

Once you know something's a good idea, why do you

have to *talk* about it any more? The main thing is to *do it*. Once you know what you have to do, it doesn't take any more palaver. The trick is finding situations where you know exactly what to do in the investment field. I wish they came along more often to us than they do.

Yet, we've done pretty well with our record of only buying occasionally and making many mistakes of omission.

I liked that Goizueta had the motive and the means....

**Shareholder:** Two years ago, you mentioned looking at Coca-Cola in *Value Line* and then being very impressed with Goizueta's letter to shareholders and the apparent drive of Roberto Goizueta to increase shareholder value.

**Munger:** Yeah — and he had a situation where he could do it. The tools were at hand....

If I haven't looked at something, I start with Value Line.

**Shareholder:** So you identified *Value Line* as being a human triumph....

**Munger:** Yeah, but not just for Coca-Cola. It happens to be a very good, intelligently organized way to lay out a lot of data. Let's ask the analyst if she uses *Value Line*. Do you use *Value Line*?

**Schroeder:** Sure.

**Munger:** What rough source do you prefer, if any?

**Schroeder:** We tend to dig more into the original source data — the 10-Ks and the annual reports.

**Munger:** No, but to start — for the rough look at something you haven't looked at before. I start with *Value Line* if it's something I haven't looked at.

**Schroeder:** The universe of companies that I deal with is so much smaller that we already...

**Munger:** You already know the *Value Line* data.

**Schroeder:** Well, we pretty much have to read everything anyway. So it's sort of redundant for us.

**Munger:** She's in a specialized tranche of investing. However, for somebody who's looking over a wide universe for a quick glance at what's happened in the past — well, [*Value Line*] is a human triumph.

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**WHY DID WE TERMINATE OUR PARTNERSHIPS?  
WE'RE JUST MORE COMFORTABLE THIS WAY.**

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We had enough money, but not enough underwear....

**Shareholders:** Both of you retired, so to speak, or got out of the business of managing public funds to do it for almost no income — seemingly just for the fun of it. Do you regret that decision? Would you do it the same way over again? And why did you do that in the first place? It's just so unusual.

**Munger:** That's a good question. Why did Warren and I stop managing other people's money for compensation very early in life? First, we had *enough* money to spend on anything that was constructive for us to spend it on. Second, I think we have kind of a hair shirt fiduciary attitude built into our psyches that makes it *hell* for us not to do well for people who trust us. And we were not taking that

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**WESCO FINANCIAL'S  
CHARLIE MUNGER**  
(cont'd from preceding page)

hair shirt off, but at least we put a layer of underwear between us and the hair shirt when we stopped managing other people's money for a share of the profits....

This way, we've got our own money on the line. And we get the same results the shareholders get. That is way less pressure than running around making presentations about how you're way better than everybody else — whether you are or not....

So I think we were just constructed in such a way that we're more comfortable in this modality.

Some don't seem to feel a fiduciary responsibility. We do.

**Munger:** And I never cease to be amazed at the way other people behave. One of the largest banks in the U.S. when it got in trouble had all of these trust funds from all of these ethnics that had trusted the founder of the bank which had agreed to take care of the crippled children, etc. And the bank had come up together with all of these trusting families. Yet the bank just auctioned off the whole trust department and sold off all those trust funds to somebody else. In effect, they just hit the high bid.

Well, that would not be my style. If I'd helped build that bank up, I would have felt that I had some duty to those people other than to hit the high bid.

Similarly, I think that investment managers who just hit the high bid in shifting the responsibilities they've gotten leave something to be desired compared to people like those at Capital Guardian where they keep the company private and try to use the opportunity to eventually be a partner in the firm to attract more brainpower....

So I guess we're talking about the way we're internally constructed — the way we were raised in Omaha in the old days. And that is the answer. We didn't like the hair shirt aspect of it.

But the hair shirt of it doesn't bother a lot of people — at all. I'm just not constructed that way. I don't want to be constructed that way. And Warren isn't either.

It's something we look for in those we need to trust, too.

**Munger:** There's a man Warren and I know who's made about \$100 million out of his share of the profits from managing invested assets even though the net returns of all the people that have trusted him over all the years have been modest or mediocre. And Warren once said to me, "Charlie, that would bother you and me terribly. But it doesn't bother him. No. He's got the \$100 million. And that's what's important to him."

I think it's much better to have this more hair shirt-type personality. It's certainly what I want when I start trusting somebody else. I want to rely on a person that cares strongly about not disappointing me....

THIS TIME, IT'S DIFFERENT?! IT ALWAYS IS.  
THERE'S A GREATER RISK OF BAD SURPRISES, TOO.

Given the inhospitable environment, Warren quit the scene.

**Shareholder:** Could you compare and contrast the period in the late '60s or early '70s [when] Warren sold all his stocks and closed his limited partnerships to today?

**Munger:** Well, that's a good question. Certainly, there was a period in about 1968-'69 when the world went crazy with stock speculation. All the junky stocks of America roared upward. All of a sudden, it was as if there was a vast investor preference for junk. Everything on the American Stock Exchange went hopping up. For somebody with a mind like Warren's, it was a very uncongenial period.

He had been so used to making money in the manner of a man shooting fish in a barrel. I always say that when my friend Sandy Gottesman wants to shoot fish in a barrel, first he drains the barrel. Then he waits for the fish to stop flopping. And only then does he shoot — with a shotgun.

Warren was having investing success back in that early period of the '50s and '60s — which was a lot like shooting fish in a barrel. But it got harder and crazier. And here was all this mass of wealth, speculation, hot mutual funds and waves of enthusiasm that looked a little like tulipmania in Holland or what have you. And so he found it uncongenial. He just concluded — what was it that Sam Goldwyn used to say — "Include me out." Therefore, Warren did quit the scene.

He didn't sell everything. And there won't be a next time.

**Munger:** He didn't sell every security in Berkshire. He certainly didn't sell his own Berkshire stock that he got in liquidation of the partnership. And certainly, we kept owning securities during that period within companies like the trading stamp company. But he did wind up the partnership. And the climate of that time contributed to it.

We're never going to do that again. We're not going to liquidate Berkshire. We're going to keep running Berkshire. But I do think there are parallels.

This time it's different? It's always different and the same.

**Munger:** It's always a different thing that people go crazy over. It was Florida swamp land in the '20s. And there was a huge, crazy real estate boom in Los Angeles in the early '20s. Then there were all those junky stocks during the late '60s. And later we had the Nifty Fifty going to amazing levels of valuation. Some of the companies in the Nifty Fifty did things like home sewing — as if that was the wave of the future in a technologically advanced nation. Can you believe it — Home Sewing!? But it was in the Nifty Fifty. So there were a lot of irrationalities. But we continued to operate right through the Nifty Fifty period of — what was it — 1970-'72.

There are always parallels. And I think you would be quite smart if you looked at the current scene and were a little more restive about what may happen that's not good than you have been at other periods. I think there is more risk that we all get a bunch of surprises that we don't like.

**THE JAPANESE EXPERIENCE: SO MUCH FOR KEYNES.  
HOWEVER, CORRUPTION AND THE WEALTH EFFECT....**

Japan is one of the most interesting case studies around....

**Munger:** I think what's happened in Japan is one of the most interesting things to think about.... Here is a very advanced technological nation with a strong, clannish government with a good tradition of being able to govern — and this *fabulous* economic record of increasing GNP per capita faster than almost anybody for decades. And their

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**WESCO FINANCIAL'S  
CHARLIE MUNGER**  
(cont'd from preceding page)

companies prospered, their stocks and land went up in value and so on and so on.

It went on so long that it went to just *amazing* levels. The land in part of Japan was worth more than the western half of the U.S. Strange things were happening. The Bank of America had a modest house that they bought so their resident executive would have a place to live. Well, they finally sold it for \$55 million cash. And people were paying rents of \$250 per square foot per year or something like that. Again, it was just amazing.

And their stocks got up to these very high multiples of book value — even in companies which didn't earn very high returns on capital — because, by and large, the Japanese priced low enough to keep market share growing and were less attentive to trying to earn high returns on equity. But it all *worked*. And once everything got to what everybody thought was wretched excess, it *stayed* at wretched excess — or *advanced* for years and years and years.

Japanese financial culture had some unpretty elements.

**Munger:** Meanwhile, in the financial institutions, but not in the engineering, you got corruption. For example, you got off-book agreements to buy back the securities in brokerage houses. You got perfectly disgusting fictional accounting in the banks. You had Japanese mafia payoffs buried in some leading institutions. In part, Japanese financial culture had some unpretty elements.

And once ... everybody [thought] land ... and stocks could do nothing but go up, the wealth effect became a *narcotic*. They resorted to stratagems like having the postal system (which was a government-sponsored savings system) buy stocks to help prop them up. So there were some very unfortunate, unsound aspects of the culture. And then, finally, it crashed.

Japan wasn't trying to refute Keynes, but that's what it did.

**Munger:** And when it crashed, you had all the economic techniques of modern Keynesianism to fix it — and a strong willingness to fix it — by a very advanced, intelligent, well-educated people advised by the world's great experts. For example, in one Keynesian technique, you reduce the interest rates practically to zero. So they did, but that didn't work. Then, according to Keynesian theory, you run up a big deficit in government spending. So they did that. They ran the deficit up to 10% of GNP. And *that* didn't work. The whole economics profession has found this a very hard example to explain.

And it's very interesting that a country so advanced could suffer so much and that the suffering could go on for so long despite the administration of all our vast knowledge of economics.... And it's going on *still*.

Japan is not mired in a depression like we had in the '30s. It's not *remotely* that bad. But it's a very significant and long-lasting depression — and nothing seems to encourage the Japanese to start spending. It's an interesting example of the so-called "wealth effect" in reverse.

We'd have wonderful software without phony accounting.

**Munger:** Does that have any parallels for our present

discussion? Is corruption in American accounting for stock options akin to Japanese corruption in having brokers agree to buy the stock back, keeping the contracts off the books, the banks pretending that their bad loans were good, etc.? I'd argue that there are at least some parallels — and that we'd still have all our wonderful software if we didn't have phony accounting. But I'm in a distinct minority.

**RASCAL-STYLE MANAGEMENT IS NOTHING NEW.  
NEITHER IS THE BERKSHIRE/ROCKEFELLER STYLE.**

American accounting: Much to be admired and regretted....

**Shareholder:** I got a "B" in accounting theory in graduate school because I argued very strongly that a public corporation had a certain trust — that insiders have certain information and understanding of the industry that an outside investor couldn't easily get. Therefore, I argued, public corporations should take a page or two — maybe up to four pages depending on the corporation's complexity — to discuss the business as if they were a grandfather explaining to his grandson how they analyze the business, how it can be evaluated, how it's likely to progress over the next five years, different industry standards of profitability and how the company stacks up.

I see those things in *your* annual reports, but I don't see it in very many annual reports. Why not?

**Munger:** Well, American corporate reporting is better than most corporate reporting in the world. So there is more integrity and better practice here than anyplace else that I know of. All that said, there's much to be regretted, just as there is much to be admired....

**Berkshire** has its own style that reflects the idiosyncrasies of Warren Buffett. Other people have different styles. We don't think we've got some monopoly on the right way to do it.

For some, defrauding shareholders was a source of income.

**Munger:** It is interesting how, at the same time, you get radically different cultures. I've always loved contrasting the culture of California's four Irish rascals — Fair, Flood, Mackay, and O'Brien (I guess that was the four) — who controlled the Big Bonanza, which was the biggest silver strike in the history of the world. One of 'em was a bartender. They'd come up from nothing. San Francisco was a rough place back in the middle to late 1850's.

Well, they had a mining exchange with no standards and corrupt stock speculation and so forth. And if you controlled the mines and had a partner in San Francisco... In those days, mining companies paid monthly dividends. So you could rev up your mine, pay big monthly dividends and your stock price would go way up — and your partner in San Francisco could sell the shares like crazy. And then you'd flood the mine and the stock would go down and you'd buy it back in.

So you could make part of your money mining and part of the money defrauding your shareholders. It was just like working a big, two-handled pump. Well, that was the way one crowd of capitalists behaved.

Rockefeller's companies were very honorably and well run.

**Munger:** At roughly the same time, you had very early Rockefeller and Cornelius Vanderbilt. And they may

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**WESCO FINANCIAL'S  
CHARLIE MUNGER**  
(cont'd from preceding page)

have been hell on competitors amid the rough behavioral standards of a former era, but they were scrupulous about being fair with their partner/shareholders. In Rockefeller's main company, for example, officers didn't take salaries or they took nominal salaries. They basically thought it was beneath them to try and make money off their shareholders instead of with their shareholders. So, at the same time, you had two radically different ethical ideas about how you behave in relation to shareholders.

And I think the proper functioning of the social order requires that behavioral standards of capitalism be high in terms of fiduciary standards to people like you. In the end, you probably create the highest shareholder values if you observe those standards. Rockefeller's companies, certainly, if you traced them through, were honorably run for many decades and rewarded their investors very well.

In my foundation talk, I didn't say so, but I think if the Rockefellers had never sold a single share of the original Standard Oil Trust and all of the companies that came out of it, they'd be way better off than they are today.

We're trying to be like early Rockefeller, not early Mackie.

**Munger:** And that type of behavior didn't end with the 1800s. One of the great bankers in the promotional era of the late 1920's shorted his own stock!? It was Fair, Flood, Mackay and O'Brien come right back to 1929. After all, if it's just a big, two-handled pump that you use to take care of yourself, there's a certain logic in behaving that way. But it's ghastly behavior.

I'd argue that in the present era, we have companies where the basic mindset at the top is that the shareholders are just one more constituency to be milked — and others where they're really trying to serve shareholders.

All I can say is that at *Berkshire*, we're really trying to be like early Rockefeller — not like early Mackay. I think that's very important. I think if you had too much of the culture the other way, capitalism itself would be in danger.

**THE BEST QUESTION ATTENDEES COULD ASK —  
AND A BOOK EVERY WESCO NUT SHOULD LOVE.**

What one thing can I do to make my life better? That's easy.

**Shareholder:** I read the Cialdini book after you recommended it at last year's annual meeting. Are there any other books you could recommend to us — including any that you're reading now? Also, someone asked you earlier what is the best question we could ask you — and I was hoping you'd had a chance to think about it.

**Munger:** If you ask not about investment matters, but about your personal lives, I think the best question is, "Is there anything I can do to make my whole life and my whole mental process work better?" And I would say that developing the habit of mastering the multiple models which underlie reality is the best thing you can do. It's way more important than whether you make an extra \$10,000 or \$20,000 next year, next month, next week or next minute.

The best question is, "What one thing can I do that

will make my life work a lot better assuming that I'm a reasonably glued together person already?" We're not up to curing defectives around here. As Warren says, "We believe in making silk purses out of silk."

Assuming that you people are all silk — which I think is roughly true — the best single thing you can do for your lives is to get this multiple model approach to continuous lifelong education. It's just so much fun — and it works so well. And so many of the people in the education establishment have done so poorly at the one thing they're sworn on earth to do — which is education — that they fail you, by and large. So you're going to have to do it yourself.

The way Rockefeller behaved was a great model for anyone.

**Munger:** At the *Berkshire* meeting, I said that I loved Chernow's big biography of John D. Rockefeller the First. It makes clear that for 30-some years after they found all that oil in Pennsylvania, nobody produced any oil in significant quantities anywhere else in the world! Oil was seeping out of the ground all over hell in big quantities. Yet Pennsylvania had a monopoly on the then major use for oil — which was making it into kerosene to provide lighting in the dark. So the Rockefeller fortune came in part from a crazy accident of nobody else getting any oil production.

That said, the way John D. and those other people used their opportunity to go to the next stage (which was in Ohio, as I recall) and the way they behaved and the conversations of the partners... John D. Rockefeller had these partners and they all came down together and made the decisions. It sounded like *Berkshire Hathaway* except that they had several general partners and we have two.

And sometimes the other partners wouldn't want to go along with something. Rockefeller would say, "I'll do it on my tab." (And after all, he was very, very rich by that time). "I'll do it. I'll take all the risk. And then two years from now if it works, you can buy me out at my cost and take it over."

Well, many of the partners would then say, "Oh, hell, if you're willing to take that much risk, I guess I can afford to carry my share." And, of course, they were immensely rich, too. So it wasn't all that noble. But that was a great way for John D. to behave.... It's a great way for [anyone to behave]. He wasn't thinking, "What can I do to get a bigger share myself out of the ownership I already have?" He was thinking, "How can I use my existing ownership to take extra risks to make the whole enterprise work better?"

And he gave away half of the money he made to good causes long before he died. And he started doing it when he was making \$3 a week or something. It's a very interesting story. I can't imagine anybody not liking it who has decided that this is the place to be on a Wednesday afternoon.

**CERTAINLY, IT'S A LOUSY WAY TO RUN A CIVILIZATION,  
BUT DON'T LOOK FOR HUMAN NATURE TO CHANGE.**

Consultant is just a modern-day word for a soothsayer....

**Shareholder:** In a philanthropy magazine article, you discussed foundations and the different portfolio managers they have and the different layers that they go through. Given the obvious answers you put forth in that article, why do foundations do it that way?

**Munger:** Well, why do we have stock option accounting in America that is corrupt? Because there's money in it.

*(continued on next page)*

**WESCO FINANCIAL'S  
CHARLIE MUNGER**  
(cont'd from preceding page)

And the existing system employs a vast number of people. The existing system also mimics, to some extent, systems that Man has *always* had: The king always had his soothsayer and his augurer. People have always wanted to know the future. And by spending money and being rich, they can have some wise person tell them how they will always be more prosperous and more secure, etc., etc.

So this basic human longing to use your existing wealth to buy security and opportunity through advice is always going to be with us. And where there is money, why, in capitalism the advice will come. Some of it will be charlatanry and some of it will be good. I'm afraid that's the kind of civilization we live in.

And today, there's layer upon layer of soothsayer.

**Munger:** I regard what the foundations are doing — the big foundations — as preposterous. It makes me sad that I live in a civilization where everybody goes to great universities that we all support — the Harvards, the MITs, you name them — and people graduate from these universities and go out and make their livings in charlatanry.

So the foundations hire soothsayers for high fees — and they hire soothsayers to choose other soothsayers. And then they hire still *other* soothsayers to tell them how the existing other two layers of soothsayers are wrong, etc. It's a mad hatter's tea party.

But that's why we have satire and comedy. That's why we have a lot of things. It's an imperfect world. And I'm afraid that it's always going to be a lot like that.

It's a lousy way to run a civilization.

**Munger:** That talk, which didn't say a single thing that isn't perfectly obvious and clearly so, has been noted fairly widely. It gives somebody something to talk about. But I have yet to see even so much as a single change in the practice of any foundation. They go back to their boards, hire these three or four layers of consultants and they listen to all this stuff — and they keep writing the checks and doing what the soothsayers tell them.

It's even sadder because the soothsayers are smart. We're attracting some of the smartest people in the U.S. into a business where their net contribution to the social welfare is negative. That is not necessarily a good way to run a civilization. In fact, it's a *lousy* way....

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MUNGERS WILL KEEP THEIR BERKSHIRE  
LONG AFTER I'M DEAD AND GONE.

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So far, share issuances haven't helped Berkshire....

**Shareholder:** Over the years, the number of shares [outstanding] at Wesco ... [has] remained constant, whereas they've gone up ... a bit at Berkshire. Do you think that fine-tuning has improved Berkshire's results?

**Munger:** Berkshire has issued shares for businesses. And Warren, being honest as he is, has carefully reported that in many cases it's turned out that we've issued shares

that were a little more valuable than the businesses we got. Nobody cheated us or misled us in any way. They're wonderful people and wonderful businesses, but our record so far in issuing shares is moderate. In some of 'em, we may have done a little better. And in a couple of 'em, we would have been — *you* would have been — a little better off as shareholders if we *hadn't* issued the shares. So to the extent share issuance affects shareholder outcome, Berkshire hasn't distinguished itself so far.

On the other hand, it hasn't hurt us significantly. And I would guess in the future — over the long pull — Berkshire's issuance of shares will *help* our shareholders. We got caught a little by buying into the forefront of a big depression in shoes. And they've had some bad luck in one respect.

We are trying never to issue a share without getting a little more intrinsic value than we're giving up. However, our existing businesses have performed so magnificently — as have the existing securities — that if you actually look back at the record as Warren carefully said (I believe in the annual report before this last one) we've made some issuances that you would have been better off without.

Over the long term, I think they will — as will General Re.

**Munger:** Now, we haven't hurt you very much. And I think over the long term, we're going to help you. However, so far, a Wesco policy would've been all right at Berkshire.

Incidentally, I don't think a Wesco policy would be the right policy for Berkshire over the *long* term. I think buying General Re is going to work out, although we got an early bad blip there. They had a nasty earnings surprise in a sub-subsidiary with an 80+% [owned] German reinsurer. Nobody at General Re knew it was coming, but it popped up for a nasty pre-tax charge right after we closed the deal. And of course, General Re's had a down quarter.

All that said, I'm *glad* we bought General Re and issued the shares we did. I think it's all going to work out fine in the long run. And I think over the long run, the Berkshire shareholders are going to be the ones who are better off in that respect.

But so far, Wesco's keeping its shares outstanding frozen at the same number — for what is it, 30 years, more or less — has been a very good policy....

Don't worry about Berkshire's payout to the Foundation.

**Shareholder:** Warren has written about corporate governance at Berkshire and described it as unfolding in a series of phases. At the point, hopefully decades hence, when Warren and Suzy are gone and most of their stock goes to the Buffett Foundation, how tricky do you think it will be to handle the 5% annual payout that the Foundation will have to meet without harming long-term stockholders?

**Munger:** Well, I do not think that 5% rule will be a significant problem at all given how Berkshire's evolving. I wouldn't waste a moment worrying about that if I were you.

Don't worry about Berkshire at all. I know I'm not....

**Shareholder:** Warren says Berkshire's structure is designed to separate operating management and place it under the control of family and foundation board members. But recent years have shown us a lot of examples where family members are no match for the upper management: Kellogg, Dow Jones, Reader's Digest and Mellon Bank in

*(continued on next page)*

**WESCO FINANCIAL'S  
CHARLIE MUNGER**  
(cont'd from preceding page)

the '80s. I worry that that structure doesn't work very well. Do you have any observations on that?

**Munger:** That is a more interesting question. And there, I have the advantage of inside information — because I know the people. And I do not think this crowd of people is going to be slothful, go crazy or be snookered by some artful management of the wrong kind. Therefore, again, I think you're worried about something that in this particular case you don't have to worry about.

I should point out that the Mungers, I hope, will have 90% or so of their net worth in Berkshire long after I'm gone. So all I can say is that *I'm* not worried.

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**DERIVATIVES WILL CAUSE HORRIBLE MELTDOWNS —  
AND SHODDY ACCOUNTING WILL MAKE THEM WORSE.**

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I know that financial meltdowns can occur....

**Shareholder:** I'd be interested to hear your thoughts with respect to the Long Term Capital Management debacle, how close the financial system came to a real meltdown and your perspective on how that's evolved and what kind of lessons we ought to learn from it.

**Munger:** Well, since the meltdown was avoided, it's hard to know exactly how close we were or how bad it would have been. Certainly, if you'd had a convulsion there and it had spread, you would have had a lot of uproar. And certainly, the cost of what was done in terms of asking a bunch of rich institutions to risk \$300 or \$400 million each and prevent disorderly market conditions has turned out to be a very unburdensome thing to the country.

I can't judge.... I know financial meltdowns can occur. I look at Japan and see that even under modern conditions they can occur in such a way that they're hard to reverse.

You have to give the Federal Reserve System some credit.

**Munger:** We would have been *against* the bailout of Long Term Capital Management because we wanted to *buy* all of the assets for cash — just take them over and not involve any Federal Reserve people strong-arming rich corporations into putting up the money. But as it turned out, we were not given that opportunity.

And as it turned out, certainly, it's worked pretty well. So in terms of the way that it's been handled, I think you have to give the Federal Reserve System some credit....

There will be future meltdowns. But don't look to us....

**Shareholder:** You and Buffett have consistently expressed your dislike of ... many kinds of derivatives. Do you think we've seen the last Long Term Capital meltdown? And if not, would you care to speculate on whether or not they'll let us buy it the next time it happens?

**Munger:** We probably won't be a buyer the next time. We knew those people. And even though they made one big mistake, we admired their intellects and many of their disciplines. We knew the positions they had. And we were quite willing to buy that one. I think it's quite unlikely that

the next time we'll be in any such position.

But, yes, I do believe there will be horrible meltdowns of some kind caused by a great wave of derivative trading all over the earth with no central clearing mechanism.

Accounting bends too much to the pressures of the world.

**Munger:** Again, you've also got shoddy standards of accounting.... It must be *hell* for Deloitte to sit up here. [He chuckles. Then, addressing the accountants:] The finance professor ought not to feel alone.

By the way, it's not *your* fault accounting is shoddy. You can't fix the whole world any more than I can. But the accounting in derivatives — for interest rate swaps, etc. — under pressure from the people who wanted to report more profits and get percentage bonuses based on those profits and so forth just got weaker and weaker. And what it does is that it front ends the profit to a considerable extent using "models" which are way less sound than those I love. And that's just the nature of what we have out there.

So sure it's going to cause trouble. And the trouble that's coming from time to time will also be aggravated by the fact that the accounting is shoddy.

I don't see why everybody doesn't share my notions about accounting. Actually, I *do* see why. But I don't like it. I believe that the world would work better if we had more old-fashioned, engineering-style standards in accounting. Accounting bends too much to the pressures of the world.

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**HERE'S A WAY FOR YOU TO GET A FAST START,  
BUT ACHIEVING WORLDLY WISDOM TAKES TIME.**

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Who wants more attention? I have enough enemies already.

**Shareholder:** From time to time, you or Mr. Buffett give a talk at a university or at some other forum. Could I be so presumptuous to suggest that you put copies of those talks on the Berkshire website?

**Munger:** Well, that's an interesting idea that I hope we don't do. I'm drawing *more* attention than I really want in the world based on the few talks that we are already giving. So I hope you will not prevail on that one.

Warren did mail out one of those OID reports to the Berkshire shareholders on that talk I gave at USC.... And if they do more of that, I'll have more enemies in the world.

A first step for someone interested in worldly wisdom....

**Shareholder:** Unfortunately, I'm going to ask you about that speech. I was impressed by your use of models. And I just wanted to ask whether or not you had any other models that a person should consider or books that you would suggest ... for a basic education that you feel would make for a wise person?

**Munger:** Well, I get that question a lot. For just quick education that a lot of people don't have and need, I think few books in America are better than Bob Cialdini's book, *Influence*, which is widely available in paperback. I think 400,000 copies or something like that have now been sold. That is a really good book in explaining the manipulative techniques of many human institutions — including business institutions.

It's *very* well written. The author is a master teacher.

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**WESCO FINANCIAL'S  
CHARLIE MUNGER**  
(cont'd from preceding page)

This guy, in his thirties, was a Regents Professor in Arizona — which is a very fancy kind of a professor. And he got that reputation by going out and being recruited by people who were selling cemetery lots or running restaurants or what have you and serving as a waiter or a salesman.... It's a book researched by a very sprightly human being. So if any of you haven't read Cialdini's *Influence*, I suggest that you go out and buy it. It's a wonderful book and a book that would be very useful to all of your children.

You can't afford to leave out even one needed model....

**Munger:** And I have given these talks in which I say that the only way to be a really good thinker is to have a multiple model system — which means all the main models must be in your repertoire. And if you're short one model, it would be like a professional football team that knew how to do everything but pass. That is not a very good way to win professional football games. So you can't leave out one needed model. And if you don't have the full repertoire, I guarantee you that you'll overutilize the limited repertoire you have — including use of models that are inappropriate just because they're available to you in the limited stock you have in mind.

Well, that's a very ghastly way to operate in the world. So what I'm doing is laying down the iron prescription that you must have all of the main models of the world. Fortunately, 98% of the world can be explained pretty well by a fairly limited number of models. So what I'm suggesting is perfectly doable, but it can't be done in a week or a weekend. You have to work at it over a period of time.

Meeting new models greatly enriches and enlightens life.

**Munger:** Personally, I find the task a lot of fun. I'm always finding something new that helps illustrate my model system. And it makes my life very interesting. I frequently cite the case of the man who left the unfinished manuscript, *Famous Middle-Western Sons of Bitches*. And at the end when he was dying, he wrote, "I'm sorry to leave this in an unfinished condition." But he says, "I was always meeting some wonderful new son of a bitch. So I never got around to finishing the book."

Models create that kind of a mindset. You're always meeting some new model or finding some new illustration for an old model. So I think it greatly enriches and enlightens life to go at it this way. And I think there's a lot to be said for systematizing the search for models. And just a few carry an unbelievable amount of the freight.

**FREQUENTLY, IT'S THE OLD MODEL WITH A THIN VEIL  
— THE SAME, OLD SCHEME OVER AND OVER AGAIN.**

The Ponzi scheme — then and now....

**Munger:** Take the model I spoke of earlier — the Ponzi scheme. That's an easy model to understand — and it's easy to understand why it fails. It's only slightly more subtle to realize that the Ponzi model can be mixed in with a lot of other things that are wonderful and yet will be adding to the brew. And when you see that clearly, I think you're wiser and better for having the model. I just cite

that as one example.

The Ponzi model was present in the conglomerate promotional phase of American corporate management. A corporation would get a stock way up in terms of P/E multiple and run around madly issuing it for a bunch of ordinary companies and announce to everybody that it was going to keep doing it forever. That had a big element of Ponzi in it. And, of course, it eventually came a cropper.

The more things change, the more they stay the same.

**Munger:** What people do is constantly bring back the old model with a thin veil — or sometimes a thick veil. Today, we have rollups — which is a wonderful new phrase for people to get rich with soft white hands. Now, instead of just buying any damn thing and saying, "My stock is worth 30 times earnings because I'm a conglomerate," you say, "My stock is worth that multiple because I'm a roller-upper and you're a mere roller-uppee. And you ought to give me your funeral parlor with all its tawdry sales methods" — and here I'm making another group of friends — "in exchange for my wonderful stock at 25 times earnings." It's really just the same old scheme over and over again. It's a touch of Ponzi — really more than just a touch....

Every rule has an exception — even avoiding Ponzi schemes.

**Munger:** And yet you see Ponzi in places where you might be shocked. In a really great law firm like Cravath, they have an unfunded pension plan for the partners where they agree to pay retired partners out of up to, say, 10% of the partners' income annual distributions — and it's totally unfunded. You might think with my attitudes toward finance, I'd say, "Isn't that shocking? It's lousy engineering. It's an unfunded pension."

But if it's Cravath with its culture, I say that's a sound plan. When you understand the Cravath model thoroughly, you realize that something that would be unsound for almost anybody else is OK for them. So you get conflicting models where you have to weigh and measure.

**TO UNDERSTAND BUSINESSES, START W/ EASY ONES  
AND PRACTICE UNTIL IT'S AS EASY AS BREATHING.**

First, you have to understand the business.

**Shareholder:** Over the years, you and Mr. Buffett have bought many businesses, both public and private, in a wide range of industries. What techniques do you utilize to learn those industries — fairly rapidly, I assume — to decide whether you indeed have a long-term winner?

**Munger:** Partly, of course, we use the existing record of the business and we try to extrapolate from that record. But if it were as simple as that, everybody would be able to do it with monstrous success.

I think you have to understand how the basic business works — what its threats and opportunities are and its competitive position, etc. — to be able to make predictions about the future of a business which are better than those that might be derived by simply extrapolating past growth, past returns on capital, past sales or what have you. So I think it helps to really understand the basic businesses.

Some businesses are easier to understand than others....

**Munger:** Some of them are so easy to understand. Take Costco where I'm a director. That is a really easy

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**WESCO FINANCIAL'S  
CHARLIE MUNGER**  
(cont'd from preceding page)

business to understand. If any of you don't understand why chain store retailing arose, why it works, what can go wrong with it, why things go wrong, etc., I think you haven't been educated properly. If I were teaching in a business school, I would start with retailing because it's so easy to understand. And once students really understood retailing, I'd go on to more complicated things — like making appliances and so on.

A lot of models are out there that you can understand. You can certainly understand Wrigley's chewing gum as a model, right? It isn't hard to understand what makes that work. And I don't think that it has to be done in any particular order. Personally, I find going from retailing on to other things the best way to do it, but some other method may work better for other people. But I think it's a lot of fun to figure out why these businesses work.

Analyzing businesses can become as natural as breathing.

**Munger:** Take automobile agencies. Nearly all of us have bought cars. Well, somebody like Warren or myself can't enter an automobile agency without thinking, "Is this a good business or a bad business? If it's a bad business, why is it a bad business? If it's a good business, why is it a good business?" To us, it's like *breathing*. I think it's fun to do. And I find that it gets fairly simple in due course.

You can walk into some agencies and know *exactly* why they work: They cheat! Others are very successful and don't cheat. And if you've read Cialdini, you'll know which cheating methods work best in automobile sales.

And the same approach works with people, too.

**Shareholder:** Are there rules of thumb or other kinds of mental models that you've developed that you use once you're past capital allocation, honesty and integrity? What are the ways you evaluate managers to decide whether they're the right people to run your businesses?

**Munger:** Evaluating human beings is a very important art in investing and in managing. How do you get good at it so that your bad surprises are few? I think that's a tough question. I think you *work* at it, just as when you walk into a Ford agency you think, "Is this working or not working?" and "Why or why not?"

When I meet people, I tend to think, "Is this a functional human being — one who can cope? Or is this one of the many sub-classes of dysfunctions in my series of models? Or is this a very functional person with one major flaw — like General MacArthur?" So I have all these little models I use to sort of guide me through the forest. And I don't get that many horrible, unfavorable surprises.

Warren's just naturally good at it. He can smell a problem.

**Munger:** Am I lucky? I can't judge. Warren doesn't get that many unfavorable surprises either. Years ago, a member of his family got charmed by a particular prominent political figure. But Warren just *smelled* something fishy. He laid down the law that the guy was not welcome. And not very much later, he appeared in a major embezzlement. Warren is *good* at that stuff — which is good for all of you.

That is a *very* unpleasant way to lose money — to be

defrauded out of it. And I don't know about you people, but I dislike that.

I owe Phil Fisher, but I invested like him naturally.

**Shareholder:** Warren talks a lot about Ben Graham and his effect on his approach over the years. But it seems to me that Phil Fisher's approach is very similar to yours.

**Munger:** Yes. It certainly is.

**Shareholder:** How much effect has he had on Berkshire over the years?

**Munger:** Well, by the time I had heard of Phil Fisher, I already pretty much had his approach. But certainly, if you have an intelligent guy that lays it out, I think it helps you get your good ideas settled in more firmly. So I think I owe a debt to Phil Fisher even though I had his basic approach. It was very helpful to me to see someone who believed in just investing in a few companies and really knowing an awful lot about those companies and their competitive environments.

Why more people don't do it like that, I don't know. I'll bet most of the people in this room *do* invest like that. Let's try an educational experiment. How many of you in this room own fewer than, say, 12 common stocks? How many of you have more than 12 common stocks? I'd say about 90% of you have fewer than 12. So in this room, we've got converts. However, you're in a distinct minority.

But Fisher was right in his approach, I think. And people are always reinventing these things. Now they call it "focus investing" — as though it were a new invention. People put a new name on these old nostrums.

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WE KNOW FREDDIE'S NOT BULLETPROOF,  
BUT THERE'S AN AWFUL LOT TO LIKE.

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Yes, we viewed Freddie Mac as having a superior model....

**Shareholder:** You originally decided to get into Freddie Mac because you felt they had a superior model to the savings and loan business that you were engaged in. And Freddie Mac today represents a material fraction of Wesco's equity and earnings.

**Munger:** Absolutely. It's certainly an instance of a "focused portfolio". That's the new lingo. I'm picking it up! I'm like the fellow who exclaims, "My God, I've learned that I'm speaking prose."

With Freddie Mac, you have to take the bad with the good.

**Shareholder:** In your models, how do you factor in the vague political risks that ebb and flow with Freddie Mac like the tide? And have you ever considered adding to Wesco's Freddie Mac position?

**Munger:** Sure. There is some tinge of political risk in a company which is that heavily involved in housing with all of the political uproar that housing frequently causes. And Freddie Mac operates under a government charter with a limited power in the government to have some influence over the company. If they had all the advantages that they have without that political risk, it would be a somewhat better company.

But we have to take the world as it is. The advantage

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**WESCO FINANCIAL'S  
CHARLIE MUNGER**  
(cont'd from preceding page)

of having the agency label is so valuable to Freddie Mac that if they take a little disadvantage along with it, I would say it's a fair world.

We take some comfort in the world of good Freddie does.

**Munger:** I hope nothing too foolish will be done by the government. And so far, Fannie Mae and Freddie Mac have been very good at fending off a lot of crazy ideas. And they do a *world* of good for housing. If you stop to think about how the purchase of the ordinary house by the ordinary person in the ordinary place has been improved by Freddie Mac and Fannie Mae, it's awesome. They've done a *way* better job than the savings and loan industry did when they had the primary responsibility. It's been a slick system for the ultimate consumer — the homeowner.

It's a basic business — classic banking run well....

**Shareholder:** Could you comment on what you think about the way that Freddie Mac's business is operating? It seems to be turning over faster and faster....

**Munger:** They have little changes from time to time. And they'll do less of their work by getting guarantor fees and more by direct lending and holding the loans in their portfolio, etc. But all that said and done, it's a basic spread business where they're loaning at one rate and borrowing at another. It's classic banking.

And they have so much leverage that they try and keep it safe by having foolproof formulas — like loaning to people with good credit histories with significant equity in the house (except for a certain small segment of more venturesome lending) and only loaning on houses of moderate valuation. All of these sort of no-brainer systems that have been used in the mortgage business for decades to limit losses are being used there.

Even better, they're needed by the mortgage bankers. And they can cut people off who are sloppy or who try to cheat them — of which there will always be a number in any business. And they have pretty good systems now for nosing out the cheaters and cutting them off. So it's a pretty good system. It's not like the Japanese financial institutions I was criticizing.

Freddie's been burned badly in the past. That's good....

**Munger:** And Freddie Mac's had just enough trouble being taken by the crooks and the promoters that they remember it painfully. They made a lot of very dumb loans to apartment house promoters in the wrong kinds of places and the wrong kinds of structures and what have you. And they got lied to and had losses and had messes that took 'em years to clean up. And I think we as shareholders have been blessed by that early education of the people at Freddie Mac and Fannie Mae.

I DECIDED TO AVOID THE MOVIE BUSINESS EARLY.  
AND I MUST SAY THAT I'VE NEVER MISSED IT.

I learned early the motion picture industry wasn't for me....

**Shareholder:** Living in Florida, we love Disney.

We've loved it for years. We were excited when Berkshire became part of that. I know over the years Capital Cities has been very good for us — and Mr. Buffett's expressed his wild enthusiasm for that. Are you wildly enthusiastic about Disney's prospects given its current problems?

**Munger:** I'm not an expert on Disney. When I was very young, I worked in a law firm that did legal work for Twentieth Century Fox. And I never liked the motion picture industry. I didn't like the corrupt unions. I didn't like the way people dishonored written contracts. I didn't like some agents. I didn't like some lawyers.... And I didn't like the expense account abuse. It was simply a climate that, as an Omaha boy, I found repellent.

All that said, the business was full of fabulous talent and a lot of very honest people. There were great writers. There were great actors. And there were great directors. There were all kinds of wonderful people in it. And it's hard to think of anything that gave more harmless pleasure over the last 60 years than the American movies which are the most desired product of that kind all over the world.

However, I had this personal feeling that the trappings of the culture weren't congenial for me. Therefore, I haven't thought a lot about the motion picture business after I decided I didn't want to be in it.

It's a lot like the mining business. I was exposed to it at a young age. And when I saw how hard it was, I sort of scratched off the mining business. And I must say, I've never missed it. So with those personal peculiarities, I'm not a good one to talk about Disney.

Disney's doing almost everything about as well as it can.

**Munger:** I do think that Disney's done a fabulous job. And I do think they have a better brand in that business than any other movie company has. And if you look at what that company was when he came and what it is now, you have to admit that Eisner has one hell of a record. But as to the exact future for the movie business...

I have only one thought about the movie business: Some people think that if you cut the dog's tail off one inch at a time, maybe it won't hurt the dog so much. And somebody at Disney decided to settle that litigation with Katzenberg in two separate transactions. I thought that was just about as smart as cutting off a dog's tail one inch at a time. I think it's crazy if you're going to settle something not to settle it. To leave something with that much underlying animosity to be done in two bites is not the way I'd have done it.

With that one caution, for all I know, Disney is doing everything about as well as it can be done at the moment.

**WE LEARNED FROM OUR EXPERIENCE WITH SEE'S  
— AND IT'S BENEFITED BERKSHIRE ENORMOUSLY.**

Our contribution to See's? Very simple — leaving it alone.

**Shareholder:** Growing up, I recall See's Candy stores. It seemed like a very nondescript company. It amazes me what's happened with See's and how wonderful an investment it's been for Berkshire. What do you view as Berkshire's contribution — Buffett's management style or anything else — to its success?

**Munger:** Our contribution to See's Candies has been

*(continued on next page)*

**WESCO FINANCIAL'S  
CHARLIE MUNGER**  
(cont'd from preceding page)

limited to leaving it alone. When we bought it, it already had a wonderful culture, a wonderful trademark and a wonderful reputation. Our contribution was not screwing it up. There are a lot of people who would have bought it and would have screwed it up. They would have thought that headquarters knows best.

On the other hand, See's contributed enormously to us.

**Munger:** Most interesting is See's contribution to Berkshire and Wesco. We learned from that experience. If the See family had asked \$100,000 more for that company, we wouldn't have bought it — which would have been an insane decision. And we almost made the insane decision and just barely made the correct decision. So we stumbled into a wonderful investment return — and not by brilliance, but just by being a quarter smart.

But we did learn. When we saw how well See's worked, it helped change our attitude toward paying up for quality and so on and so on. So the See's experience has had an enormous ultimate effect on your welfare as shareholders of Berkshire and Wesco. So we owe See's an enormous debt. See's doesn't owe anything to us.

**WHAT WE'RE TRYING TO DO ISN'T EASY? YOU BET.  
EVEN STAYING AFLOAT AIN'T SO EASY AT TIMES.**

We're talking about huge numbers, all right.

**Shareholder:** I understand your goal is to increase Berkshire's intrinsic value 15% per year over time....

**Munger:** At a maximum. Of course, we'd like more, but that's the maximum that we would regard as attainable. And we don't guarantee that — to put it mildly.

**Shareholder:** Mr. Buffett also said that Berkshire's book value of \$57 billion far understates its intrinsic value.

**Munger:** Yes.

**Shareholder:** And since intrinsic value is a function of the return and the discount rate used, let's assume that Berkshire's intrinsic value, just for the sake of discussion, is \$80 to \$100 billion today. If we look out 10 years and assume 15% growth, that would require Berkshire to achieve an intrinsic value of between \$320 and \$400 billion.

**Munger:** You're good at your arithmetic.

**Shareholder:** We're talking about huge numbers.

**Munger:** You're right about that.

You bet it's difficult. Fortunately, we know how hard it is.

**Shareholder:** Take me through the math of achieving that in the kind of environment that you and Mr. Buffett have described.... It seems a little difficult, huh?

**Munger:** You bet. You bet that it's difficult. On the other hand, if you understand the difficulty of something, then I think you're more likely to be able to do it than somebody who thinks it's easy.

We have a date in mind for delegating our investing duties.

**Shareholder:** You've said you want to invest in

businesses you understand, that have global franchises, hopefully, run by people you like. With those incredible criteria and \$15 or 16 billion in the bank and \$200 million worth of cash flow a month, do you foresee Berkshire decentralizing the investment process/decision to investment advisers that you know, trust and admire?

**Munger:** I would not envision our methods changing. There may be a new person in the group — and, in due course, a successor to the old group. But will Berkshire ever hire 20 different investment counseling firms to manage its insurance assets? I think it'll be a cold day in hell.

Even worldly wisdom has its limits....

**\* Shareholder:** Is it true you almost drowned Warren in your boat?

**Munger:** No. We borrowed a boat — a ski boat with a low transom. And I was using it to go around slowly and cast for bass. I use my regular boat in forward and reverse naturally because that's what many a bass fisherman does. But in this borrowed ski boat, I didn't quite notice that the transom was about an inch above the water.

So when I put it in reverse, the water rapidly entered the boat. As I was running the motor and looking for the logical place to cast for the bass, the boat was filling with water. [Holding back laughter throughout.] Warren and Rick Guerin were waving and screaming. However, I just assumed they were trying to interfere with the fishing. But in due time, the boat filled with water and turned over.

We were only about 75 yards from shore. And a folder-sized portion of the boat remained above water. So the boat was floating. And you could put your hands on it and stay afloat. But I will say that I looked over at Warren's face as he went in and I did see a little fear — until he quickly realized he was safe and then it flashed away. Rick Guerin, who's very athletic, immediately thought of throwing off his clothing, diving under the boat, taking the life preservers out of it and so on. And Warren and I paddled to shore holding life preservers.

We were never in danger. However, you know, that episode has not been so great for my reputation. Some of my wise-ass friends routinely call me Admiral Munger. And it's not a term of approbation.

It's a very peculiar practice that we've developed.

**Munger:** I've sometimes called the people who come to our meetings a bunch of nuts. And I say that in a complimentary way. I say I'm a biography nut and so forth. So you're a bunch of Berkshire Hathaway/Wesco nuts. You actually like this kind of thing.

I don't know why a bunch of us nuts get together. Partly, I think, it's because we like thinking. It's not entirely because we like money.

I don't know any other corporate meetings in America like Berkshire's and Wesco's. It's a very peculiar practice that we have developed. Can you imagine going to the average lawyer or public relations officer at headquarters and saying, "We want the chief officers to be out there just answering any question?" [Munger chuckles.]

The meeting's adjourned.

—OID

*(Wesco/Berkshire coverage continued on next page)*

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

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THE UNICOVER AFFAIR WAS AN AMATEUR'S ERROR.  
BUT UNLIKE OTHERS, WE'RE ALREADY RESERVED.

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It may be the tip of the iceberg for the industry, but not us.

**Shareholder:** ...The Wall Street Journal published an article entitled, "When Insurers Pass Trash, Some Are Left Holding the Bag" — and that "some" included Berkshire. It focused on passing the workers' comp "trash" to, among other groups, Cologne Re. To make a long story short, the assistant general counsel for General Re (which I understand now owns most of Cologne Re) said this is a classic example of an insurance company seeking growth in a very competitive market by writing business outside its area of expertise — namely, within workers' comp — when its area of expertise is life reinsurance.

Mr. Graham went on to say, "Don't write business you don't understand.;" "Proper controls are critical in the insurance business.;" and "If a business opportunity appears to be too good to be true, then it probably isn't."

If this is true, could you tell us how this came about, what measures are being taken so it won't happen again and what the ultimate cost to Berkshire shareholders may be — because I gather that only the tip of the iceberg has been represented in the charge to Cologne Re.

**Buffett:** [Your question] regards... what's been called the "Unicover Affair", Cologne set up a \$275 million reserve for losses to be incurred on that [workers' comp] business. And that \$275 million still represents the best estimate. In other words, it may be the tip of the iceberg in terms of the loss to the *industry* because no one else has acknowledged any losses. And that's amazing. Believe me, there are plenty of other losses out there. We've said that we're going to lose about \$275 million. And I think that's a good estimate. But I think a lot of other people are going to lose — they *have* to lose — *very* significant money. Somebody has to lose some significant money besides us on that.

So what we have reported may be the tip of the industry iceberg. I don't think it's the tip of the General Re or Berkshire Hathaway iceberg. It's our best estimate today of what that loss will be.

If that estimate changes, I will let you know through the quarterly reports. Or if it were really material, we'd make some announcement. I don't anticipate that. But we'll report to you faithfully — as I've promised you — as to how the loss develops over time.

In terms of what you read about something that looks too good to be true usually *not* being true, that sort of thing makes a *great* deal of sense.

We've been through these things before. They take time....

**Buffett:** The distribution of the losses in the "Unicover Affair" will probably not be fully settled 10 years from now. I have seen these things before in insurance — and in other areas, but particularly in insurance — where there are multitudes of parties and there are allegations of stupidity, fraud, misrepresentation and everything else. There are so many people involved [and] so many factual

matters to determine [that] there will be lots of litigation. And it will take a long, long time to sort out the litigation. In the end, the losses will get paid by somebody....

But we may find out far more in coming months and years as to the involvement of other parties. [We'll] find out a great many things because there will be lots of litigation — not necessarily involving us, but that even as a viewer of them, we'll be learning about what took place.

A similar experience at Berkshire cost us dearly....

**Buffett:** Unfortunately, there have been some similar things in insurance. We were involved in one with some similarities to this at National Indemnity 20-odd years ago. And it was very expensive to us. It didn't cost us that many millions of dollars, but it happened exactly at the time the stock market was down around 600 on the Dow. And we did not know how big the losses would be. Therefore, it caused us to have to be more conservative in investing in equities than we would have been otherwise — if this hadn't been hanging over our head.

So conventional accounting will never pick up the loss that we suffered in that. It was called the "Omni Affair." Like I say, it had some — I'm sure it had many differences too, but it had some — similarities.

It's distracting to have something like this [where] obviously there was some mix of mistakes and some mix of misinformation. All of that will have to get sorted out. But our best guess today is that when it's all done — 10 or 15 years from now — the \$275 million will be our loss. That most certainly won't be the *exact* figure. But like I say, if there's any reason to revise that number upward, we'll tell you promptly.

You can get some very unpleasant surprises in insurance.

**Buffett:** It's in the nature of insurance to get unpleasant surprises from time to time. Loews Corp. bought CNA back in the early 1970s. And just in the last few years, there was a fiberboard settlement on a policy that I believe was written in the late '50s. And there was, as I recall, a loss of \$1-1/2 billion on something where the premiums were only a few thousand dollars.

GEICO lost, as I remember, \$60 million on a book of business written in the early 1980s where the premiums totaled less than \$200,000. How much of that's stupidity? How much of it's fraud? Who *knows* exactly?

But you can get some very unpleasant surprises in insurance. And unfortunately, this will not be the *last* one. It won't occur in the same place in exactly the same way. However, the nature of insurance is that the surprises are on the unpleasant side. It's not the kind of thing that happens when you're writing personal auto insurance or anything of that sort. But when you write business where the claims pop up 10 or 20 or 30 years later... We have one claim in a small workers' comp company, for example, that goes back 25 years or so — and it's just popped up to life in the last year or so. And it costs real money.

So it's a business where the surprises can come *big* and they can come *late*. And that will happen even with good managements. But with good managements, you'll have *fewer* such surprises. Charlie?

It was an amateur's mistake. But those things will happen.

**Munger:** Well, that was a marvelous question.

*(continued on next page)*

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

Imagine anyone asking the question of how to get educated. Who knows how to educate people? It's the same way that you educate the dog — by rubbing his nose in it.

Generally speaking, that was a dumb error. It was an amateur's mistake. It doesn't mean that General Re is suddenly full of amateurs. It was a rare lapse — just as we think the Omni Affair was a rare lapse for us at Berkshire. I don't think that we've repeated it since, have we Warren? At least I can't think of a single one.

**Buffett:** But, again, we don't know yet whether we've repeated it or not. [Chuckling] These things pop up later. But the answer is that we haven't repeated it.

**Munger:** Yes, it was a dumb, amateurish error. And these things do happen. But we don't think it reflects a sudden lowering of the intellectual standards of General Re — which, incidentally, are probably the best in the world. It's just one of those things that happen once in awhile.

There's one good side to these things. It does make you more careful. It really refreshes your attention to get banged on the nose like that.

We did better than expected before. Maybe we will again.

**Buffett:** Yeah. And it remains to be seen where the costs of that affair will be borne — because the entire set of facts in terms of what was committed to and all of that has not been resolved yet.

In the Omni situation, we had significant disputes on the facts for some time — and we eventually recovered a fair amount of money that for a time it didn't look like we would recover. So the final chapter on this is not going to be written for some time.

But it was appropriate to set up \$275 million as a reserve given what we know at this time. And that number could go up. It could also go down depending on the facts that we discover.

**WE'RE PREEMINENT IN THE SUPER-CAT INDUSTRY.  
IT'S A GREAT ASSET TO BE VIEWED AS FORT KNOX.**

Our reputation & commercial position is stronger than ever.

**Shareholder:** In the 1994 annual report, you made the following remarks:

"A prudent insurer will want its protection against true mega-catastrophes such as a \$50 billion windstorm loss on Long Island or an earthquake of similar cost in California to be absolutely certain. But that same insurer knows that the disaster making it dependent on a large super-cat recovery is also the disaster that could cause many reinsurers to default. There's not much sense in

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paying premiums for coverages that will evaporate precisely when they're needed. So the certainty that Berkshire will be both solvent and liquid after a catastrophe of unthinkable proportions is a major competitive advantage for us."

Please give us an update on those remarks. Is that competitive advantage you described intact? Has it been enhanced with the merger with General Re? And what's happened in the super-cat insurance industry since?

**Buffett:** Certainly, our reputation's stronger than ever. Berkshire's preeminent position as *the* reinsurer most certain to pay after any conceivable natural disaster — that reputation is stronger today than it's ever been ... and General Re's right along with it.

The commercial advantage inherent in that reputation is very important. I can't tell you exactly how it rates compared to 1994, but I can tell you that it is important. It tends to be more important when we're reinsuring other very large entities — primary insurers or large reinsurers — than it is with smaller companies. The smaller company probably focuses less on credit quality.

But we're writing, probably this week, a very large cover for a very important reinsurer. I don't think they'd want to buy it from almost anyone else. There are a couple of people maybe. And they could decide not to buy it from us because they might not feel they wanted to buy it. I think in this case, they will. But I don't think they'd have a list of 10 people from whom they'd buy it. They're too smart for that — because it's a very high level cover. And if it's called upon, there will be a number of people whose checks won't clear — and Berkshire's check undoubtedly *will* clear.

It will be a great asset to be thought of as Fort Knox.

**Buffett:** Our reputation has never been better. And the commercial advantage is significant. [As to] how much it translates into increased premiums, that can vary from year to year. But I think it's a permanent advantage that Berkshire will have. I think five years from now and 10 years from now — and particularly after there has been a huge super-cat — it will be a great asset to Berkshire to be thought of, essentially as I've described it, as Fort Knox. We will pay under any circumstances. There aren't many people in the insurance or reinsurance business that can truly say that. So when the very big cover comes along, we should have very few competitors. Charlie?

**Munger:** Well, I think that's exactly right.

**RATES ARE UNDER PRESSURE IN THE AUTO AREA,  
BUT THAT MAY SPELL OPPORTUNITY FOR GEICO.**

A student of Buffett who's learned well....

**Shareholder:** First, let me thank both of you for the incredible education that you've provided me through your annual reports and various presentations that you've given in public and in publication. I was about to send you my tuition check last week, but instead I decided to buy more shares of your company. I hope you'll forgive me.

**Buffett:** No, you've learned *well*. [Buffett chuckles.]

Whether the trends make sense, they'll probably continue.

**Shareholder:** Today, there's excess capacity in the

*(continued on next page)*

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

insurance industry — which comes and goes. But there seems to be a trend towards international consolidation. Also there seems to be a trend towards demutualization in the life insurance companies in the U.S. Could you tell us what you think the insurance industry will look like?

**Buffett:** Both of the trends you talked about do exist. I don't think consolidation usually solves many problems. If you have two lousy businesses and you put 'em together, you've got one *big* lousy business usually. I'm not a big fan of consolidation where two very mediocre businesses merge and theoretically you're going to wring the cost out of one. It just doesn't work that way in my experience. However, the consolidation will go on. And the demutualization of life companies will go on, too.

It's not inconceivable that we'll play some part in one or the other in some way, although it's not high on our list. But I've learned in this business never to say never — because things do happen from time to time that cause me to want to retract some earlier statements.

Among auto insurers, GEICO's package of virtues is unique.

**Buffett:** The winners are going to be those companies that possess some franchise based on specialized talents, on terrific distribution systems, on managerial knowhow or even on the ability to use the float effectively — and in the case of something like GEICO, on a combination of the franchise and a superior distribution system. We have the low-cost method of distributing personal auto insurance on an all-comers basis.

USAA does a terrific job delivering low-cost insurance to a specialized group. GEICO actually in a sense came out of USAA. Leo Goodwin and his wife, Lillian, who founded GEICO in 1936 were both employed by USAA. And Leo, as I remember, was an officer of the company. So the idea of GEICO came out of USAA.

But USAA limits their coverage to a given class, whereas we offer it to everybody in the country — except ... in New Jersey and Massachusetts because we can't figure out any way to make any money there.

Twentieth Century has done a terrific job of becoming a low-cost operator within a given urban area — in the greater Los Angeles area. But in terms of an all-comers, all-geography, all-occupation type of operation, in my view, GEICO is the best operation in the U.S.

Better yet, consumers around the country are *agreeing* with that view. GEICO's policyholder count increased 20.8% last year. This year, in the 12 months ended March 31st, the policyholder count is up 22.5%. And these are on big numbers. So the growth has accelerated.

There's a surplus of capital in the auto insurance industry.

**Buffett:** That sort of advantage will make for a good insurance business — a *very* good insurance business — over time. But I think the average insurance company is going to remain very average. And there is a lot of capital in the industry, as you pointed out. There is more capital in the industry than there is opportunity to use it intelligently. Nevertheless, it doesn't go away. We're not seeing consolidation that takes away a lot of the capital in

the industry. And you're not seeing massive share repurchases or anything of the sort. So the capital is there. It's seeking an outlet in premium volume.

That actually hurts a General Re to an extent because it means that the primary companies want to retain more of the premium they generate just so they can show some kind of growth against their capital base.

When times get tough, it may actually help GEICO grow.

**Buffett:** I think generally we're very well positioned in the industry. I think the industry will be tougher in the next few years by a significant margin in the personal auto segment. But frankly, I look forward to it — because I think it may offer us the opportunity to grow even faster.

We have the best vehicle in a very, very big industry — the auto insurance business. We've got incredibly good management to take advantage of that. And we have policies available as you leave at the door....

**LIFE INSURANCE IS NOT SO GREAT HISTORICALLY.  
AND EQUITY-ORIENTED PRODUCTS WOULD CONFLICT.**

We don't want to wear two hats — or sell our best ideas.

**Shareholder:** Berkshire has been investing in the property and casualty and reinsurance business. I notice that except for annuities, you have avoided life insurance. Do you anticipate investing in the life insurance business?

**Buffett:** We have no bias against the life insurance business. We are in the life reinsurance business in a fairly significant way through General Re. As you say, we've done a little on annuities.

However, the problem with the life insurance business is that it isn't very profitable. You can look at the records of the big companies on that. Also, a lot of the activity in the area is in some way equity related. And Charlie and I have never wanted to get in the business of managing equities for other people. We want our sole interest on equities to be Berkshire itself. We do not want to wear two hats.

We would never go into the mutual fund management business or any kind of investment management business — because if we were to be managing \$20-30 billion in the investment management business and we get a good idea that we can put \$1 billion in, whose money do we put in it? So we'd rather just be wearing one hat — and we want that hat to be Berkshire Hathaway.

And we don't want to promise other people that for a fee of 1/2 of 1% or 1%, they're going to get our best ideas — because those ideas belong to Berkshire. Therefore, we'd be misleading people if we promised otherwise.

So anything that involves an equity component — and that's a big part of the life business now — is just something we wouldn't be comfortable being involved with.

We have a very, very competitive product in annuities....

**Buffett:** We've looked at term life insurance in terms of putting it on the internet. But it's priced at rates that we find very hard — even with the absence of commissions — to make sense out of. It's a business we understand. So we'd be perfectly willing to be in the life insurance business if we had a way of doing it where we thought there were reasonable profitability attached to it....

**Munger:** We do those structured settlements that are

*(continued on next page)*

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

sort of like the annuity business. And the life business we're doing is mostly annuities on a very low-cost basis.

**Buffett:** That's right. Anyone who would like to buy a non-equity related annuity should go to our website.... In terms of weighting for the safety of the product and everything, you will find a very, very competitive product — because we have a low-cost operation. If you're buying it to get paid 30 years from now, you're *certain* to get paid from Berkshire — and you're not necessarily certain to get paid with various other entities. So we have a very competitive product there, but it's not a big business.

**THE BERKSHIRE BRAND HAS ENORMOUS POTENTIAL  
— WHICH IS ONLY MADE GREATER BY THE INTERNET.**

Brands are enhanced by the association with Berkshire....

**Shareholder:** You mentioned the power of brands on the internet. I can't think of a better brand — at least in my view — than the Berkshire brand. Have you thought about ways to further use your brand on the internet to capitalize on the reputation that you've built over the past decades?

**Buffett:** That's a very good point. It is something that could be of real value. It's probably of some value to us already with the brands that we're associated with: Executive Jet or the NetJets program, Borsheim's and Berkshire Hathaway Life — each of those brands, I think, are enhanced by their association with Berkshire, just as a lot of other brands would be. But I think that's got a long way to go. I think you're dead right on that.

**The internet creates more and more of a premium on trust.**

**Buffett:** The internet reinforces the necessity for trust in dealing with people. You're getting further and further removed from face-to-face dealing where you can go back to the store the next day or look at the person who sold it to you the next day and get an adjustment or something of that sort. You're really having to place more and more trust in somebody you're never going to see.

And I think you're right that Berkshire Hathaway, if it behaves itself properly, can get a reputation for trust that's far greater than that possessed by the average company. And when we properly associate that with some of our brands, those brands will be enhanced by the association.

So I've thought a lot about what you're talking about there — and so have our managers. And it's something that we intend to capitalize on in the future.

If you like Amazon, then you should love GEICO.

**Buffett:** It's rather interesting. If you look at the companies that do business with people where there's no face-to-face interaction either with the company itself or some intermediary like a retailer or anything of the sort, there's Dell Computer and now you have Amazon.com. But GEICO's doing business with 3.7 million policyholders. And before the year is up, it'll be close to 4-1/2 million and probably \$4.8 billion or so of business with people that have never met anyone from GEICO. They've talked to someone on the phone.

We're one of the largest companies in the U.S. in terms of doing business on a direct-to-consumer basis. We're doing it with people who on average are paying us \$1,200 a year or thereabouts for a *promise*. So people talk about the Amazons of the world — where people are buying X dollars worth of books each year and so forth. However, we have a much more direct connection with people — and they tend to renew with us year after year.

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

**Buffett:** That is based on *trust*. There's no neighbor next door who they can go to if they have a problem. It's based on the fact that they trust this company that's back in the District of Columbia to perform in the future.

And that's a huge asset — and one that's growing daily. We're adding policyholders every day who are signing up with us who have never met anybody from the company. Well, that's already a very big asset — and one that will be many times bigger, in my view, 10 years from now.

[As] the Berkshire umbrella gets involved in one company after another like that that people trust, we can be in an awful lot of homes over the years. And as more and more business is done direct with the consumer, the power of that, in my view, should grow. We just have to be very smart about how we maximize that growth....

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**EACH OF OUR OPERATIONS HAS ITS OWN CULTURE.  
IF THEY AIN'T BROKE, WHY SHOULD WE FIX 'EM?**

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We supply the principles; our managers supply the plans.

**Shareholder:** As a small businessman, one of the trickiest jobs I have is dividing up the profits of our business between the employees who generate it. Would you share your thoughts with us on how you divide up the profits of Berkshire's subsidiaries with the employees who generate them?...

**Buffett:** Our arrangements with compensation vary to an extraordinary degree among our various subsidiaries — because we've bought existing businesses and tampered as little as possible with their cultures after we bought them. And some of those cultures are very different than others. You saw Mrs. B earlier. As you can imagine, she would leave a very strong imprint on any business with which she was involved. We have a number of very talented managers who've worked out the system they believe to be best for their company.

It's true — if there's a stock option plan in a company, we'll substitute a performance-based plan which ties compensation much more clearly to the performance of the business than any option plan could. And we'll design one with an expected cost equivalent to the expectable cost of the option plan. So we try to equate the cost. And we try to make it much more sensible from the standpoint of both the owner and the employee in terms of the way it pays off based on how that business performs.

You probably read in our annual report how we have put in an across-the-board plan at GEICO that ties with our objectives. But basically that was Tony Nicely's work. He developed that plan. He and I thought alike about what counted. And he developed a compensation grid that

*(continued on next page)*

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

applied to everybody in the whole place based on achieving the objectives that he felt were important and that we felt were important.

We don't tell our managers how to swing or how to pay....

**Buffett:** If you go to any Berkshire subsidiary, you will probably find that they have a compensation plan that's quite similar — with the exception of options — to the plan that they had before we bought the operation. They have successful businesses.

And people get there in different ways. Some people bat left-handed and some bat right-handed. Some people stand deep in the batter's box and some crowd the plate. They all have different styles. The styles of our managers have proven successful in their own businesses. We keep the same managers. So with the exception of what I've mentioned, we don't superimpose any system from above.

We do like the idea of paying for performance. That's a fundamental tenet. Everybody says they like that, but then they design systems that pay off no matter what happens in many cases. We've been reluctant to do that. Charlie?

We just leave our managers alone. That comes naturally....

**Munger:** I think it's important for the shareholders to realize that we are probably more decentralized in terms of personnel practices than any company of our size or bigger in America. We don't have a headquarters culture that we force on the operating businesses. Each one has its own. In every case I can think of, it's a wonderful culture. And we just leave them alone. It comes naturally to me.

**Buffett:** Charlie says that we don't have a headquarters culture — and sometimes people think we don't have a headquarters. We have no human relations department at Berkshire. We have no legal department. We have no investor relations or public relations — we don't have any of that sort of thing.

We've got a bunch of all-stars out there running businesses. We ask them to mail the money to Omaha. And we'll even give 'em a stamp if they request it. But beyond that, we don't really go. It would be foolish.

There's more than one way to get to business heaven.

**Buffett:** What is interesting to me... I had a lot of preconceived ideas of what motivates people when I started out in business. But you can find certain organizations that resist paying stars on an individual basis. They like to think of themselves as a team — and they'd rather have a *team* concept of payment. You can see others where they're much more *individually* oriented.

Actually, Charlie can probably tell you about that in terms of law firms. Some law firms have a culture that is much more star-oriented than others. And you've seen successes in both places, haven't you Charlie?

**Munger:** Absolutely.... [Long pause.]

**Buffett:** OK.... [After another long pause. Charlie says nothing and the audience begins to laugh.]

**Munger:** I can't remember a case when anybody has

transferred from one operating Berkshire subsidiary to another. It's very rare.

**Buffett:** Yeah, we don't try to cross-fertilize. We think we've got a good thing going in every plot of ground. We just assume they'll do best if left to their own initiative.

AT OUR SUBSIDIARIES, WE BASICALLY HAVE TWO JOBS:  
GET OUT OF OUR MANAGERS' WAY AND CHEER 'EM ON.

We sometimes bring something to the party business-wise.

**Shareholder:** How does Berkshire add value to its various wholly-owned companies?...

**Buffett:** In certain specific cases — General Re being the most recent example — we actually laid out in the proxy material why we thought there was at least a reasonable chance that the ownership by Berkshire would add value. And we got into various reasons about the ability to use the float, tax advantages, the ability to expand faster around the world and that sort of thing. So we've actually spelled it out in that case.

In the case of Executive Jet, you might well figure that there are some reasons why the association with Berkshire would put Executive Jet on the map and in the minds of people who can afford to buy fractional ownerships of planes faster than might otherwise be the case. So there are specific cases where we bring something to the party.

We have the best ownership environment around....

**Buffett:** But the biggest thing we bring to the party generally is what I spelled out a bit in our annual report this year in talking about GEICO:

We enable terrific managers to spend, in many cases, even a *greater* percentage of their time and energy on what they do best, what they *like* to do best and what is the most productive for owners than would be the case without our ownership. We give them a very rational owner who expects them to spend *all* their time focused on what counts for the business and thereby eliminate the distractions that often come with running a business — particularly a publicly-owned business.

I'd guess that the CEOs of most public companies waste a third of their time, at least, in all kinds of things that don't add a thing to the business. In many cases, those things actually *subtract* because they're trying to please various constituencies and so they waste their time with them and thereby take the company backwards.

We eliminate all of that. We think that we can create the best ownership environment, frankly, that can exist for any business other than maybe owning it 100% yourself. And that happens to also go along with how we like to lead our lives because we don't *want* to run around and attend a lot of meetings and do all of these things that people do. So that can be a significant plus.

Most of what we do is just not to interfere.

**Buffett:** GEICO's probably grown a fair amount faster as a subsidiary of Berkshire than it would have had it remained an independent company, although it was a hell of an independent company and would've continued to be one. But I think billions and billions of dollars will be added to GEICO's value over and above what would have happened had it remained a public company — and not because we

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

taught management anything. We haven't taught them one thing about the classification of insurance risk, how to run better ads or anything of the sort. We've just let 'em spend 100% of their time focused on what counts. And that is a *rare* occurrence in American business. Charlie?

**Munger:** Just not having a vast headquarters staff to tell the subsidiaries what to do — that helps most of the kinds of subsidiaries that we buy. They're not looking for a lot of people looking over their shoulder from headquarters and a lot of unnecessary flights back and forth and so on.

Most of what we do — or at least a great part of what we do — is just not to interfere in a counterproductive way. And that noninterference has enormous value — at least it does with the kind of managers and the kind of businesses that have joined us.

**Buffett:** You have to see it to believe it. But in a great many corporate operations, the importance of a large group of people is tied to how much they meddle in the affairs of other people who are out there doing the work. We stay out of the way.

We also add value by being knowledgeable owners.

**Buffett:** Furthermore, we're appreciative owners and knowledgeable owners. We know when somebody has done a good job — and we know when they've done a good job when industry conditions are terribly tough....

We could look at our shoe operations, for example. They are in tough industry conditions now. But we've got some absolutely terrific people. And we're knowledgeable enough about that so that we don't go simply by a bunch of figures and make a determination about whether people are doing the right thing. So we're knowledgeable owners.

Since they appreciate what we do, they're more productive.

**Buffett:** Further, we have no one at headquarters whose job is to go around and tell people how to run their human relations departments, their legal departments or a dozen other things. So not only do our managers have more time to work on productive things, but I think they probably actually appreciate the fact that they're left alone. So I think you even get more than the proportional amount of effort out of them than would be indicated simply by the amount of time you free up because I think you get added enthusiasm for the job.

And having people in a large organization who truly *are* enthusiastic about what they're doing — that doesn't happen all the time. But I think it does happen to a pretty good degree at Berkshire....

OUR SUCCESSORS ARE IN PLACE AND READY.  
YOU'LL BE QUITE PLEASED WITH THEIR RESULTS.

It's easier to groom a younger successor today than ever....

**Shareholder:** Mr. Buffett, will you groom a younger man or woman as your heir apparent? If so, when might you do this? By younger, I mean a person 15-20 years younger than yourself. Of course, I'm not complaining. After all, you're the best in the world.

**Buffett:** Well, 15 or 20 years younger is a lot easier to do than it used to be.... A large percentage of the world's population is now eligible.

We have our successors in place now — and they're ready.

**Buffett:** We have today the people to take over Berkshire. There's no problem about that at all. They've been named in letters that the directors have and they're there in place.

Exactly who the two people — or one person — will be will depend on exactly when Charlie and I leave the picture. If we'd written the letter 10 years ago, it might have been different than today. And it might be different 15 years from now. So the timing of our death or incapacity will determine exactly who the person in that letter will be.

But we have those people in place. They don't need to be groomed going forward. They exist. They're ready — they'd be ready — to run Berkshire tomorrow morning.

There's only one Buffett, but that's just too damn bad.

**Buffett:** I think you'll be quite pleased with the job they'll do. That's why I don't worry about having 99-3/4% of my net worth in Berkshire. And I don't want any of it sold. If I knew I were going to die next week, I wouldn't want it sold — and I don't want it sold *after* I die. I feel very comfortable with the businesses, the managers and the successor top management that we have at Berkshire. I just don't want 'em to take over too early. Charlie?

**Munger:** I actually think the prospects for continuity of corporate culture, to the extent we have one, at Berkshire is higher than the prospects for continuity of corporate culture at most other large public companies. I don't see Berkshire changing its way of operating even if Warren were to expire tonight.

I think the capital, the fresh cash, would be allocated less well. But as I've said at past shareholder meetings, well, that's too damn bad.

**Buffett:** That's why we don't have a public relations department....

**Munger:** By the way, I don't think that the job would be ill done. I just don't think it would be done quite as well as Warren does it.

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THE PROBLEM WITH ADDING US TO THE S&P 500 —  
AND A SOLUTION. BUT IT'S NOT A BIG DEAL TO US.

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If Berkshire joined the S&P 500, its price would spike.

**Shareholder:** Much has been made of the fact that Berkshire is the largest company not in the S&P 500. Should Berkshire be included — and why?

**Buffett:** We've been asked that question quite often since the General Re deal was announced. If you talk to the people at S&P, I think they would say — and I think they've even said it publicly or at least a representative has — that we certainly qualify in every way except in what they might term liquidity. Maybe 6-7% of equity funds in the U.S. are indexed and that amount's going up somewhat as we go along. I saw an article to the contrary, but I think they had it wrong. The amount of indexed money is, in my

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WARREN BUFFETT & CHARLIE MUNGER**  
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view, rising month by month.

So if Berkshire joined the index tomorrow, in effect you'd have a market order to buy 6-7% of the company — or roughly 100,000 Class A shares. That wouldn't be good. The stock would obviously spike up dramatically as some stocks already have when they've been added. I've looked at the list of all the companies that have been added and some have moved up substantially. And there would be even more impact at Berkshire than the typical stock because our stock is fairly tightly held and most people don't want to sell it.

Selling shares would solve the problem. But no thank you....

**Buffett:** There are three solutions to that — one of them being not to put us in the index. But I think we are probably the most significant company in the U.S. that isn't in the index in terms of market value and a lot of other factors. So if you want to add Berkshire or a company like it to the index and not have some crazy market aberration, one of two things could be done. This would be true, I think, more and more of other companies as well as they add them into the index and as more money gets indexed:

One would be that you could have the company agree that at the time it was added to the index, simultaneously it would sell an amount of stock that was about equal to the index buying that would be generated. In other words, if we were to offer roughly 100,000 shares of A stock at the same time as it's being added to the index, that would neutralize the index buying.

The problem with that is that we don't want to sell 100,000 shares — or 10,000 shares or 100 shares — of A stock at Berkshire unless we have some very good use for the money. It isn't going to happen. We're not going to do something like that just because we want to be in an index.

Option #2: Phase in our addition to the index over time....

**Buffett:** The other possibility — and I believe this was used in Australia when a very large mutual life company converted to stock (I think it was the largest company in Australia, AMP) — would be to phase in the weighting of a stock like Berkshire into the index. And I think later on, they may have to do it for all stocks. [But they could] phase in the weighting, say, over a 12-month period, so it was 1/12th weighted the first month, 1/12th weighted the second month and so on. That means, in effect, that there would have to be a market order once a month for 1/2 of 1% roughly of Berkshire.

I don't think that would be particularly disruptive. And I think that once you knew that phase in was coming, there would be some anticipation so that you would not get big spikes in the stock and a dip subsequently. I think that would be a logical way. But Standard & Poor's to date has not had to do that sort of thing. And they may have various reasons — and various good reasons — for not wanting to do that.

If they solve preceding problems, we're a logical addition.

**Buffett:** Now, if indexation were to continue to grow as

it has to the point where 15% of money becomes indexed, then I think they'll have to come up with some approach similar to one of these two that I've named. Otherwise, it will simply get too disruptive to the market....

It would be interesting — I know America Online has behaved very well since it was introduced to the S&P some time back. But I would think it might get to be the case that if you simply shorted the companies that got added to the S&P after the S&P effect had been felt, you might find that those stocks would tend to *under-perform* as the impact of that one artificial buy order, in effect, wore off.

So I think something's going to happen. I think indexation's far exceeded what anybody anticipated — including S&P and me or Charlie. And I think there's been a good reason for it to develop.

But as it continues to develop, it will have more and more impact on the market in ways that probably S&P is not that excited about — nor would the index funds be that excited about. So there is likely to come a solution to the liquidity problem that might be particularly acute at Berkshire, but that prevails throughout the market that occurs when stocks are added.

And I'd think that if they adopt some solution — but, certainly, if they adopt the solution of gradual weighting — Berkshire would be a very logical candidate for the S&P.

It's not a big deal to us either way....

**Buffett:** It really makes no difference to us what is done along that line. We would not be unhappy being in the S&P as long as it didn't have some huge market impact at the moment of putting it in. On the other hand, we love the owners we've got and I don't see how we could improve on this group much by adding index funds as shareholders. So we'll see what happens on it. It's not a big deal to us.

And we want to be sure where we're added, it isn't too big a deal to the market.... I would not like — [even though] the people who sold that day might like it — the stock to jump up \$20,000 a share on one day because there's some market order for 100,000 shares and then have it gradually work its way back down to where it should have been in the first place. No one benefits from that except the people who sell in the very short term — and that is not the group that I primarily worry about. Charlie?

**Munger:** My guess is that Berkshire will eventually be in the S&P index. Somebody will figure out how to do it sensibly — maybe not soon, but someday.

**WE'LL ALWAYS CONSIDER SHARE BUYBACKS,  
BUT ONLY IF THE DISCOUNT'S FAIRLY DRAMATIC.**

Many times, we'd have been better off buying our shares.

**Shareholder:** Would you please revisit the question of share repurchases for Berkshire Hathaway? We have heard today your comment about Berkshire having been inefficiently priced from time to time in the past. And we know that there are now more shares outstanding. Is the buildup of cash causing you to spend more time looking for investment situations where you're more comfortable on the 10-year outlook?

**Buffett:** There have been times when I thought Berkshire has been underpriced, or even significantly underpriced, but at the same time I was finding other things

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WARREN BUFFETT & CHARLIE MUNGER**  
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which I felt were even *more* attractive. When Berkshire sold at \$50 a share in 1974, I might have thought it was cheap. But I was also looking at the old Washington Post Company selling for \$80 million when I thought it was clearly worth \$400 million. And I did not think that Berkshire was as underpriced then as the Washington Post Company was. And that has been true at various times....

But many times I was wrong. We would have been better off buying our own stock instead of buying the things that I was buying.

Most companies aren't getting much for their money....

**Buffett:** Even though repurchases are probably close to an all-time high if they're not at an all-time high, I think it's difficult for share repurchases at most companies to make a whole lot of sense these days. I don't think that they're getting much for their money — because we don't want to buy those shares ourselves. (I'm talking about the stock of various companies in America.)

Yet companies are much more enthusiastic about repurchasing shares now than they were 20 years ago when they stood to get *far*, far greater returns by doing so.

It's always an option, but only if the discount's dramatic....

**Buffett:** But if we have money around and we think Berkshire is significantly underpriced and we're not finding other things to do with the money, it makes sense, obviously, for us to repurchase Berkshire shares.

It's an option that we will always think about. And we're unlikely to do it unless we think it's fairly dramatically underpriced — because ... we would want a big margin for error in making that kind of a decision. We would not want to buy a dollar bill for 95¢ or 94¢ or 93¢. But there is *some* level where we would start getting excited — if we didn't have other uses for the money....

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EVEN ADJUSTED RETURNS ARE SURPRISINGLY HIGH.  
ARE THEY SUSTAINABLE? COLOR ME DUBIOUS.

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I "chess" knew this young man would do well....

**Shareholder:** Warren, you wrote in 1977 that the

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investment letters."

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return on equity for corporate America tended towards and averaged about 13% no matter the inflation environment. After properly expensing options and so-called "nonrecurring charges" and taking into account the high P/E ratio paid for increasingly frequent acquisitions, do you think that 13% figure is still roughly correct?

Also, what quantitative method would you suggest investors use for expensing option grants of publicly-traded firms where there's no realistic prospect for the substitution of such an options program with a cash-based performance incentive plan? In other words, how do you derive the 5-10% earnings dilution referred to in your latest annual report? And might the dilution figure be even higher than that?

**Buffett:** ...Jon Brandt is the son of a very good friend of mine with whom I worked for decades. And Jon is now an analyst with Ruane, Cunniff — and a very good one.

[Editor's note: Absolutely. Plus, as we've observed, he's the closest thing we've ever encountered to a young Charlie Munger. (See our June 22, 1992 OID edition for our interview with Steve Farley and Jon Brandt.)]

**Buffett:** Also, he says it didn't happen this way.... But when he was about four years old, I was at his house for dinner with his parents and he suggested to me after dinner, "How about a game of chess?" Well, I looked at this four-year-old and ... I thought that this is the kind of guy [that maybe I should say], "Should we play for money?" So I did. But he said, "Name your stakes," so I backed off.

Well, we sat down to play. And after about 12 moves, I could see I was in mortal trouble. So I suggested it was time for him to get to bed.

Even adjusted, returns have been surprisingly high.

**Buffett:** As for your question about return on equity, it's true — in 1977, I believe, I wrote an article for Fortune that talked about ... this figure of 12-13%, more or less, that return on equity kept coming back to and explained why I *didn't* think it was affected by inflation (which was very much the hot topic of the day). And it wasn't.

But in the last few years, earnings have been reported at very high figures on the S&P, although you've had these very substantial restructuring charges which every management likes to tell you don't count. I love that. They say, "We earned \$1 a share in total last year. But look at the \$2 a share that we tell you we really earned. The other \$1 a share doesn't count." And then they throw in mistakes of the past or mistakes of the future and every three or four years ask you to forget them as if they don't mean anything.

We've never had a charge like that that we've set forth at Berkshire — and we never will. It isn't that we don't have things we do that cost us money in moving around, but we don't ask you to *forget* about those costs. Still, even allowing for options costs, restructuring charges and everything else, return on equity has, to me, been surprisingly high in the last few years.

Are recent returns sustainable? Color me dubious.

**Buffett:** However, there's a real question in a capitalistic society if long-term rates are 5-1/2%, whether return on equity can be some number like 18-20% virtually across the board. An awful lot of companies out there today are implicitly promising you — either by what they

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say their growth in earnings will be or various other ways — that they're going to earn a return [on equity] of 20%+. Well, I'm dubious about those claims. But we'll see.

**WE ADJUST FOR CORRUPT OPTIONS ACCOUNTING.  
OTHER INVESTORS ARE FOOLISH IF THEY IGNORE IT.**

How Buffett and Munger adjust for stock options....

**Buffett:** The way we ... [adjust] for stock options is very simple. We look at what a company issues in options over, say, a five-year period — and, because the grants are irregular, we divide by five. Or if there's some reason why that seems inappropriate, we might use something else. But we try to figure out what the average option issuance is going to be.

Then we ask ourselves how much the company could have received for those options if they'd sold 'em as warrants to the public. They could sell me options on any company in the world. I'll pay *some* price for an option on *anything*. And we would look at what the fair market value of those options would be that day if they were transferable. Now they aren't transferable. But employees sometimes get their options repriced downward — which you don't get if you have public options.

So we figure the cost to the shareholder of issuing the options is about what [the company would have received] had they turned them into warrants and sold 'em to the public or sold 'em as options.

That it's not reflected in accounting is truly a scandal.

**Buffett:** And that's the cost. It's a compensation cost. [And if you don't believe it's a *real* cost,] just try going to a company that's had a lot of options grants every year and tell them you're going to quit giving the options and pay people the same amount of money. They'll say, "You took away part of my earnings." And we say if you've taken away part of the earnings, show it on the income account and show it as a cost — because it *is* a cost.

Actually, a number of auditors agreed to that position many years ago. But they started receiving pressure from their clients who said, "Gee, that might hurt our earnings if we reported that cost." So the auditors caved. And the clients put pressure on Congress when it came up a few years ago.

And I think it's a scandal. But it's happened.

Once corrupt practices get embedded, good luck....

**Munger:** It's fundamentally wrong not to have rational, honest accounting in big American corporations. And it's very important not to let little corruptions start because they become *big* corruptions — and then you have vested interests that fight to perpetuate them.

Surely many wonderful companies issue stock options — and the stock options go to a lot of wonderful employees that are really earning them. But all that said, the accounting in America is corrupt. And it's not a good idea to have corrupt accounting.

**Buffett:** But I don't think it's going to change. It's

too much in corporate America's interest to keep it out of the income account, keep issuing more options percentage-wise and not have it hit the income account and reprice them when stocks go down. But that doesn't make it right.

You can see the problem of creep once it starts. It's much like campaign finance reform — if you let it go for a long time, the system becomes so embedded and the participants become so dependent on it that there becomes a huge constituency that will fight like the very devil to prevent any change regardless of the logic of the situation. Once you get a significant number of important players benefiting from any kind of corruption in any kind of system, you're going to have a terrible time changing it. That's why it should be changed early.

It would have been easier to change the accounting for stock options some decades back when it was first proposed than now — because, basically, corporate America is hooked on it.

We're not against properly designed options — even here....

**Buffett:** That doesn't mean we're against options per se. If Charlie and I were to die tonight and you had two new faces up here who didn't have the benefit of having bought a lot of Berkshire a long time ago and they had responsibility for the entire enterprise, it would not be inappropriate to pay them in some way that was reflective of the prosperity of the whole enterprise.

I'd be crazy to pay the people at Dairy Queen or Star Furniture or any of our operations in options of Berkshire — because they have responsibility for a given unit. And what the price of Coca-Cola stock does could swamp their efforts in either direction. It would be inappropriate.

But it would *not* be inappropriate to pay somebody that's got the responsibility for all of Berkshire in a way that reflected the prosperity of all of Berkshire. And a properly designed options system, which would be much different than the ones you see because it would be much more rational, could well make sense for one or two people that had the responsibility for this whole place.

Charlie and I aren't interested in that. But I think that you may be looking at two people up here — 50 years from now, I hope — where it *would* be appropriate.

Option consultants know how to keep their clients happy.

**Buffett:** However, any options system (A) should not involve giving an option at less than the place could be sold for today regardless of the market price — because once management's in control, it can make that decision. And (B) it should reflect the cost of capital. And very, very few stock option plans reflect the cost of capital. If we're going to sit here and plow all the money back every year into the business and, in effect, use your earnings interest-free to increase our own earnings in the future, we think there has to be a cost of capital to have a properly designed options system.

But needless to say, people aren't interested in that. The option consultants aren't interested in what is rational or fair, but in what their clientele wants....

Whatever the accounting, investors are foolish to ignore it.

**Buffett:** Nevertheless, in evaluating a business, whether we're going to buy an entire business or part of it, we're going to figure out how much it's costing us ... when

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the company issues those options every year. And then, if they reprice 'em, we're going to figure out how much that particular policy costs us. That's coming out of our pocket as investors. So I think people are quite foolish if they ignore that.

**DUMB ACCOUNTING LEADS TO DUMB ACTIVITY.  
WE THINK THE SYSTEM SHOULD BE BETTER.**

Goodwill is real — and, therefore, should be reported....

**Shareholder:** Several different methods are used worldwide to account for goodwill — from amortization to direct write-off. What would you recommend as a more appropriate method for accounting for goodwill?

Secondly — and I'd like to direct this to Charlie — why not tie goodwill to the share price and have an intangible and a tangible part of shareholders' equity with the intangible part being the difference between book value and the share value of a company?

**Buffett:** I'll take the first part. It's a good question about goodwill and the treatment of goodwill for accounting purposes. I actually wrote on that subject — I think it was in 1983 in the annual report. And if you click on to [berkshirehathaway.com](http://berkshirehathaway.com), you can look at the older letters and see a discussion of how I think goodwill should be handled. And we've discussed it at various other times in the owners manual.

But I'll give it to you briefly: In the U.K., for example, goodwill is written off instantly. So it never appears in book value. And, therefore, there's no subsequent charge for it. If I were setting the accounting rules, I would treat all acquisitions as purchases — which is what we've done virtually without exception at Berkshire.... I would set up the "economic goodwill" because we are *paying* for goodwill when we buy a General Re. I mean we're paying billions and billions of dollars for it — or when we buy a GEICO or when we buy an Executive Jet. That is what we're buying — what I call "economic goodwill".

Therefore, I believe it should stay on the balance sheet as reflective of the money you've laid out to buy it.

Goodwill amortization's another matter altogether.

**Buffett:** But I don't think it should be amortized, although in cases where it's permanently impaired and it's clear that value has lessened, the value loss should be charged off at that time.

However, generally speaking, and in our own case, the economic goodwill that we now have far exceeds the amount that we put on the books originally and, therefore, even by a greater amount exceeds the amount that remains on the books after amortization. I do not think an amortization charge is appropriate at Berkshire for the goodwill that we have attached to our businesses. Most of those businesses have increased their economic goodwill — in some cases by dramatic amounts — since we've purchased them.

But I think the cost ought to be on the balance sheet. It shows what we paid and I think it should be reported. And I don't think the coming change in accounting is likely

to be along the lines I've suggested here, although I do think it's the most rational way to approach the problem.

Irrational accounting leads to irrational corporate activity.

**Buffett:** Also, because there is this great difference between purchase and pooling accounting, some really stupid things are done in the corporate world. I've talked to managers who *deplore* the fact that they were using their stock in a deal and going through various maneuvers to get pooling accounting because they thought it was economically a dumb thing to do. Nonetheless, they did it rather than record amortization charges that would result from purchase accounting. They're very frank about that in private, but they don't say as much about it in public. Charlie?

The system should be better.

**Munger:** Generally speaking, I think that what Warren argues for would be the best system — where you set up the goodwill as an asset and you don't amortize it in the ordinary case. However, there would be plenty of cases that wouldn't be ordinary cases — when amortization would be rational and, in fact, *should* be required. So I don't think there is any one easy answer to this one.

There's a lot of crazy distortion in corporate practice because of all the different accounting practices. Australia has what you might call "mining promoter" accounting. Europe has, in effect, "write-it-all-off-immediately" accounting which you might call *half*-"*mining promoter*" accounting. We think the system should be better than that.

**DECEPTIVE ACCOUNTING HAS BECOME PREVALENT —  
WHICH PUTS THE HONEST AT A DISADVANTAGE.**

We do more good by hating the sin and loving the sinner.

**Shareholder:** You've recently been quoted as saying that some major corporations have used questionable practices to make their operations seem more favorable. Might you be more specific about these practices?

**Buffett:** Not 'til I'm on my deathbed. I've followed a policy of criticizing by practice and praising by name.... Charlie and I both find certain practices very, very deplorable — and they aren't limited to ... a few large corporations. But we would probably be less effective in arguing for change if we went to a few specific examples. [First,] they would not be that much different probably than dozens, if not hundreds, of other companies. And second, those who get critical of the world find the world gets very critical of them — promptly.

I think we do more good, in a sense, by hating the sin and loving the sinner. So we'll continue to point out the sin, but we will not name the sinners. Charlie?

It's become fashionable to play games with the accounting.

**Munger:** Warren, I think she wants you to name the practices...

**Buffett:** Oh, the practices.

**Munger:** ...Not the miscreants.

**Buffett:** Oh! The practices are some of the things we've said — like accounting charges designed to throw into a given period a lot of things that should have been

*(continued on next page)*

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

covered in subsequent periods in the earnings account or to smooth out or inflate future earnings. There's a lot of that being done — and a lot of it that's been done.

The SEC under Arthur Levitt, whom I admire enormously for his efforts on this, is making a concerted attempt to get corporate America to clean up its act on that. But it'll only be because somebody hits 'em over the head. It has become totally fashionable to play games with the timing of expenses and revenues. And, frankly, until the SEC got tougher, in my view, the auditors were not doing enough about it....

Until accounting gets cleaned up, the honest are punished.

**Buffett:** In terms of hiding compensation expense and not recording it in the case of options and all of that, companies now have the *option* of recording option costs in the income account. But you have not seen any great flood of people *doing* it. Actually, the way they show it in the footnotes is quite deceptive in my view because they try to make assumptions that minimize the income account impact. But the cost to the shareholder is what counts. That is the compensation cost as far as we're concerned. And that's been minimized.

The whole effort to engage in pooling rather than purchase accounting — there's been a lot of deceptive accounting in that respect. There's been deceptive accounting in purchase accounting adjustments. So those are the kinds of things we're talking about. Charlie?

**Munger:** Yeah, one abuse is "big-bath" accounting and the subsequent release back into earnings of taking an overly large bath....

**Buffett:** We could name names. We won't. But we have seen firsthand managements who ... say they are doing what everybody else does. The truth is they are now doing it because everybody else is doing it.

It's going to take an outside force — probably in this case the SEC, [although] it should've been the auditors — to clean it up. That's because once it becomes prevalent, the fellow who does it fair and square finds himself at a disadvantage. He gets penalized in the capital markets. So he says, "Why should I penalize my shareholders by doing something when legally I can get away with doing something else?"

**WE MAY DISAPPOINT YOU WITH OUR RESULTS,  
BUT WE SHOULDN'T WITH OUR ACCOUNTING.**

First, the brown nosing, then the zinger....

**Shareholder:** I read many annual reports for a living. And I [typically] spend 20-30 hours looking at five years of 10-Ks and annuals and probably some 10-Qs and going through a lot of numbers to have any kind of idea how the company really is working. Berkshire, by comparison, basically has crystal clear clarity. And it's quite refreshing to read honesty and to see accounting actually presented in a clear fashion that isn't trying to hide the facts.

So as a shareholder and an investor, I'm very grateful for the effort and the high quality of your annual report....

And now that I've brown-nosed a little bit...

**Buffett:** Here comes the zinger, huh?

You can get in trouble while accounting sails merrily along.

**Shareholder:** Yeah. The derivative operations of General Re make me nervous. The balance sheet figure right now says there's a \$400 million net asset position, but there are also some really hairy derivatives — swaps, floors and caps. Knowing you haven't used those types of derivatives in the past, is that now going to change?

**Buffett:** That's a good question — because it involves big balance sheet numbers and off-balance sheet numbers that are large in relation to the amount of money made, particularly in relation to the amount of money made on capital employed. And the credit guarantees, with their long-term nature — all of that — makes that something that we do always want to look at very hard. It's a business that people can get in trouble in. And they can get in trouble while the accounting sails along merrily.

When we were at Salomon, we found — actually Charlie and I didn't find it, other people did finally — mismarked derivative positions that were very substantial. Those positions had been mismarked for a long time. And that was with them paying a lot of money to auditors to look at 'em. Am I right about that Charlie?

**Munger:** Yes.

**Buffett:** Charlie was on the audit committee.

**Munger:** The worst glitches were that their books got so out of control — not in the derivative department — that there were multi-million dollar errors.

**Buffett:** We found mismarks, as I remember, in the \$20-odd million area on [derivative] positions.

**Munger:** Yes.

Elements of derivative accounting a formula for disaster....

**Buffett:** In some cases, the contracts got so complicated that the people who were *valuing* 'em didn't understand 'em — at least partially didn't understand 'em. There's a lot of potential for mischief when people can write down a few numbers on a piece of paper, nothing changes hands for a long time and their compensation next month and this year depends on what numbers are attached to a bunch of things that don't come to fruition for a long time — particularly when you're not a guaranteed creditor or anything of the sort.

So you're very correct in observing that when the numbers are big in relation to the amount of profit, you want to look very carefully because if anything goes wrong, it could go wrong on a fairly big scale. And you're not getting paid a lot for running that type of risk.

Results we can't control; accounting and candor we can.

**Buffett:** I very much appreciate what you said about our annual report. We may disappoint you in how the business performs over time. That is not totally within our control. We'll try hard, but we can make no promises.

But we shouldn't ever disappoint you in our accounting methods or in the candor of the reporting. That is in our control. And we may not like what we have to tell you, but there can be no reason for failure in those areas. If we fail there, it's because we set out to fail. We can fail in terms of

*(continued on next page)*

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

operating performance for a lot of reasons — some within our control and some not in our control. That can happen. And if so, we'll tell you about it.

But we're going to try very hard to make sure that *you* see the business in a form exactly like *we* use in seeing the business. We don't sugarcoat things and we don't put spin on things. And we'll judge ourselves to a significant degree by how well we handle that particular part of the problem. Of course, we'll also try to do a good job in operations....

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LTCM COLLAPSE IS A FASCINATING CASE STUDY,  
BUT IT WON'T BE THE LAST CONVULSION....

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I didn't want to bother Charlie with a \$100 billion deal.

**Shareholder:** I'd like to get your thoughts about the near collapse of hedge fund Long-Term Capital, how these partnerships operate, the Long-Term Capital deal and the Fed's intervention to save it.

**Buffett:** In that movie [preceding the annual meeting] — when Old Faithful was performing in the background and Bill Gates was trying to get me to watch that while I was on the phone — I spent a lot of that trip talking to New York about making a bid for LTCM (which is what we'll call Long-Term Capital Management). The caption on that photo, incidentally, is "The geezer and the geyser".

We started in Alaska. We were going down these canyons in a boat. The captain was saying, "Let's go over there and look at the sea lions". And I'd say, "Let's stay right where we are where we've got a satellite channel" — because I was trying to talk on the phone all the time. Charlie was in Hawaii — and we never *did* get a chance to talk during that whole period. (I didn't want to bother him with a little thing like a bid for \$100 billion+ of securities.) [Actually,] I couldn't find him. So we were ... in an awkward place to pursue that.

A firm bid for \$1+ trillion of derivatives in an hour or less.

**Buffett:** It's possible that if I'd been in New York — or if Charlie had been in New York — during that period that our bid might have been accepted. There was a report just published within the last three or four days by a special committee representing the SEC, the Fed, the Treasury and the CFTC (I think I'm right on those four) [that] describes just a tiny bit of the events leading to the bid.... On page 14 of that report, I remember that it talked about our transaction unraveling.

It didn't unravel from our side. We made a firm bid for \$100+ billion of balance sheet assets and many hundreds of billions — in fact, over a *trillion* dollars' worth — of derivative contracts. This was in a market where prices were moving around very dramatically. And with that bulk of assets, we thought we made a fairly good bid for a 45-minute or an hour period. I don't think anybody else would have made the bid.

But in any event, the people at LTCM took the position that they could not accept that bid. Therefore, the New York

Fed arranged a bid from a group consisting largely of investment banks.... Faced with the prospect that LTCM could not or would not accept our bid, they arranged another takeover ... where additional money was put in.

News flash: The 1920s preceded 1949.

**Buffett:** It's interesting. If you read that report, which was put together by these four very eminent bodies, I think it says on the first page that the first so-called "hedge fund" (which is the term generally applied to entities like LTCM) was set up in 1949. I probably read that or heard that 50 times — particularly in the last year. And, of course, that's not true at all.

As I've pointed out once or twice before, Ben Graham and Jerry Newman had a classic hedge fund in the '20s. And I worked for a company called Graham-Newman Corp., which was a regulated investment company, and Newman & Graham — which was an investment partnership with a 20% participation in profits and *exactly* the sort of entity that today is called a hedge fund. So if you read anywhere that the hedge fund concept originated in 1949 ... with A.W. Jones, it's not an accurate history....

You can be sure that hedge funds won't wither away.

**Buffett:** I ran something that would generally be called a hedge fund. I didn't *think* of it that way. I called it an investment partnership, but it would have been termed a hedge fund. Charlie ran one from 1963 to the mid-'70s or thereabouts. And they have proliferated in a big way.... [Audience reacts to a facial expression from Munger.] Buffett responds:] Did he *blink*? There are now *hundreds* of them.

Of course, it's very enticing to any money manager to run [a hedge fund], because if you do well — or even if you *don't* do so well, but the *market* does well — you can make a lot of money.... And this report that just came out has nothing particularly harsh to say about the operation. So I think you will see hundreds and hundreds and hundreds of hedge funds....

There's a lot of money in those funds. And there's a huge incentive to form them. There's a huge incentive to go out and attract more money if you run one. And when that condition exists in Wall Street, you can be sure that they won't wither away. Charlie?

[Editor's note: Van Hedge Fund Advisors Int'l's George P. Van estimates that over 300 new hedge funds were formed last year — bringing the total worldwide up to nearly 6,000 funds.]

Brains + Experience + Serious incentives = Going bust?!

**Munger:** What was interesting about LTCM was how talented the people were — and yet they got in so much trouble. I think it also demonstrates that the general system of finance in America involving derivatives is irresponsible. There's *way* too much risk in all these trillions of notational value sloshing around the world. There's no clearing system as there is in a commodities market.

So I don't think it's the last convulsion we're going to see in the derivatives game.

**Buffett:** It's fascinating. In effect, here were 16 extremely bright — and I do mean *extremely* bright — people at the top of LTCM. The average IQ among their top 16 people would probably be as high or higher than at any

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

other organization you could find. And individually, they had decades of experience — collectively, *centuries* of experience — in the sort of securities in which LTCM was invested.

Moreover, they had a *huge* amount of their own money up — and probably a very high percentage of their net worth in almost every case. So here were super-bright, extremely experienced people, operating with their own money. And yet, in effect, on that day in September, they were broke. To me, that's absolutely fascinating.

Don't risk what's important to you for something that's not.

**Buffett:** In fact, there's a book with a great title — *You Only Have to Get Rich Once*. It's a great title, but not a very good book. (Walter Guttman wrote it many years ago.) But the title is right: You only have to get rich *once*.

Why do very bright people risk losing something that's very important to them to gain something that's totally unimportant? The added money has no utility whatsoever — and the money that was lost had enormous utility. And on top of that, their reputation gets tarnished and all of that sort of thing. So the gain/loss ratio in any real sense is just *incredible*. It's like playing Russian Roulette. If you were to hand me a revolver with six chambers and one bullet and you say, "Pull it once for \$1 million," and I say, "No," and then you say, "What is your price?" — the answer is there *is* no price. And there shouldn't be any price on taking the risk — when you're already rich particularly — of failure and embarrassment and all of that sort of thing. But people repeatedly do it....

It's almost impossible to go broke without borrowed money.

**Buffett:** Whenever a really bright person who has a lot of money goes broke, it's because of leverage.... It's *almost* impossible to go broke without borrowed money being in the equation. And as you know at Berkshire, we've never used any real amount of borrowed money. Now if we'd used somewhat more, we'd be *really* rich. But if we'd used a *whole* lot more, we might have gotten in trouble sometimes. There's just no upside to it. What's two percentage points more in a given year [when you] run the risk of real failure?

But very bright people do it and they do it consistently — and they'll continue to do it. And as long as explosive-type instruments are out there, they will gravitate toward them. And, particularly, people will gravitate toward them who have very little to lose, but who are operating with other people's money with large profit-sharing incentives.

If OPM leads to trouble, derivatives could lead to disaster.

**Buffett:** One of the things in the LTCM case — and Charlie mentioned it in terms of derivatives — [was that,] in effect, there were ways (that were legal obviously) to get around the margin requirements. Risk-arbitrage is a business that Charlie and I have been in for 40 years in one form or another. And normally that means putting up the money to buy the stock on the long side and then shorting something against it where you expect a merger or something to happen.

But via derivatives, people have found out how to do it

essentially putting up *no* money — just by writing a derivative contract on both sides. Margin requirements that the Fed promulgates, I believe, still call for 50% equity on stock purchases. But those requirements don't apply if you arrange the transaction in derivative form. Therefore, these billions of dollars of positions in equities essentially were being financed 100% by the people who wrote the derivative contracts. Well, that leads to trouble.

And 99% of the time it works. But 83-1/3% of the time it works to play Russian Roulette with one bullet and six chambers. In our view, neither 83-1/3% nor 99% is good enough when there is no gain to offset the risk of loss. Charlie?

Irresponsible accounting leads to very interesting results.

**Munger:** I would argue that there's a *second* factor that makes the situation dangerous — and that is that the accounting for entities that are actively engaged in derivatives (interest-rate swaps, etc.) is very weak. I think the Morgan Bank was the last holdout. They finally flipped to a lenient standard of accounting favored by people who are sharing in the profits from trading derivatives. And naturally, they like weak, optimistic accounting.

So you've got an irresponsible clearing system and irresponsible accounting. This is not a good combination.

**Buffett:** J.P. Morgan shifted its accounting — I'm not sure exactly when — I think around 1990. Charlie and I probably became more familiar with that when we were at Salomon. It's absolutely standard ... GAAP accounting, but it "front ends" profits in a very unconservative way. And if you "front end" profits and you pay people a percentage of the profits, you're going to get some very bad results sometimes.

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GEICO AND AVIATION — TWO BUSINESSES IN FLIGHT  
WITH THE PROSPECT OF MUCH MORE TO COME.

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Where did we gain value last year? Aviation and GEICO....

**Shareholder:** What produced the substantial gain in intrinsic value mentioned in your report? Per share gains in your investment portfolio and operating profits were modest and you said that there was no immediate gain from issuing shares for acquisitions.

**Buffett:** Well, we did increase the float per share very significantly last year — the invested assets per share. Second, GEICO was our largest subsidiary at the start of the year. Also, its business was worth far more at the end of the year than at the start of the year. And if anything, its competitive position continues to improve.

Executive Jet is a natural fit into Berkshire. We paid a significant sum for it, but it'll be a very, very big company 10-15 years from now. I'm almost sure it'll get there sooner as part of Berkshire than it would have otherwise. And its dominance may be even greater over the years as part of the Berkshire family than it would have been independently, although it would have done very well. It had a terrific management, it started early, and it was the most service-oriented company you could imagine. So it would have done fine without us. But I think it will do considerably better and get there faster with us.

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

So in aviation and primary insurance certainly, we had large gains in intrinsic value. And we have a significantly greater amount of invested assets per share to work with. So I feel good about what happened with intrinsic value last year. The problem is doing it year after year after year. Charlie?

**Munger:** Basically, we have a wonderful bunch of businesses. We have float that keeps increasing and a pretty good record of doing well in marketable securities. None of that has gone away.

With FlightSafety's ROE, what you see is what you get.

**Shareholder:** What sort of return on equity do you expect for each of your flight divisions?

**Buffett:** Yeah, the more capital intensive is the FlightSafety operation — because every simulator costs real money and we'll add a number of simulators each year. For FlightSafety, you can look at their figures before we acquired them — and it's reasonable to extrapolate those numbers out on a larger base as we go along. But FlightSafety's return on equity is not going to move up or down by a dramatic amount. Our simulator training prices are related to the costs of the simulator. So there's not going to be way higher returns on equity, nor should there be way lower returns on equity.

There's growth in the equity employed in the business because it's a growing business and we train more and more pilots every year. But that'll be a fairly steady thing.

Down the road, Executive Jet could have a very good ROE.

**Buffett:** The Executive Jet business is in an earlier part of its development, although it's the leader in its field by far. But we're doing substantial investment spending in a place like Europe. And we'll be doing that on an accelerated pace, if anything.

In the end though, our customers end up owning the planes. So we have an investment in a core fleet of planes which supplements the customers' planes. By its nature, however, it's not a capital intensive business. We move around a lot of capital every day. We have 140 or so customer planes now. In aggregate — just to pick a figure — those planes are certainly worth \$1-1/2 billion or more. And we've got \$7 billion of planes on order or some number

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for the serious investor."™

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like that. But we'll sell those planes to our customers.

So down the line, it could be a business with a very good return on capital. We'll still have an investment in the core fleet, some hangar facilities and that sort of thing. But our customers will have the big capital investment. I should point out that they'll have a whole lot less capital investment than they'd have if they owned the entire plane themselves. So they'll be getting a bargain, too.

**IN THE HEALTHCARE INDUSTRY,  
WE DON'T KNOW WHERE TO START.**

We look at everything in turmoil that's important....

**Shareholder:** Given Berkshire's competencies in the insurance industry and with the health care services area being relatively depressed, ... have you looked at taking a position in or buying a health insurance business?

**Buffett:** Charlie runs a hospital. So I'm going to let him talk about this.

**Munger:** We've looked a little. We look at everything in turmoil that's important in the world. But so far, it hasn't seemed to yield to our particular mental approach.

We don't know who we'd want to partner with in that area.

**Buffett:** I don't know who I'd want to get in with in that business at the moment. I'm not condemning people in the business. It just means I don't know. I haven't been able to evaluate that. And I think it would make an enormous difference in terms of wanting to get in with a quality operation, quality people and at a sensible price. We haven't seen that. However, that doesn't mean that we've canvassed the whole field either.

**Munger:** There is a significant percentage of schlock operators in the field who are painting the reality different than it is. That makes it harder.

**RECENT NEGATIVES AT COKE ARE JUST "NOISE".  
TUNE IT OUT AND LOOK OUT 10-15 YEARS OR MORE.**

Currency moves matter. But to us, they're unknowable.

**Shareholder:** Are you worried that Coca-Cola's earnings ... might continue to be affected by the weakness in the emerging markets and the strength of the dollar over the next few years? ... And at 35 times earnings, are you worried about a potential rise in interest rates?...

**Buffett:** Well, in relation to the strength of the dollar, which means that profits in foreign currencies don't translate into as many dollars, we don't have any big feeling on that. If we had strong feelings about the behavior of the dollar vis-a-vis the yen, the euro, the British pound or whatever it might be, we could give vent to those views by buying or selling large amounts of foreign exchange. But we don't. We don't know which way the dollar's headed. So I have nothing in my mind with regard to any decision on buying or selling Coke that would relate to any prediction about the course of the dollar.

Coke's earnings have been affected by the strength of the dollar in the last few years — particularly the strength against the yen when it went from 80-odd to 140-odd. That was a huge hit in terms of the yen's translation into

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

dollars from those profits. And the strength of the dollar generally would hurt. But again, looking forward, I don't have any prediction on that.

What matters long term, and is knowable, is Coke's share.

**Buffett:** It's in Coke's interest to have countries around the world prosperous. They will benefit from increased prosperity and increased standards of living throughout the world. And I think we'll see that over any 10 or 20-year period, people's preference for Coca-Cola products will do nothing but grow.

So I'm concerned about share of market and then what I call "share of mind": What do people think about Coca-Cola now compared to 10 years ago or 20 years ago? And what will they think about it 10 years from now?

Well, Coca-Cola has a *marvelous* share of mind around the world. Almost everybody in the world has something in their mind about Coca-Cola products — and overwhelmingly, it's *favorable*. Try to think of three other companies like it. I can't do it in terms of that ubiquity of good feeling, essentially, about the product.

We don't care about slower recent sales growth.

**Buffett:** We measure it by unit cases sold and by shares outstanding. We want a lot more unit cases sold. And we like the idea of fewer shares outstanding over time. I'll be giving you that same answer 10, 15 or 20 years from now and I think there'll be a lot more unit cases sold then.

It's true that case growth slowed starting in the second half of last year and continued in the first quarter of this year. But that's happened from time to time. In my view, that's not an important item. It may be important in terms of what the stock does over six months or one-year. But we'll be around 10 years from now. So will Coca-Cola. And right now, we own 8.1% or 8.2% of Coca-Cola — and we'll probably own a *larger* percentage 10 years from now because they'll probably repurchase some stock.

Coke's price today seems very full. But we're spoiled.

**Buffett:** The P/E ratio of Coke, like that of virtually every other leading company in the world, strikes us ... — they *all* strike us — as being quite full. That doesn't mean they're going to go down. But it does mean our enthusiasm for buying *more* of these wonderful companies is less than it was when P/E ratios were substantially less.

Ideally, those are the kind of companies we want to buy more of over time. We understand their businesses. And my guess is that there's a *reasonable* chance, at least, that some time in the next 10 years, we'll buy more shares of either Coke, Gillette, American Express or some of those other wonderful companies we own.

We do not like the P/E ratios generally. But, again, I want to stress that doesn't mean they're going down. It just means that we got spoiled in terms of how much we got for our money in the past — and we hope that we'll get spoiled again. Charlie?

Tune out noise. If you look at the big picture, Coke's fine.

**Munger:** If what matters to you is what you think

Coke is going to look like 10 years or even further out, you don't really pay much attention to short-term economic developments in this country or that or to currency rates or to any other such thing. They don't really help you in making the 10 or 15-year projection. And that's the one we're making.

So we have tuned out all this "noise" as it's called in communications networks. Tune out the noise. And if you look at the big picture, we think Coke is fine.

**Buffett:** It's hard to think of a better business in the world among big businesses. Obviously, some companies starting from much smaller bases could grow faster. But it's hard to think of a much more solid business.

**THINGS DON'T PROGRESS IN A NICE, STRAIGHT LINE.  
BUT OUR VIEW ON COKE & GILLETTE IS UNCHANGED.**

Our inaction should tell you something about prices....

**Shareholder:** You've hinted about Coke and Gillette's current valuations and their great prospects for the future. But in the past year, both stocks have been down 30-50% from their highs. How much farther would they have had to fall before your criteria of margin of safety would have been satisfied and allowed you to buy more shares?

Second, has the Disney/Cap Cities merger gone as well as you hoped? And do you believe Disney's future prospects have changed?

**Buffett:** That's a good question on Coke and Gillette — because, obviously, we think about the businesses that we're the most familiar with and where we're committed. Neither one of those businesses got to the price that left us happy putting new money in. But we are quite happy ... — *very* happy — owning those businesses and *will* be happy owning them for a very long time to come.

It's evidence of how high the market has been that even when these great companies ran into tougher business conditions than they anticipated, their stocks did not get down to prices that caused us to get excited about them.

If you own a great business, it's best to sit on your assets.

**Buffett:** Charlie, do you want to comment on that — or on the second part?

**Munger:** No, but I do want to remind people that the Dilly Bar's a Dairy Queen product and they should eat 'em.

**Buffett:** And they are good. I can tell you that much.

**Munger:** I wouldn't want shareholders to believe that the commercial standards of this operation are faltering....

[After a long pause.] Generally speaking, trying to dance in and out of the companies you really love on a long-term basis hasn't been a good idea for most investors. We're quite content to sit with our best holdings.

**Buffett:** People have tried to do that with Berkshire over the years. I've had some friends that thought it was getting a little ahead of itself from time to time — and they thought they'd sell and buy it back cheaper.... But that's pretty tough to do. You have to make *two* decisions right. You have to sell it right first, and then you have to buy it right later on — and usually you have to pay some tax in-between. Usually, if you get into a wonderful business, the best thing to do is to stick with it.

*(continued on next page)*

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

Nothing's changed my long-term view on Coke or Gillette.

**Buffett:** Both Coke and Gillette experienced disappointments in their results so that they were below what they anticipated a year or two ago or whenever it was — and below what we anticipated. That will happen over time. It happens with some of our wholly-owned businesses. And sometimes they do *better* than we anticipate, as well. It's simply not in the nature of things for everything to progress in a nice, straight smooth line upward.

For example, you mentioned Cap Cities. Well, parts of Cap Cities have done *extraordinarily* well. But in the network business, if you go back 30 years and look at what network has been on top, you'll find that no one stays on top — or on the bottom — indefinitely. As I mentioned earlier, it's a competitive world. And sometimes your competitor's correct moves, your own incorrect move, the world environment or all of those things can interrupt trend lines.

I see nothing that's happened in the last year in terms of the long-term trend line of the blade and razor business — which is the one I've referred to as "inevitable" at Gillette. They're in other businesses that are not in the same category as the blade and razor business.

Coke, fortunately, has virtually its entire business in soft drinks. It comprises almost 100% of the whole there. But I see nothing that would change my thinking about the long-term future of either the blade and razor business or Coke's position in the soft drink business.

**OUR JOB IS TO FIND A FEW INTELLIGENT THINGS,  
NOT STAY UP ON EVERY DAMN THING IN THE WORLD.**

Where will growth be greatest? That's easy.

**Shareholder:** For the consumer franchise companies that Berkshire owns — Coca-Cola and Gillette in particular — in which emerging markets do you anticipate the greatest 10-year potential for unit sales growth? And what economic, political and/or social changes are precipitating that growth?

Second, do you believe that the U.S. market cap as a percent of the world's at its current 53% is near its zenith? And which countries do you believe will likely show the greatest percent growth in total market cap?

**Buffett:** Well, I wish I had the answers. As regards your first question though, in something like Coke, it's just a matter of raw numbers. There's *huge* potential in ... the largest country in the world [by population] — China — where the per capita consumption is very low, but where it's growing very fast. So it's very easy for me to predict, and probably be right (absent some tremendous upheaval or some real surprise) that China will be the fastest growth market among countries of any size in the world for Coke from today's level. But that's based on the fact that it just has a huge number of people who clearly like the product, that it's starting from a very low base and where a lot more bottling infrastructure will be needed — infrastructure which will be supplied — to facilitate that growth.

With Gillette, it's a little different. People are already shaving. So what you do is upgrade the shaving *experience* that they have. So you have great differences in the quality of the blades available throughout the world. (They call them "shaving systems" when you get into the more advanced ones.) And as people's disposable income grows, they trade up to a far more enjoyable shaving experience — to better shaves — than they did when they were forced to rely on the lowest-priced product.

We don't need to do a country-by-country market analysis.

**Buffett:** But both of those companies have tremendous opportunities as prosperity around the world — as the standard of living — grows. And there's no doubt in my mind in the blade and razor business for Gillette (which is only one third of their business) and in the soft drink business for Coke, they're going to share in it.

It'll be uneven in the years that it happens and all of that sort of thing. However, I would almost *guarantee* that 10 or 20 years from now, both of those companies will be doing a *lot* more business in those areas I named than they're doing currently.

We don't fine tune it a lot more than that. I don't sit around and try to work out country by country what's going to happen with a Gillette or Coke. It would be a waste of time. I wouldn't know the answer anyway. But I'm pretty sure of the conclusion that both of them will prosper a great deal. And I'd hate to be competing with either one of them here or anywhere else in the world. They have the winning hand. Charlie?

Our job is not to stay up on every damn thing in the world.

**Munger:** I agree with everything you've said. But I'd like to add that if I knew for sure that the U.S. share of worldwide market capitalization was going to go from 53% down to 40%, I wouldn't know how to make money out of that insight by running around buying foreign securities.

**Buffett:** Yeah, we just don't operate on that basis. A few years ago, emerging markets were all the rage. And every institution in the country was getting promoted by somebody who said, "I'm going to run an emerging markets fund" — and they felt they had to participate in it. And their advisers told 'em they had to participate in it. We regard all of that as nonsense.

In the end, you've just got to think for yourself about what you know and what you don't know and go where that leads you. You don't do it by buying into things with names on 'em or sectors or country funds or any of that stuff. That's merchandise that's designed to sell to people. And it's usually sold to people at the wrong time.

**Munger:** Our game is to find a few intelligent things to do. It's not to stay up on every damn thing that's going on in the whole world.

**YOU'LL BE BETTER AT WHATEVER YOU DO  
IF YOU PERFORM REGULAR POSTMORTEMs.**

Selling McDonald's must have been Charlie's idea.

**Shareholder:** Peter Kenner, from New York City.  
Good afternoon Warren, Charlie.

*(continued on next page)*

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

**Buffett:** Hi, Peter.

**Shareholder:** Good to see you. I'd like to know your thought process when you ... decided to sell McDonald's.

**Buffett:** That must have been Charlie's idea, Peter. Incidentally, Peter's family has essentially invested with us for four generations. They're all terrific people, I might add. His dad, Morton, was a wonderful guy.

[Editor's note: We couldn't agree more.]

**Buffett:** I said it was a mistake to sell it. And it was. I just reported that in the interest of candor. There were some reasons why I thought that it was something that we [should sell]. I didn't think, obviously, it was any great short sale or even a great sale, but I didn't think it belonged on the list of 8 or 10 of the very few businesses we wanted to own in the world. And I would say that that particular decision has cost you, hmm, in the area of \$1 billion plus. Charlie?

You'll be a better investor if you do regular post mortems.

**Munger:** You want me to rub your nose in it? You're doing a pretty good job of that by yourself. By the way, that's a good practice around Berkshire. We do rub our noses in it — even without the help of the Kenners.

**Buffett:** We really do believe in postmortems at Berkshire.... One of the things that I used to do when I ran the partnership was that I contrasted all sale decisions versus all purchase decisions. It wasn't enough that the purchase decisions worked out well. They had to work out better than the sale decisions.

Managers tend to be reluctant to look at the results of the capital projects or the acquisitions that they proposed with great detail only a year or two earlier to a board. And they don't want to actually stick the figures up there as to how the reality worked out relative to the projections. That's human nature.

But I think you're a better doctor if you drop by the pathology department occasionally. And I think you're a better manager or investor if you look at each decision that you've made of importance and see which ones worked out and which ones didn't — and figure your batting average. Then, if your batting average gets too bad, you better hand the decision-making over to someone else....

**WE DID BLOW IT ON THE PHARMACEUTICALS.  
THEY DON'T DESERVE A DISCOUNT P/E MULTIPLE.**

We did blow it in the pharmaceuticals....

**Shareholder:** Last year, somebody asked you about pharmaceutical companies, the aging baby boomers, etc. You said it was difficult to single out individual companies — and Mr. Munger said that you guys blew it on that one.

Does the prospect of regulation and the spectre of what happened in '92-'93 with an unelected politician [which] dampened the whole industry for awhile play a part in your ambivalence about investing in that area? Is that simply an unknowable? Or does that concern you?

I know that you're concerned about the growth of

companies having to spend money in Washington with regulation, etc. So do you have some ambivalence because of future regulation with pharmaceutical companies?

**Buffett:** Well, if we could buy a group of leading pharmaceutical companies at a below-market multiple, I think we'd do it in a second. And we had the opportunity to do that in the 1993 period that you mentioned — and we didn't do it. So we *did* blow it — because clearly, the pharmaceutical industry as a whole has done very well.

Drug stocks don't deserve a discount P/E.

**Buffett:** It has some of the threats you enumerated — regulation, etc. But *every* industry has *some* problems. And the pharmaceutical industry has enough going for it that the threats you name, in my view, should not cause the securities in that area to sell at a depressed multiple — which they did.

That's no longer the circumstance.... And we're not going to buy 'em at today's prices. But at least I think as a *group* that they're good businesses. [On the other hand,] I do think that it's very hard to pick out the winner. So if I were to buy them, I'd buy a group of the leading companies. But I wouldn't be buying 'em at today's prices. Charlie?

The possibility of obscene drug profits benefits the country.

**Munger:** I'd argue that the pharmaceutical industry has done more good for the customers than almost any other industry in America. It's just fabulous what's been invented in my lifetime — starting with all the antibiotics that have prevented so much death and family tragedy. And I think the country's been very wise to have a system where the pharmaceutical companies can make almost obscene amounts of money. I think we've all been well served by the large profits in the pharmaceutical industry.

[Editor's note: The preceding view is not necessarily shared by this station or its affiliates.]

**THE LEGISLATIVE THREAT TO TOBACCO IS SERIOUS,  
BUT I HAVEN'T THE FAINTEST IDEA HOW TO PREDICT IT.**

I think the legislative threat to tobacco is serious.

**Shareholder:** It seems that the threat of government regulation or government appropriation of cash flows led to a reasonable market opportunity [in the] pharmaceutical industry. And the same thing happened with Sallie Mae. Do you feel that that's going on with the tobacco industry now — or is it a larger, permanent threat to that industry?

**Munger:** I don't know about Warren, but I think the legislative threat to tobacco is serious. And I haven't the faintest idea of how to predict it.

**Buffett:** Yeah, I would say that there's *no* comparison between the threat to tobacco currently and the threat to pharmaceuticals in 1993. The problems of the tobacco companies are of a *far* different order than the problems of the pharmaceutical companies.

Nobody was against pharmaceuticals. There were just different ideas about pricing and distribution and all that. However, tobacco's a different story. Tobacco companies — well, you can figure it out for yourself.

*(continued on next page)*

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

**CABLE RETURNS SO FAR HAVEN'T BEEN GREAT,  
BUT VALUATIONS IMPLY HIGHER FUTURE RETURNS.**

Cable prices have been galloping. That's not good news....

**Shareholder:** The company has a large investment in Washington Post Company, which has many cable systems serving non-major metropolitan areas, as well as a recent investment in TCA Cable. Would you comment about the cable TV business generally?

**Buffett:** We own about 17%+ of the Washington Post Company. And I believe that they have 700,000+ homes. As you say, they're largely in smaller areas. It's been a good business. As you know, cable prices (in whole-company transactions) have been galloping here in the last year or thereabouts.

From the Post's standpoint, that's *bad* news because it would have been a net buyer of cable, not a seller. And it's really very much like our attitude towards stocks and stock prices. It is *not* good news for the Post when cable prices go up. It's going to be a generator of funds over time. Therefore, it's going to be investing funds. And if it wants to put more money into cable, it's way better off, long term, if acquisition prices go down rather than up.

Don't believe everything you read....

**Buffett:** Lou Simpson [President and CEO of Capital Operations] runs a separate equity portfolio at GEICO. If he still has TCA Cable, that's Lou's investment — at GEICO for GEICO. I've never read their annual report. I know nothing about it. It's not anything that falls under my management at all.

That's a point I should elaborate on briefly because periodically the press picks up some item that says Berkshire's buying — or sometimes it says that *I'm* buying — X, Y or Z. And sometimes it's true. However, sometimes it isn't true — because filings are made on behalf of various other entities that are associated with us and I don't know anything about 'em. I saw one here a couple of weeks ago reporting that I was — I don't remember if it said me or Berkshire, but I think it was me personally — buying some real estate investment trust.... Well, I've never *heard* of it. But that story appeared in various places.

And I can assure you that I filed no form with the federal government that said that I was buying that stock, although you would have deduced that from certain press accounts....

But there are various other entities.... For example, a subsidiary of General Re, New England Asset Management, may have to report periodically on what it does. And, therefore, since General Re is owned by Berkshire and New England Asset Management is a part of General Re, who *knows* what they pick up on that.

So I do caution you generally to be a little careful about reports as to what is being bought or sold by me or by Berkshire Hathaway.

We blew it on cable. And in hindsight, it was obvious.

**Buffett:** Now as I recall, there was a second question that I didn't like the idea of answering quite as well.

Charlie, do you want to tackle that one?

**Munger:** I think there was more interest in the future of cable. We've demonstrated a remarkable lack of aptitude in correctly diagnosing the future of cable in a way that made us a lot of money. And we've done that in spite of the fact that, in retrospect, it seems like a lot of perfectly obvious opportunities were lying around.

Cable pricing suggests that people expect returns to go up.

**Buffett:** Cable's been here for what — 30 years or so? And to date, cable has not made extraordinary gains on invested capital at all. However, it's always had the promise of greater returns — and the promise that you wouldn't have to keep investing money in it the way that you have had to invest to date.

But, currently, people think that future unusual returns *will* be made in cable — not relative to purchase price, but relative to the capital invested in the property itself. And like I say, that has not really been the case thus far.

Returns have been better in cable *programming*. In cable programming, there's been a *lot* of money made in relation to invested capital. But in terms of the actual investment in cable facilities, the capital investment has been so high — the expenditures in developing systems — that the returns so far have not been great.

However, the prices being paid for cable systems now would indicate that people think that those returns are finally going to start going up — and in a big way.

**THE LATEST INSTALLMENT (FIVE NEW ENTRIES)  
IN THE MUNGER (AND BUFFETT) BOOK CLUB....**

I recommend that all of you buy Hagstrom's second book.

**Shareholder:** In our never-ending effort to have the Munger Book Club surpass the Oprah Book Club, I wonder if you could make some book recommendations?

**Munger:** Yeah. Hagstrom sent me chapters of his latest book on Warren Buffett, The Warren Buffett Portfolio — and I didn't read them because I thought his first book was a respectable book, but that it didn't contribute too much to human knowledge. At any rate, he sent me the second book — a full version — and I read it. Well, I was flabbergasted to find it was not only very well written, but that it was a considerable contribution to the synthesis of human thought on the investment process. And I would recommend that all of you buy a copy of Hagstrom's second Buffett book.... It doesn't pick any stocks for you, but it does illuminate how the investment process really works if you think about it rationally.

[Editor's note: We agree. For your convenience, here's the full title: *The Warren Buffett Portfolio: Mastering the Power of the Focus Investment Strategy* (published by John Wiley & Sons, New York, NY 1999).]

I'd also recommend one biography and one treatise....

**Munger:** Another book I liked very much this year, *Titan*, is the biography of the original John D. Rockefeller. It's one of the best business biographies I've ever read. And it's a very interesting family story, too. That is just a wonderful, wonderful book. And I don't know anybody who's read it who hasn't enjoyed it. So I would certainly

*(continued on next page)*

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

recommend the latest biography of John D. Rockefeller.

The third book is a revisit of the subject matter of a book that I recommended a year or two ago called *Guns, Germs and Steel*, which was a physiologist's view of the economic history of man. And it was a wonderful book. Much of that same territory has now been covered by an emeritus history professor from Harvard who knows way more economics and science than is common for a history professor. And that gives him better insight. His book is a takeoff in title on Adam Smith. And the title of that book is *The Wealth & Poverty of Nations*. The author's name is Landis. So I would heartily recommend those three books.

Buffett's recommendations: Kay Graham and Jack Bogle.

**Buffett:** In terms of books — and many of you may have read it [because] this goes back more than a year — but if you haven't read Katherine Graham's autobiography, it is one terrific book. It's an incredibly honest book — and a fascinating story. It's a life that's seen all kinds of things in politics, business and government. And it's a great read.

A book that came out just in the last few months in the investment world I'd certainly recommend to everybody is entitled *Common Sense on Mutual Funds* by Jack Bogle. Jack is an honest guy. He knows the business. And if mutual fund investors listened to him, they'd save billions and billions of dollars a year. He tells it exactly like it is. He asked me for a blurb on the book — and I was delighted to provide it.

WE VALUE LOTS OF THINGS ABOVE MONEY.  
THANKFULLY, WE MOSTLY HAVE THOSE, TOO.

I like being Warren Buffett just fine....

**Shareholder:** Whenever you walk down the street, heads turn to watch you. Do you ever get tired of being Warren Buffett? If you could come back again, would you want to be Warren Buffett?

**Buffett:** I think I'd probably want to be Mrs. B. She made it to 104. And, incidentally, I think there were three siblings at her funeral. That's some set of genes. You don't have to worry about the Furniture Mart.

You see a lot of the publicity bit here for a couple of days around the time of the annual meeting, but most of the time life goes on in a very normal way. And I have a lot of fun. I have fun every day of my life. I had a lot of fun when I was 25, but I have just as much fun now. And I think if my health stays good, it'll keep being the same way — because I get to do what I *want* to do and I get to do it with people I like and admire and trust. It doesn't get any better than that.

Charlie? [After a pause:] Do you want to come back as Lieutenant Jones?

**Munger:** I think there are very few people who would change their skin for somebody else's. I think we all want to play our own games.

After a moderate level, money makes very little difference.

**Shareholder:** In response to an earlier question, you

spoke of people being rich and very, very rich. It seems to me that that there's a difference between being rich and being wealthy — which doesn't necessarily equate to having a lot of money....

**Buffett:** I agree with you that certainly there's nothing you'd value more than good health for yourself and your family. There's no question about it. Money makes very little difference after a moderate level.

I don't live that different than the average college student.

**Buffett:** I tell this to college students that I talk to. I tell them they're living about the same life I'm living. We eat the same foods — that I can guarantee. And there's no important difference in our dress. There's no important difference at *all* in the car we drive. There's no difference in the television set that we watch the Super Bowl on.... They have air-conditioning in summer and I've got air-conditioning. And they've got heat in the winter. Almost everything that's of any importance in daily life, we equate on.

The one thing I do is I travel a lot better than they do — NetJets. Travel I do a lot easier than they do. Everything else in their lives, I'll switch places anytime. It doesn't make any difference.

Lots of things in life are way more important than money.

**Buffett:** Then you get down to ... health and who loves you.... You want to have enough so that you eat three times a day and that you sleep in reasonably comfortable surroundings and so on. But everybody in this room has that.

Yet, some of the people by the definition you've given are obviously much more wealthy than others — and it's not measured by their net worth if you define it that way. And I don't disagree with that definition. I might not use the term "wealth" in describing it, but I'd certainly maybe call it "well-being" or something of the sort.

Charlie? [Pause]. He's thinking.

**Munger:** Sure. There are a *lot* of things in life *way* more important than money. All that said, some people do get confused. I play golf with a man who says, "What good is health? You can't buy money with it."

**Buffett:** Did I ever tell you about Charlie's twin brother that he golfs a lot with?...

I'll take health *any* time, incidentally.

**Munger:** So will I.

More important — enjoying your work & who you work with.

**Buffett:** The important thing even in your work — to an extreme extent, it seems to me — is *who* you do it with. If you're going to spend eight hours a day working, the most important thing isn't how much money you make. It's how you feel during those eight hours in terms of the people that you're interacting with, how interesting what you're doing is and all of that. Well, I consider myself *incredibly* lucky in that respect. I can't think of anything I'd rather do. And I can't think of any group of people that I'd rather do it with.

And if I were able to trade away a very significant percentage of my net worth either for some extra years on my life or to be able to do during those years what I want to do, I'd do it in a second.

—OID

**ENTERPRISE FUNDS'**  
**MARIO GABELLI & BILL WITTER**  
 (cont'd from page 1)

(All performance figures provided by William D. Witter, Inc. and GAMCO Investors.)

With small cap stocks having experienced a prolonged period of underperformance (in part because their earnings have done the same), we found their comments regarding an impending turnaround in 2000 especially interesting.

The following excerpts were selected from comments by Witter and Gabelli at the first annual Enterprise Funds Economic and Investment Outlook Press Briefing which took place on November 9th, 1999. We hope you find them as interesting as we do.

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IT'S A GOOD BACKDROP TODAY GENERALLY,  
 BUT A GREAT ONE FOR THE RUSSELL 2000.

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We're going to talk about our favorite subject.

**Mario Gabelli:** It's always a privilege to talk about my favorite subject — namely, how to earn a return in the public markets.... On the panel with me is Bill Witter [who] was my first boss about 20 years ago.... I grew up in the Bronx. And on my first day out after I finished school, I went to work for Loeb Rhoades. Mike Steinhardt quit and went on to start Steinhardt, Fine and Berkowitz — one of the great hedge funds of the last 30 years. So I became the auto analyst....

I went from there to William D. Witter.... And Bill — who's one of the great visionaries on Wall Street — kept me enticed.... I actually started an emerging growth product for you, Bill. So I'm absolutely ecstatic — not only to be here, but also to share this podium with Bill and talk about his favorite subject and mine — namely, small caps....

A good backdrop generally, a great one for the Russell....

**Gabelli:** First, a quick overview on the market.... The economy looks *terrific*. The world is reflating. Japan is going to do quite well. Euroland, which is the name that we use for mainland Europe, is terrific. We think earnings for the S&P this year and next will be up by double digits — particularly as non-U.S. earnings are translated into U.S. dollars with the benefit of that stronger economy.

The Russell 2000, however, will be up *substantially* more than that. We don't put our [own] numbers together, but we use a Merrill Lynch-type number — and we're looking at 20% [per year] for both years. So we think that's a good economic backdrop....

We think there's a great opportunity in the broadcasters.

**Gabelli:** But we're really bottoms-up, stock pickers. We have a strong focus and intensity in research. We read 10-Qs, 10-Ks and visit companies....

The investment process that we follow is fairly simple. Analysts are assigned to follow industries on a company basis. For example, if you want to know about broadcasting, we know it. We think short term, there's a *great* opportunity in the broadcasters. Bill Kennard at the Federal

Communications Commission sounded a gong in August when he said every TV station operator in the country can now own two TV stations. So the Granites that we're buying in the portfolio, the Chris Crafts that we own in the portfolio, will announce ... who they're going to partner with....

A GREAT TIME TO THINK SMALL AND MAKE BILLIONS.  
 THERE ARE HUNDREDS OF LITTLE NUGGETS....

We like little companies that can leverage globally.

**Gabelli:** Ideally, we like domestic, cash-generating companies. But with the Berlin Wall having gone down almost 10 years ago, we have a *great* opportunity globally to earn a return wherever a company exists.

For example, a tiny, little company — MTV — when it first went public had less than 20 million viewers. Today, there's close to 400 million people who can watch MTV at any point in time. And we *like* that. We like to find growing companies that can leverage their business on a global basis.

Take a simple thing like tea: Celestial Tea is an important part of our portfolio. It dominates the market for green tea. Tea is good for you....

The internet's a great blessing — like monks losing work....

**Gabelli:** We look for stocks that [can appreciate] 50% in two years. And we look for a catalyst — something that's changing — [that will unlock the value].... [We have] the ... ability to shift things around — [between] value/growth, long/short, internet/steel, etc. So how and where does a Graham & Dodd investor in an internet world find net-nets? How do you make money by finding companies that are clearly going to drive the world?

All of us — every single one of us — are *extraordinarily* blessed to be here in this internet world. If I'd been here in 1454, I bet I'd have said the same thing about Gutenberg: "You mean to tell me we can put the monks out of work and have books for all of us to read?! That's *fabulous*!" Well, the internet's doing all of that.

The analysts in our firm are told: "Gather the data, array the data, project the data and come up with economic conclusions." Well, the internet allows you to gather the data more efficiently. It's a wonderful tool. But for all of us, it's changing [very rapidly]. And how do we generate [a return]?

There's a simple reason why value has underperformed....

**Gabelli:** You've all asked that question of growth versus value. And we have a chart that shows how [value has performed relative to] the benchmark over the last 21 years since we founded the firm. In 1976, why did value do so well? It wasn't complicated. When you have no conviction that you can project the future, what's in hand is worth a lot more. You have various cycles in which value functions. Today, we're down at the bottom of the chart. Why? Because we believe we can project far into the future. So it's not a complicated world we live in. And that makes growth even more attractive — the more confidence and conviction you have that things maintain themselves...

Watts is terrific. We're in there every day buying it.

**Gabelli:** What do we own? Among the things we own are Carter-Wallace, Chris-Craft, Gaylord, GC Companies,

(continued on next page)

**ENTERPRISE FUNDS'**  
**MARIO GABELLI & BILL WITTER**  
 (cont'd from preceding page)

Media General, Liberty, Watts and Wynn's.

Watts [WTS/NYSE] is a good example of what we own. Founded about 130 years ago, any time water is moved anywhere around the world, the little valves Watts makes control the flow. They dominate the business. The guy who runs the company, Tim Horne, is 62 years old. He comes to work every day saying, "I'm going to drive the value of this firm."

It sells at 11 times earnings. And we're in there every day buying it. It's terrific. This is what I dreamed about when I got out of school. I said, "God, how am I going to get to be a billionaire? I can't do it if stocks go up!"

Even in a bull market like this, there are hundreds of little companies that are nuggets. And it's so much fun finding them. Watts is a good example of that.

Wynn's growth is about to accelerate. And its price is right.

**Gabelli:** Wynn's International [WN/NYSE] is another example. Wynn's is located in Nashville, Tennessee. It has 18 million shares outstanding. Its stock is selling at \$18. So \$18 per share times 18 million shares outstanding implies a market value of \$324 million for the company.... They just made an acquisition that doubled the manufacturing part of the company. They're going to accelerate the growth rate. And it's selling at 10 times earnings.

It's run by a guy, Jim Carroll, who's a great old Scotchman that really understands precision products and engineering products. They have a division Clorox wants. They have another division that three or four companies will want to own. And Jim at 68 says, "Mario," (his accent is Scotch and I can't do it) "if I can't drive the stock up, I'm going to sell the company." So we like that, particularly in a world in which there's a lot of [overvaluation].

This is a great time to think small and make billions....

**Gabelli:** Carter-Wallace is a consumer products company that brings you Arrid, Trojans and a bunch of other great products. And they're a great cash generator. Here's a company with 44 million shares outstanding selling at \$18. So it has a market cap of around \$800 million.

Nobody knows the company. We own 20% of the company for our clients. Enterprise is a big shareholder. We met the chairman, Henry Hoyt, at a country club. He comes up to me — and I say to him, "I want to say, 'Hello'." And he says, "I know who you are. My lawyers tell me I can't talk to you." He doesn't talk to the Street at all — and he has a public company. So it's a lot of fun and a lot of challenges. And that's what we do....

So thank you very much. We'll obviously conclude that this is a great time to think small and make billions....

(continued in next column)

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**SMALL CAPS ARE VERY CHEAP.  
 THE TIME TO BE THERE IS NOW.**

We think the time to be in small caps is now.

**Bill Witter:** ...Our definition of small cap ... is stocks with market caps under \$1 billion. And [as you know], small caps have underperformed the S&P since '94.... However, based upon P/Es, price-to-book, price-to-cash-flow, they're very cheap. They're at the lower end of their all-time valuation. And we think now is the time to be there.

My first experience investing in small companies was as founder of a semiconductor firm [National Semiconductor]. What attracted me to it was some of the same factors that attract me to small companies today — [namely] the ability to grow more rapidly from a small base of revenue, the focus on one or two products or services and direct access to management. More importantly, [there was] the potential to make a lot of money from an early investment.

We want our investors to have a long-term perspective....

**Witter:** In spite of the past four years, we all know that over the long term, the Ibbotson work shows that small caps are the highest performing U.S. asset class. However, you also get what is known as "above average risk".

They call it "volatility" — which is up and down [movement in the stock price]. We like the up movement. We don't like the down part. However, we believe it comes with the territory. And we believe that smaller companies should be part of an overall investment program.

In addition, you should have a long-term perspective. That's so you're not calling me late at night complaining.

Candela is a play on the graying of America.

**Witter:** There are two elements to our approach. The first is a 25% annual hurdle rate. This is a minimum. We're not interested in adding a company to our portfolio unless we think we can make 25% per year. And this total return is from a combination in large part of earnings, but also, we hope, from an improvement in its P/E multiple....

A company which represents a combination of earnings growth and prospective P/E improvement is Candela Corp. [CLZR/NASDAQ]. This is a Massachusetts company which is a long-time developer of laser products. Well known in the laser field, its growth has been limited until very recently. New products, however — GentleLASE and ScleroPLUS — used for hair removal and vascular lesions, have led to a 49% increase in revenues in the September quarter and more than a doubling of earnings [compared to the same quarter in '98].

The products are benefiting from the aging process. Everybody's getting older. And for social and business reasons, they don't want to look as old as they are. Doctors are looking for new procedures to maintain their income levels — [even though] this is a little bit out of the main line of many doctors. It's unreimbursable. So they don't have to get into preparing insurance forms.

We expect 20% per year growth. And it sports a P/E of 10.

**Witter:** Candela recently entered into an agreement with Physicians' Sales & Service, which has 700 salesmen, to market their product. To put it in perspective, Candela only has 38 direct salesmen themselves in North America.

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**ENTERPRISE FUNDS'**  
**MARIO GABELLI & BILL WITTER**  
 (cont'd from preceding page)

We believe this company — and we own just short of 25% of it for our clients — will grow at a 20% annual rate for the next two or three years. Its larger competitor, which is Coherent, has a P/E multiple of 20 versus 10 for Candela. At \$13.50, it has \$3.50 in cash, it's adding a new PR agency and it's considering a share buy-in program. And this is truly a small-cap. It's got 8 million shares with a little over \$100 million market cap.

We believe in concentration. And our size lets us do it....

**Witter:** The second thing we try to do is focus or concentrate. Our firm manages only \$1.1 billion of total assets which includes about \$600 million of small caps. Therefore, we can focus on 35-40 stocks in most portfolios without confronting serious buying or selling problems....

I referred previously to having invested in a semiconductor start-up early in my career. At that time, the total investment, including plant and equipment, was \$600,000. It was located next to a hat factory in Danbury, Connecticut. And semiconductor producers like Texas Instruments ... made their own capital equipment back then in some corner of their facility.

Today, the equipment alone for a semiconductor production facility costs from \$750 million to \$1 billion. And a new industry's been born — the semiconductor capital equipment industry — which accommodates the needs of these semiconductor manufacturers. And although it's cyclical, this is a 25% per year long-term growth business. Within this area, we have investments in Applied Science & Technology, Cymer, Nanometrics, PR Automation, and Veeco Instruments — which represents about 17.7% [of our portfolio] in this sector.

A majority of voters becoming investors will help....

**Witter:** Going forward, we believe that small-cap companies will soon receive an added boost. Today, 48.2% of the country owns stock — either directly or through mutual funds. And this is growing about 4% per year.

Therefore, we will soon have an investor majority. There have been some opinion surveys of investors. And strangely enough, investors want to have their capital gains taxes reduced and their death duties eliminated. Therefore, we think over a three or four-year period, that some of this will come to pass — and that it'll give us a new, higher P/E, pro-growth environment....

(continued in next column)

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While we expect a bumpier experience in managing a small growth company portfolio versus a large-cap portfolio, we believe in the long run, it will be worth it.

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**BETTER PROSPECTS + VERY ATTRACTIVE VALUATIONS  
= AN EXPLOSIVE UPSIDE FOR THE RUSSELL 2000.**

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Russell 2000's earnings will materially exceed the S&P's.

**Attendee:** *First Call* says that by the end of the ... fourth quarter, the small caps are going to outperform the large caps in terms of earnings for the first time in years — and that the spread is going to be something around 20%. Is that your prognosis, too?

**Gabelli:** Well, we don't do that. We have two sources: Abby Cohen for the S&P and Merrill Lynch for the Russell 2000. And if you just call Merrill Lynch, you can get the Russell 2000 numbers. My recollection is that the earnings of the Russell 2000 will be up 20-25% per year for the next two years. And the S&P's [are expected to be] up in the low double digits — 10%, 11%, 12%. And Abby may be at 8% or 9% for the S&P 500. So the conclusion is that a powerful, powerful tailwind of very good earnings is on the way.

It's like Patrick Ewing — if he ever gets to play basketball again. Is he 6'11-1/2" or 7'1"? You don't care — you just call him a seven-footer. The point is that the Russell 2000 will *materially* exceed the S&P earnings.

Better prospects + lower valuations = explosive upside.

**Gabelli:** To echo what Bill has been saying, the Russell 2000 has better earnings and lower valuations. And, therefore, it's just ready to *explode* in terms of [upside]. There were 7,000 transactions last year in the U.S. And while you talk about Warner Lambert, and while it's fun to talk about CBS and Viacom, 7,000 transactions took place — and most of them are \$200 million. So it's really been the smaller companies....

**Witter:** These companies are going to buy in their stock or somebody's going to take 'em over in many cases. We think that they're at a *very* attractive valuation level.

**Gabelli:** Take Tim Horne at Watts. He can pick up the phone today and call Messier at Vivendi and say, "Hey, I've decided that Wall Street's never going to pay what I call intrinsic value." And Messier will say, "What is it?" And he says, "\$24," — and the guy will say, "Done." Meanwhile, his stock's trading at \$13.

That's not a conversation that I think will take place because I'm still buying the stock — so he should give me another six months [before he does] that.

Lower capital gains tax will benefit faster-growing equities.

**Attendee:** People have been saying small caps are going to outperform big caps for a long time. But all of the money has been going into the big cap names where people have had the best performance — from momentum players. Why will that change in the coming year?

**Gabelli:** Microsoft, Intel and Amazon.com ... probably have a market cap greater than the Russell 2000.

**Witter:** We think some of it will be in these tax changes which we really think are real. I mean, the Cato

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**ENTERPRISE FUNDS'**  
**MARIO GABELLI & BILL WITTER**  
 (cont'd from preceding page)

Institute did this study that asked people, "If you're a stockholder, what do you think of the capital gains tax?" And strangely enough, 65% of stockholders said they wanted to have it reduced.

Once you get a majority of voters being stockholders, it probably *will* be reduced. And we're a year away from [that] at the current rate of growth. So if you reduce the capital gains tax, it will benefit equities — and it'll benefit smaller, faster-growing equities basically.

There's no incentive for Wall Street to focus on small caps.

**Gabelli:** My own reaction to you is simple: There are a lot of structural reasons why people tend not to look for the ignored — even though they're high growth. For example, if I'm working at a sell-side brokerage firm, how do I make \$2 million a year? I don't make it by buying and recommending small-cap stocks. I do it because I'm on the All-Star Team — or I do investment banking. And I do that by buying and focusing on larger companies.

And unless there's a road show today... There's an old expression on Wall Street, "Either net it or forget it." Today, it's a little different — it's IPOs. So nobody's out there talking about the smaller caps.

And scale and size are important in the global marketplace.

**Gabelli:** And third, when the Berlin Wall came down, the business model of most companies became global. Coca-Cola, MTV [Viacom], Boeing — everybody — could go global. And therefore, scale and size become important in a global marketplace — and you can capture at the margin these greater growth opportunities. So we could make a compelling case that from an earnings and market dynamics point of view, scale is important on a global basis and size is important — and, therefore, that's an advantage.

Then, of course, there's always "momo" — the effect of the momentum investors. And they're all terrific. Everybody's going to make a lot of money.

But with the numbers so right, we'll do extraordinarily well.

**Gabelli:** But we know that when you do the research and find great companies that can grow at the rates that we're finding them [selling at] 10, 11, 12 times earnings, it's okay. We're going to create wealth for the Enterprise shareholders who buy the small-cap stocks. We're going to do it against our benchmark. And we're going to do it extraordinarily well with less risk.

THESE ARE THE COMPANIES WE DREAM ABOUT.  
 THEN AGAIN, YOU MAY PREFER THREE-CARD MONTE.

And we look for a reason why the value will be discovered.

**Attendee:** I've heard [many] times that when growth stocks fall out of favor, investors will come to mid-cap stocks first. And I want to know if you think that may be true? And, if so, how [does that impact your investment strategy]?

**Gabelli:** Well, we buy small-cap companies that are going to become mid caps. You [want to] take that, Bill?

**Witter:** We think that there should be a precipitating

event. We don't say to run out and assemble 20 or 30 small caps. There has to be something going on. There has to be a new management, a new product, a share buyback program or an exciting industry where you have the leader. And we *have* those things in our portfolio.

Also, we used to say, "We don't want to find the acorn out in the woods — because it might *stay* an acorn out in the woods." You want to have somebody discover the acorn. So we want them to be coming to New York to talk to the analysts, doing a road show or raising new money — some activity to bring the news out.

Sybron is what you dream about if you want to get rich....

**Gabelli:** I look at it differently, and almost the same. I took a trip recently down to South Jersey. It's about a two-hour drive. And I did it in an hour and a half. The first company I went to visit was a company called Sybron Chemicals. No analyst had been there in four years. The company's listed on the American Stock Exchange. There are 5.6 million shares outstanding. The stock's at \$13. Thirteen dollars per share times 5.6 million shares outstanding comes to \$72 million for the whole company!

[It should do] \$2 in earnings, has great niche products — and Citicorp Ventures owns 42% of the company. They tried to go private a year and a half ago at \$34. Gencorp at the time overbid at \$37. And the bidders said, "Screw the shareholders. We're not going to sell it to Gencorp." So they pulled their bid. And here the stock is at \$13. Meanwhile, the company's in a better fundamental position today.

This is what you *dream* about if you want to get rich.

A company without the name just came out at 2X the price.

**Gabelli:** The second company I went to visit was Berlitz. It's selling at \$19.50. And Apollo [Investment Fund] bought a convertible on the common at \$33. And Fukutake ... owns about 40% of the company. And he's either going to take it out or I'm going to have a double in the stock. And Berlitz is repositioning itself to become a *terrific* purveyor of translation services. Prudential just took a company public with a market cap twice [that of] Berlitz without the Berlitz name. I mean it's *wonderful* to find these things.

A phenomenal company — with phenomenal growth ahead.

**Gabelli:** And the third company I went to visit is *phenomenal*. It's called SL Industries. It trades on the New York Stock Exchange. Any time power comes into the home, particularly with PCs, the quality of the power is becoming erratic — lower quality. And SL Industries makes uninterruptable power supply supplies [UPS's].

They're going to do, after a slow start, probably \$1.30 per share this year and grow thereafter at 40% a year. And if nobody finds it, that's okay because we're going to own the whole company. That's how we're going to create wealth. And that's how we're going to drive returns over the next 20 years — at 20% a year.

How many of you would be unhappy earning a return of 20% a year? What has the stock market done for the last 60 years? We all know what it's done for the last four. So that's the way we think about it — owning businesses. We're not buying soybeans or commodities — we're not buying stocks that represent trading pieces of paper....

[Editor's note: Because of a poor fourth quarter, SL Industries ended up earning 81¢ per share for the year.]

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**ENTERPRISE FUNDS'**  
**MARIO GABELLI & BILL WITTER**  
 (cont'd from preceding page)

Then again, you may prefer Three-Card Momentum Monte.

**Gabelli:** Now ... the other way you could do it is to ... go down the street in New York — where they used to have these Three-Card Montes and see if you can catch the fastest hand — and play the momentum game.

But all of my friends are rich. Some of them who are very rich play momentum — and some ... play small cap. I just think this is a great area to buy cheap companies.

**THE AGONY AND THE ECSTASY:  
 INTERNET STOCKS AND UTILITIES.**

Creative destruction and overpriced stocks are a good thing.

**Attendee:** Is the internet stock bubble about to burst — or is it for real?

**Witter:** I think it's a very important new technology. I think some of the stocks will do well — and continue to do well. And I think some of 'em are overblown — and will disappear. The question is, which is which? And that's a good question. We ask ourselves that every day. To me, the internet is one of the great dynamics of our lifetime. It's terrific. It's changing everyone's life.

We all know from an economic modeling point of view, Schumpeter had said it right — and that is that the beautiful part of capitalism is that it recreates itself and destroys itself. And when I was growing up in the Bronx, you had what you would call today the *Bodega* — the little mom and pop store. Then came along the big supermarket.

Now you have Webvan. So everybody's business model constantly has to change — and that's terrific. There is nothing like having a Bill Gates who's an American hero that you can point to in a grammar school in the South Bronx and say, "If you do it, you could be worth \$40 billion. Just come up with an idea that works." This is *fabulous!* So I'm very excited about the internet. And I think it works.

Now, are some stocks overpriced? Of course. That's great — because you can make money on the short side....

Aren't utilities dull? Not if you care about risk and reward.

**Gabelli:** Someone asked why, in an internet world, does the portfolio start including some gas, electric and water companies? Isn't that about as dull as you can find?

Well, we decided about two or three years ago that there's a major structural change taking place. And going back to the model of risk/reward, we started buying all the water companies. Why? Because of a consolidation. We started buying gas companies because of the consolidation that was led by *Eastern Enterprises* out of Boston where there were about seven or eight gas companies — and they bought three or four.

Then we started buying the electrics, in part, because of the combination of the deregulation in that industry — when manufacturing was uncoupled from distribution and uncoupled from the retail side. So we've been rewarded by our patience because in the last three months alone, there have been 24 transactions.

Utilities not conservative; they're very aggressive w/low risk.

**Gabelli:** Even *Warren Buffett* went out and just bought a company in Iowa. And what he sees is an ability to put billions of dollars to work at low risk. Basically, the CEO said, "Hey, I'm going to do a whole bunch of deals." Just this week alone, you saw three or four of them. So we are into "take out power".

I don't know how many of you acknowledge that you live in Brooklyn. Brooklyn Union Gas-owned *KeySpan* has just announced they're buying Eastern Enterprises. Woody Ives had his company up for sale. The stock went from \$20 to \$42. Well, this is a Boston *gas* company. He just got \$65 a share for it. That's phenomenal!

So that's why those are creeping into our portfolio — not because we're being conservative, but because we're being *extraordinarily* aggressive with low risk.

**EVERYONE IS EXTRAORDINARILY OPTIMISTIC TODAY.  
 HOWEVER, FOR EVERY EBB, THERE'S A FLOW.**

Sometimes investors will look way out and pay way up.

**Attendee:** Do I understand that you believe that value stocks do better when people are uncertain of the future and growth stocks do better when they're confident? If that's the case, why won't people continue buying growth stocks unless they're uncomfortable with the future?

**Gabelli:** Oh, they absolutely *will*.

**Witter:** Yeah. Only the P/Es are very *high* on some of them. I mean *Coca-Cola*'s got a P/E in the 40s — and the earnings are going parallel.

**Gabelli:** When you discount ... the future stream of earnings that you get from a company — the present value of that — ... first, you're willing to look further out, and second, you're willing to pay a lower discount factor. So you're willing to start with a much higher price.

But on Wall Street, everything goes in ebbs and flows.

**Gabelli:** But those things *change*. In 1978 or '79, Bill, I wrote a research report on one of my favorite stocks at the time — Lin Broadcasting — in which if you owned it (as I know some of our friends did) you would be *extraordinarily* rich.... But at that time, I wrote a five-year research report. And the research director threw it back at me and said, "That's not long enough."

Here's a report written by the guy at Baker Weeks who projected out comparable store sales for *McDonald's* to the year 2000. This was over 20 years ago. Today you have the same dynamics. It goes in ebbs and flows.

Today's extraordinary optimism shall pass.

**Gabelli:** In 1979, *Business Week* featured the article "The Death of Equities". We started a sell-side brokerage firm at the time that William D. Witter merged into Drexel. And everyone was saying, "What are you doing?! You can't do that! You've got to go out of business."

So [I've seen] these ebbs and flows in my brief investment horizon of 35 years.... Right now, everyone is *extraordinarily* optimistic — and *deservedly* so. However, as Bill has pointed out, what price do you want to *pay* for that optimism?

—OID

## DAVID M. KNOTT KNOTT PARTNERS, L.P.

"November was an awful month for us. There is no other way to describe it. It was particularly disappointing after such a fine October. As we've often said, the one market that we do not expect to do well in is a wildly speculative one. November (and December) has been in some respects the most speculative market that I have ever seen. The first problem speculative manias present to us is that they hurt us on the short side. We were damaged in this respect, but fortunate in that we kept our short exposure at a relatively low level — particularly with respect to the internet."

"More harmful was a dramatic pullback in bank stocks occasioned by pre-announcements of earnings disappointments by two banks, neither of which we own. This reversed the positive moves made in October by our holdings in this group. The market continues to believe the glass is half-empty regarding the banks. It is more than a little galling to watch this manic behavior after our banks have consistently met their earnings targets every quarter (as they have for many years)."

"At the same time, the market bid, virtually overnight, a host of unproven companies (the majority of which are unlikely to ever make a penny) to market capitalizations of \$10 and \$20 billion. The internet mania not only affects our relative performance, but our absolute as well in that it seems to suck money from most stocks as the momentum crowd chases stock symbols of companies that in many cases they'd be hard pressed to explain what the companies ... ever do."

"If this wasn't bad enough, we have been going through an unusually warm winter that has suddenly caused people to start selling oil and gas stocks with a vengeance. The group seems to be probably the cheapest it has been in at least a decade in terms of price to cash flow or price to net asset value. Yet, for the moment, no one seems to care."

"To me, it takes only a limited knowledge of recent financial bubbles to predict that the internet mania will come to a bad end as did earlier such episodes in oil ('79-'80), personal computers ('82-'83) and biotechnology ('91-'92). Every one of those experiences was characterized in its latter stages by a larger and larger IPO calendar that had more and more issues of dubious quality. A famous underwriter once said, 'When the ducks quack, feed them.' The Humane Society will be happy to know that no starving ducks have been spotted in Manhattan this holiday season."

"The harder questions to answer in any of these bubbles is when it will end and from what level. The only clue I have to this is that within the internet group the secondary and tertiary stocks seem to be having a rough time — particularly many of the e-tailers — as money runs to catch the 'stocks du jour', which are now the infrastructure and B2B names. We're watching this closely since most internet stocks are attached to the life support system of Wall Street that told them, 'There's no need to worry about money. We'll be there when you need it.' Many of these managers will learn the hard way why bankers are known as fair weather friends."

Letter to clients of Knott Partners, L.P. — December 31, 1999

Dear Subscriber,

As pointed out by this edition's contributors, today's stock market remains a two-tiered market. The "haves" — consisting primarily of the stocks of high-tech and communications companies, especially large cap members — seem to get more expensive almost by the day. On the other hand, the "have-nots" — particularly, the stocks of small-cap companies, especially those in financial services, real estate and other areas perceived as being interest-rate sensitive and/or cyclical in nature — seem to be unwanted at almost any price.

Making the opportunities more interesting, as Enterprise Funds' Mario Gabelli and Bill Witter point out, not only are Russell 2000 stocks much cheaper than their S&P 500 brethren, their earnings are expected to increase much more rapidly over the next year or two, as well.

We're very pleased with the ideas our contributors have agreed to share with you in this edition. Among them are two discussed by Fairholme Capital's Bruce Berkowitz

— including "an extraordinary bargain" and "an extraordinary company at a very ordinary price".

Longleaf Partners' Mason Hawkins, Staley Cates and C.T. Fitzpatrick discuss several ideas which they're particularly excited about today.

Enterprise Funds' Mario Gabelli and Bill Witter mention half a dozen or so companies whose stocks they suggest have explosive upside today. And we could go on.

Happy hunting.

Until next edition,

  
Your Editor

P.S. In case you're as shocked as we suspect you are about the relatively brief period between this edition and last, feel free to think of it as a once-in-a-millennium event. (Please don't ask which millennium.)

P.P.S. Here's to a happy, healthy and prosperous millennium for you and yours.

*Outstanding Investor Digest* is published bimonthly, more or less (usually less) by Outstanding Investor Digest, Inc.  
Outstanding Investor Digest, 295 Greenwich Street, PMB 282, New York, New York 10007 Telephone: (212) 925-3885

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