

Outstanding Investor Digest

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

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MARSHFIELD ASSOCIATES'
SAMUEL MITCHELL & CHRISTOPHER NIEMCZEWSKI
LETTER TO CLIENTS — JANUARY, 2002

Please accept this *Patient Subscriber's Bonus Edition* as a token of our appreciation for your patience and support in 2001 and always.

WITHOUT UNPRECEDENTED GROWTH IN EARNINGS,
WE'RE IN FOR A PERIOD OF LOWER RETURNS.

Context Is King

"Most victories come from instantly exploiting your enemy's stupid mistakes and not from any particular brilliance in your own plan."

— Orson Scott Card

To get some idea of future returns, we can look at the past.

The recent surge in stock prices, especially in the tech sector, suggests that investors are expecting good times to start rolling again soon. Surveys indicate that many investors remain bullish. Pundits believe the excesses are being wrung out of the economy and that earnings will recover within the next twelve months and continue to rise in the future.

These expectations as to the near-term course of the economy may or may not be met, but their potential implications for stock prices need to be put in context. Short-term stock price movements are absolutely unpredictable, and history is at best a rough guide. But we can get some idea of what future long-term returns would be if historical norms were a reliable benchmark. In providing this context, we shall be presenting data on past equity returns in real, i.e., inflation-adjusted, terms.

Stocks' long-term compound real return has been 7%.

Over periods that have been carefully studied by stock market historians, 1802-1997 and 1871-1997, the annualized cumulative past return on U.S. equities was 7.0%. For the 1802-1997 period, this was comprised of an average dividend-to-price ratio of 5.4% and an annual growth rate of stock prices of 1.6%. The comparable numbers for the 1871-1997 period were 4.9% and 2.1%, respectively. The annual price/earnings (P/E) ratio over the 1872-2000 period for the S&P 500 was 14.5, which is equivalent to an earnings yield of 6.9%. No matter how you cut it, the long-term compound annual real return on stocks has been around 7%.

The future ain't what it used to be....

Valuations today remain way above long-term norms. Even after repurchases are added to dividends, the dividend-to-price ratio has declined to about 2.4%. Unless the long-term growth potential of the economy has reached a permanently higher plateau, the expected annualized cumulative return on stocks is around 4.7%, net of inflation.

The return on long-term inflation-indexed Treasury bonds, which is the benchmark rate for a risk-free asset, is about 3.5%. The difference between the expected return on stocks and the return on a risk-free asset has shrunk to less than 1.2%. This is the so-called "equity premium" — the premium investors require to compensate them for the extra risk assumed when buying a stock. By comparison, over the past 110 years, the equity premium has averaged about 6.9%.

High returns tend to be followed by low returns...

If traditional relative valuations were restored, stock prices would drop dramatically. This possibility cannot be dismissed out of hand, as the history of stock prices shows that the stock market is mean-reverting — i.e., periods of high returns tend to be followed by periods of low returns. We, of course, don't know if we're entering a new world of permanently higher stock valuations, but we do know that such a profound ... deviation from the past is unlikely to occur whimsically.

Traditional valuation ratios could be restored without a decline in stock returns below long-run trend if there were an unprecedented increase in earnings and dividend growth — which is possible, but unlikely. After-tax profits as a percent of gross domestic product (GDP) over the past 50 years has ranged between 4% and 6.5%. Profits in the vintage year of 1999 were under 6% — and this year probably will be below 5%. There is no evidence that capital's share of GDP is in an uptrend.

To assume the optimistic case is a given would be foolish.

The optimistic case for stocks — an expected return of about 4.7% in real terms or about 6.5% in nominal terms — has to rest mainly on the assumption that the equity premium has declined permanently. We don't know whether the equity premium is permanently lower or whether investors are placing undue emphasis on recent experience and are ignoring the arithmetic of history. We'd be foolish however if we assumed that the optimistic case was a foregone conclusion.

Therefore, we must become even more fussy than usual.

1. The statistical record suggests that it would be

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quite extraordinary (but not impossible) if the compound annual increase in the major stock averages over the next decade were to exceed the mid-to-high single digit range. Therefore, since we cannot count on a rising tide to save us from poor navigation, we must become even more fussy about the quality of individual stock selection.

2. We must have the discipline to remain *patient* and wait for the opportunities that will occur as the result of inevitable volatility in individual stock prices.

3. Remembering that we have recently been through one of history's great stock market bubbles and that things can go to extremes in both directions, we need to be extremely disciplined in making sure that the price we pay is well below our estimate of value.

**WELL-MANAGED INSURERS, ALREADY ADVANTAGED,
 SHOULD BE EVEN BETTER GOING FORWARD.**

Ruinously low rates + 9/11 = Shortage of P&C capacity.

For the last decade, the property and casualty (P&C) insurance business has earned an average return on capital well below the average for American industry. This occurred because of a widespread willingness to accept underwriting losses. Losses and loss adjustment expenses consistently and significantly exceeded premium income.

Writing insurance at prices that all but assure an underwriting loss is called "cash flow underwriting". Insurance companies did this on the theory that they could invest the float at high interest rates. ("Float" is the term used to describe the funds available for investment as the result of the lag between the receipt of premium income and the payment of claims.)

"Cash flow underwriting" proved ruinous and will not recur for a long time. Interest rates have declined from over 13% in 1981 to about 5.75% today, so the incentive for "cash flow underwriting" has disappeared. At the same time, P&C companies are discovering that they have grossly under-estimated their likely losses, so loss reserves have to be very substantially increased.

Compounding the problem are extraordinary losses from the catastrophe of September 11 and losses in insurance companies' equity portfolios. The result is a shortage of underwriting capacity of somewhere around \$100 billion.

Our companies know what it's about. Just ask John Byrne.

Companies that have followed the four principles espoused by White Mountains Chairman, John Byrne, are well positioned to benefit from the stronger pricing

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environment. These principles are:

1. Maintain a strong balance sheet.
2. Maintain underwriting discipline. Make sure that loss reserves are properly estimated and there is some built-in margin of safety. Never invest in a risk you don't understand, and be very careful to avoid a hidden, large exposure to one catastrophic risk as the result of an aggregation of exposure across multiple policies.
3. Invest for total return. Loss reserves should be backed by safe bonds whose duration matches the expected payout of losses. Invest shareholder funds in common stocks when attractive opportunities present themselves.
4. Think like owners.

And our "big four" core insurance holdings — White Mountains Insurance Group (WTM), Berkshire Hathaway (BRK), Markel (MKL), and Odyssey Re (ORH) — at least for the most part already meet these criteria in spades. So their balance sheets do *not* have to be strengthened.

On the liability side of their balance sheets, their reserving practices have been realistic. General Re, a subsidiary of Berkshire, is a slight exception in that it faltered in the late 1990s. However, Mr. Buffett recently made it clear that straying from underwriting discipline will not be tolerated. And General Re has a new CEO.

All is well on the asset side of the balance sheet, too.

The asset side of the balance sheets of our big four also is in good shape. None of these companies suffered a disproportionate decline in the value of its equity portfolios. White Mountains, for example, sold its equities in the spring of 2001, invested in bonds, sold them in the summer and at the end of the third quarter was sitting in short-term securities — a truly bravura performance.

At September 30th, Berkshire had short-to-medium-term bonds and cash equivalents of about \$40 billion. Markel's equity portfolio has performed very well in the past two years, thanks to Tom Gayner's astute investing. And the decline in stock prices over the last two years has had virtually no effect on Odyssey Re.

Going forward, the P&C industry may earn a decent return.

Over the next couple of years, the P&C business — unlike almost all other industries — will probably enjoy strong pricing power. It is less clear exactly what will happen long term, but there are encouraging signs. The structure of the business may be changing so that insurers will have a decent chance of consistently earning a return on equity in the mid-teens. The reinsurance business is consolidating in the hands of companies whose managers think like owners.

To the extent that primary insurers will no longer be able to get reinsurance at ridiculous prices, they will be unable to price their own products poorly without running the risk of ruining their profit margins or having to bear an unacceptably high risk.

With low interest rates, it is all but impossible to earn a competitive return without earning an underwriting profit. While new capacity inevitably will come into the business, there will be a shortage of first rank underwriters for several years. Thus, companies with superior underwriting skills should enjoy a competitive advantage.

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Well-managed insurers have some little-noted advantages.

Well-managed insurance companies have an advantage over other equity investment alternatives that is obvious, but little noted. Not only is demand for the product virtually recession-proof, but unlike most other companies whose assets are highly concentrated, both the asset and liability side of insurer balance sheets are widely diversified. The major asset of most insurance companies is a diversified portfolio of stocks and bonds, financed at no cost by other people's money — float. Meanwhile, the major liability — assuming underwriting discipline — is a widely diversified portfolio of uncorrelated risks.

Put another way, a good insurance company is equivalent to a diversified investment portfolio, leveraged with non-callable, low or no-cost debt (provided, of course, that the company is writing insurance at a breakeven level, i.e., losses and loss adjustment expenses are not greater than their associated premiums).

[Editor's note: Also, insurance expenditures have historically increased disproportionately with increases in our incomes and standard of living.]

An additional advantage if the equity portion of an insurer's portfolio is invested for the long term is that taxes can be deferred a long time so that the present value of taxes is much lower than the nominal value shown on the company's balance sheet.

**DEVELOPMENTS IN INSURANCE ARE PROMISING,
 BUT THE JURY'S STILL OUT. DISCIPLINE IS REQUIRED.**

Some slight movement toward rationality in asbestos....

What can go wrong? There are two big negatives. The first is asbestos. The second is stupid competition. Asbestos claims are wildly greater than anyone imagined. While this is obviously bad news for the companies that are being pushed into bankruptcy, the stupendous amount of claims may force some return to rationality.

With very large amounts of money going to people who were exposed to asbestos but have no symptoms of related illness whatsoever, some in the plaintiff's bar are becoming

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WARREN BUFFETT, Chairman
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concerned that there will not be enough money to compensate people who are really sick from asbestos. A judge whose opinions are widely respected in the asbestos litigation world has expressed similar sentiments.

Consequently, there may evolve an understanding involving limits on payments to people who are asymptomatic in order to assure that the really sick people are properly compensated. If so, this would be good news, as it is possible to model how much money will have to be paid out and therefore put limits on the total.

With asbestos exposure capped, albeit at a very high number, insurers will no longer face the uncertainty of unlimited liability. It is too early to tell if some rationality will be restored, but there is some slight movement in the right direction.

The jury's still out on underwriting discipline and rates....

A deeper potential problem is the continued prominence in the insurance business of managers who fail to understand that in the long run, cutting prices to gain share harms their own companies as well as their competitors. By weakening the strength of the industry, customers also are ultimately adversely affected to the extent claims paying capability is compromised.

There's been much talk of a change in mindset among the very large insurers after the events of September 11, but how long the resolve to stick to rational pricing will last remains an open question.

We are confident that the current supply/demand imbalance will result in strong pricing over the next couple of years. However, the longer-term outlook, while possibly promising, will bear close watching.

Our challenge: not to get carried away and overpay.

It remains to be seen whether the insurance industry can adjust to the new context. Some will; the largest writer of medical malpractice is exiting the business. Some regional companies are leaving the personal lines business. And Warren Buffett is taking steps to restore General Re to underwriting profitability.

However, several companies will go bankrupt in the next five years unless they sell out, drastically reduce the lines of business they write or receive large capital infusions from innocent foreign owners. Confronting this context, we must be careful not to let our enthusiasm cause us to overpay, even when dealing with a business that we think we understand.

—OID

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