

## Introduction

The saying is: “To try to teach you how to fish rather than handing you a fish.”

Value investing is simply the search for bargains. Value investing involves determining a value of a company and then investing when the price is significantly below the value of the firm to allow for a margin of safety. Simple to say, but not easy to do.

I want to define some key terms as I use them. We may think we mean the same thing, but I want you to understand exactly what I mean when I use the terms: **Value Investing**, **Intrinsic Value** and **Margin of Safety**.

**Value Investing:** Appraising the intrinsic value of businesses and purchasing fractions of those businesses at significant discounts to those appraisals. Buying bargains.

That is what value investing means when I use the term. What is not to like about value investing? How many people wouldn't wish to be considered value investors? That is why I want to define terms as I understand them.

The definition of **Intrinsic Value** (“IV”) is the Present Value of all distributable cash flows whether operating or non-operating over the entire life of the business. Or another way of defining IV is the price at which a buyer and seller—equally knowledgeable and neither one operating under duress—would agree to a transaction for cash. Both of these definitions are easy to articulate, but not so easy to implement or to determine. For example, there are some businesses for which no one can ascertain their value within a tight enough range to be useful to make decisions.

What type of companies are those? A company where the future prospects are so uncertain both good or bad, that no one knows what the long term future or cash flows will be. Then again there are businesses that we, I, or you do not have the knowledge to project the future cash flows and discount them back--that is a very important element of humility which you should take into this work.

The **Margin of Safety** is, of course, the discount from intrinsic value of the business. Needless to say, in the case of margin of safety, the bigger is better. Margin of safety is typically determined by the price discount but the concept may be embodied in the conservativeness of your assumptions and estimates.

What is your investing edge? Who is on the other side of your trade?

Combined in this idea of Intrinsic Value and a Margin of Safety is the idea of having an edge. An edge, being the circumstances, that is the opposite of operating on a level playing field. We are all looking for an insight or knowledge edge that allows us to perceive value perhaps where others are incapable of doing that. Find your competitive advantage.

This gets to the question of defining intrinsic value. One thing I want to make sure that you understand is that for some businesses, the intrinsic value is simply not knowable. The array or ranges of possible future cash flows are so wide, so unpredictable, that discounting them back is a fruitless exercise. Additionally, some businesses lend themselves to appraisal by me and not by other people. And for other businesses, some other people are better qualified to assess intrinsic value than I am to make the appraisal. Certain businesses and industries, I feel, I am better able to forecast the cash flows than other people.

There are many, many industries that I am very unqualified to come up with intrinsic value. Or the range of value is too wide to be helpful to me. In those instances I can't come up with an intrinsic value that would be helpful to me.

### EXAMPLE OF MSFT DCF

This is another way of saying, **stick to what you know**—this is *Warren Buffett's* idea to stay within your circle of competence.

I try to be very humble and modest. I think the investment business is full of very bright, hardworking people. I never would be so presumptuous to say I could compete with any of them on any subject. I think I am quick to acknowledge that there are other people who know more about certain things than I do. And I try not to be so egotistical as to try to play their game on their terms. Therefore I avoid being where I don't have the edge.

### Interrelationships between Intrinsic Value and Margin of Safety

It has to do with the usefulness of the appraisal of intrinsic value. If I conclude that the Intrinsic Value is somewhere between \$100 to \$300 a share, that is probably not a useful appraisal. If I can't refine it more than that, then I should move on. If the stock is trading at \$150 and the range is \$100 to \$300, then what do I know? I don't know anything of value. If it turns out it (*the company*) is worth \$200 to \$300 then there may be a big margin of safety there. But if I can't be sure the company won't be worth \$100 or not, move on to where the odds seem more attractive--where determining the tighter range is something that I am qualified to determine.

One of the old stories about giving a talk on value investing is you come in, stand up and say intrinsic value, margin of safety and then sit down. The talk is over. I wanted to pass over it quickly because I am sure you have heard it from others.

### ***Buffett's Definition of IV: Intrinsic Value (Owner's Manual 2005 Annual Report of Berkshire Hathaway pg. 77 – 78.***

The calculation of intrinsic value, though, is not so simple. As our definition suggests, Intrinsic Value is an estimate rather than a precise figure, and it is additionally an estimate that must be change if interest rates move or forecasts of future cash flows are revised. Two people looking at the same set of facts moreover will almost inevitably come up with at least slightly different intrinsic value figures. That is one reason we never give you our estimates of intrinsic value. What are annual reports do supply, though, are the factors that we ourselves use to calculate this value.

#### **I. What is the definition is value?**

Value investing is one of those terms like Motherhood and Apple Pie. Everyone is for it. Determine the valuation of a company then invest if the market price is less than the value. What is the definition of value?

The **intrinsic value** has two (2) definitions:

1. The NPV of all future distributable cash and the assets sold outside of the normal operations. There are some companies, which have valuable assets that are not intrinsic to their operations, which can be sold for cash. An investment analyst should properly recognize those assets that can be converted to cash—then value the NPV of that cash stream.
2. The other definition of value is the price at which an equally knowledgeable buyer or seller would negotiate under duress a transaction for cash. All those words are important especially the last two. The transaction is for cash that sets comparable values for looking at similar investments.

When transactions are not for cash as many acquisitions have been in recent years, there is much less informational content for investors in terms of determining comparable values. When there are acquisitions made with securities, you often get a \$10 dog for two \$5 cats. It doesn't tell you anything about evaluating other cats. If, on the other hand, you see what an investor has paid in dollars for a cat.

Now, you say we should go out and look at all the companies and value all companies. Usually novice analysts and investors naively assume that almost all companies can be valued by them. Investing experience will ultimately crush such hubris and naiveté.

Warren Buffett's definition of **Intrinsic Value** (Of Permanent Value, pg. 933): Intrinsic value is the discounted value today, of all future distributable cash generated by an entity less the additional capital, including retained earnings that the owners must put in to generate that cash. A simple way to get to how much a company is worth is to ask how much you would get for it if you sold it today.

A very interesting characteristic of some of my companies like *Coke* is that they can grow without the addition of much of the owners' capital, which remember, *includes* retained earnings. This, by the way, means that *Coke* can take its excess cash and repurchase its shares, such that Berkshire's original 6% stake is now 8%.

If your discount rate is 10%, you are saying you have the low-risk alternative of putting \$10 in, say, government bonds that will pay you \$1 of interest, which *never* grows. But if you have a company that has \$1 in distributable cash that will grow 5% per annum *forever*, you might be happy to own that company and pay up to \$20 for it. If that cash grew 8% a year forever, you could pay up to \$50 for it. If it grew 9% a year forever, you might even pay up to \$100 for it. What you are paying as a multiple of cash flow is equal to 1 divided by (the discount rate less the growth rate). Multiple = 1 divided by (k-g). (Of Permanent Value)

Unfortunately, not nearly as many companies can be valued fruitfully. A fruitful valuation is in a narrow enough ban that the range would help you make an investment decision. For example, if you look at a company and you come up with a conclusion that the values ranged from \$20 per share to \$200 per share that is not a useful valuation. The reason you can't tighten up the valuation range may be because the future cash flows of the business may be too inherently unpredictable or it may be that YOU do not have enough knowledge to adequately project the cash flows to value the business.

### Self-Awareness

**You may not have enough industry knowledge to come up with an adequate valuation to make an investment decision. This is an important idea, because one thing that underlies the kind of value investing everything that I do is self-awareness.** The awareness that you don't know everything is important. There is a lot you don't know. There are experts in lots of areas you might be looking and you should be humble and say you don't know enough to make the investment or do the analysis, therefore, I will cast it aside and move on to something where I may have the knowledge.

I and others like me are always looking for an edge. We don't want a level playing field. When I buy **I want to know more than the guy on the other side of the trade**. The other person knows less about that security than I do. If I don't have that feeling of confidence; if I don't think I have been very honest with myself, then I step aside. There are a lot of arrogant people in this business, quick studies who think they can run nimbly from one hot area like oil & gas to another like Biotech. I have learned the hard way that I can't do that.

**So the idea is to stick with what you know and be honest with yourself about what you know.** Stay within your circle of competence. If you look at our holdings, you will see they fit specific financial characteristics or industries. *Charlie Munger* has a concept where each of us has one in-box (represents ideas) and three outboxes: a yes box, a no box, and then there is a too tough to call box, which is where you put most things. You must be honest enough to say I don't know enough to make a reasoned decision so I will pass. This is the concept expressed by *Warren Buffett* of waiting for a fat pitch and letting the balls go by with no called strikes. If you don't have the knowledge or insight, don't do anything. Moreover, you don't have to make a decision you don't know enough about.

**Buffett on learning from Ben Graham:** In applying Ben's guiding principles, Charlie and I try to be thorough and methodical. We must also be realistic. We look for businesses we can understand, where we're familiar with the product, the nature of the competition and what might go wrong over time. We try to figure out whether the economics of the business--including its earnings power over the next 5, 10 or 15 years--is likely to resemble a fine wine--to be good and getting better. Then we decide whether we would be buying into a business managed by people we feel comfortable being in business with--people with intelligence, energy--and most important--integrity.

## II. How big a discount from intrinsic value is big enough?

Depending on the accuracy and confidence of your valuation of intrinsic value, the bigger the discount you buy the security, the better. There are practical limits, however. If you want to buy at 1/3 of your appraisal of intrinsic value, that would be an admirable approach, however, you might have to wait 10 years before you could find such a discount. Except for 1974 and 2008/2009 when stocks were incredibly cheap, I haven't been able to find stocks below 1/2 intrinsic value.

Usually, when you think you find securities at 1/2 or less of your appraisal of intrinsic value, go back and check your work--you will find that you are probably making a mistake. My experience has been to use a 33% discount to intrinsic value to enable me to find a useful number of ideas. Now, there is nothing magic about buying a stock at 2/3 of intrinsic value, the price could go down further. There is a wonderful book, The Money Game, written by "Adam Smith" which said, "Remember that when you buy a stock, it doesn't know that you own it." When *Warren Buffett* bought the *Washington Post Company* in the 1970's, he believed he bought it at 40% of intrinsic value, yet the stock declined another 50%.

*Buffett* in a talk to Columbia business school students in 1993, said: "If you had asked anyone in the business what their properties (*Washington Post Company*) were worth, they'd have said \$400 million or something like that. You could have an auction in the middle of the Atlantic Ocean at two in the morning, and you have people to show up and bid for that much for them. And it was being run by honest and able people who had a significant part of their net worth in the business. It was ungodly safe. It wouldn't have bothered me to put my whole net worth into it. Not in the least."

By 1973, the beginning of the severe 1973-74 stock market slump, *Post Company* stock had dropped from its original \$6.50 issue price to \$4.00 per share, adjusted for later stock splits. *Buffett* struck, buying his \$10.6 million of *Post* stock, a 12% stake of the Class B stock at or about 10% of the total stock. The \$4 price implied a value of about \$80 million evaluation of the whole company, which was debt free at a time when *Buffett* figured the enterprise had an intrinsic worth of \$400 million. Yet it was not until 1981 that the market capitalization was \$400 million.

### Regression to the Mean

Why do you expect that a stock purchased below intrinsic value will rise to intrinsic value and close the gap between price and value? The answer is not scientific--because stocks have always migrated back to intrinsic value. There is a pull towards intrinsic value. Stocks overvalued move down, while stocks

undervalued move up (**Regression to the Mean**). It would be extremely unusual for a diversified portfolio of undervalued stocks not to return to value. *Ben Graham* in his later years studied a method of mechanically buying stocks at 50% of book value or net working capital with no debt and then selling either when the stocks returned to value or after three years if the gap between price and value had not been closed.

### **Insert more on R-T-M**

#### How and Why Value anomalies occur.

How do these kinds of sizable discounts arise?

I did not define for you how big (a discount) is enough. My experience is a Margin of Safety of 25% to 30% is something that can be found with some frequency. I could say I would like to find some investment at 20% of value or with a 50% or 80% discount to intrinsic value—that may be a perfectly reasonable idea to have, but I may have to wait until 1932 (or 1973 for those opportunities to buy at 50% to 40% of intrinsic value) to come around again.

Example from Fisher Black and the Revolutionary Idea of Finance Perry Mehrling by John Wiley & Sons 2005, p. 236: “We might define an efficient market as one in which price is within a factor of 2 of value; i.e. the price is more than half of value and less than twice value. By this definition, I think almost all markets are efficient almost all of the time. “Almost all” means at least 90%.” (Fischer Black, 1986, *Journal of Finance* 410).

I gave you quotes from these book excerpts, an excerpt from *Fisher Black* that most markets are efficient. Most sell for ½ of value and twice (2x) value. I can't address the twice value part of that claim. I have almost had no success in many, many years of my investing career of finding companies trading at ½ of value. Usually when I find them, I go back and try to figure out what happened. That is not to say they don't happen, but they are so infrequent. The people who tell you they find values at ½ of value are probably deluding themselves.

I know such people. People who tell spell-binding stories about incredibly cheap stocks they have found. If a cheap stock is at a 50% discount--usually, I find they are wrong.

### **Placing opportunities into Context-Greenblatt.**

#### **III. Why stocks do become so significantly undervalued?**

Many people believe the market is efficient--why pick up a \$100 bill from the ground, because it can't be there! What allows me to buy stocks at a discount to intrinsic value? This is a commonality among all value investors whether they invest in big caps, small caps or real-estate; they are **contrarians**--buying when others are selling. Value investors have the ability to go against the emotions of the crowd. Research shows that valuations get carried to extremes on the upside and downside relative to intrinsic value. People become too emotional, overreact, and focus on the short-term news.

Another characteristic of value investors is our timeframes. We have longer than normal time horizons. Most of us, including me, manage money not being measured every day or living in fear that money will be taken away based on short-term performance. If you were to manage a mutual fund, you would be

aware of being monitored daily and if there was a short period of underperformance, the money undermanagement could be removed. This pressure creates a mad dash for the exits, which we see when a company comes out with disappointing news or earnings. Frequently the market reaction is frequently far out of proportion to the actual reality. This creates opportunities to buy. Having a longer time frame offers an opportunity to take advantage of time arbitrage—the market slowly overcomes the short-term focus on news and eventually recognizes true values.

### Arbitraging time

In fact, if you think about it in a general sense, what are the circumstances that are going to create valuation disparities that are favorable to investing? The bad news either relates to the company or to the market in general like an act of terrorism.

Another related question is how long does it take for the gap to close? You must understand that it takes time for psychology to change from negative to positive. Understand the concept of regression to the mean. Nothing is ever as good or as bad as it seems. Companies have a central tendency to normalize profitability and growth. If there should be some short-run deviations especially on the disappointing side, it creates an opportunity for a value investor. There is a tendency for a business to regress to its mean of LR performance. In fact, these opportunities present themselves. If I knew enough to determine the value of *IBM*. And I have looked recently at *IBM*, but I don't have nearly enough expertise to value *IBM*. But I can look at a *Value Line*. I can see over a long period of time that *IBM* as been a remarkably stable and predictable business in terms of its revenue growth, in terms of its profit margins, its cash generation. It is a financial engine that doesn't really change much. However, there is *enormous volatility* in the price of the stock.

If I could establish a real, bedrock intrinsic value, there is not much that could radically change my appraisal of the intrinsic value of *IBM* from year to year given the size of *IBM*, the diversity and stability of its businesses--with one big exception--a change in interest rates. If interest rates, say, were to rise in the 30-year bond, it would affect my appraisal of intrinsic value because of the discount rate that I use.



### Discount Rates to Use in Valuation

For the types of businesses that I invest in they have a long-term track record, which enables me to normalize their earnings. Value means where I find it--big or small. I don't define myself as small, mid or large cap.

My valuation is a function of interest rates. I am sure none of you here will not make the mistake made on *CNBC* or *Bloomberg* of comparing stocks, which are very long duration assets--particularly in a time of very low cash dividends--against short term interest rates. When someone says, "I can't afford to get sub 1% on my cash, so I must buy stocks." This isn't comparing apples-to-oranges; it is much larger apart than that. If you want to compare a fixed income instrument to a stock, it must be the longest risk free duration bond you can find.

*Insert Hussman's discussion of Stocks as perpetual assets.*

The discount rate that I use would be the long-term risk free rate plus whatever premium you demand. There is no right answer to that, because each of you has a different demanded return. Each of you has different tolerance for risk. But if you say I will only buy companies selling at 1/3 to 1/2 intrinsic value or discount at 500 basis points over 30 year Treasuries, then you won't find very much to buy. The tougher you are at setting discounts, the less you will find to buy.

The 1977 *Buffett* Article in *Fortune*, talks about 12% equity returns. Those numbers are obsolete in 2004 (more like 6% to 7%). I am sure he would like to rewrite that article. *Buffett* is saying the normalized earnings figure for the stock market is 12%. Over a long period of time, some years it is less and other years it is more, but on average the stock market returns 12%. In the 26 years since that article was written, the returns have been higher. Also, the *Dow Jones* return on equity has much more questionable content. Because of so much writing down of book value, there are probably better ways to assess the profitability of a business. What he (*Buffett*) was doing was normalizing the whole market place. And he was trying to make the point of first, understand what you are buying. And then how much are you willing to pay for that underlying business to earn the returns that you need to earn. If you could buy the *Dow Jones* at 1982 at book value you would be getting a 12% return for 100 cents on the dollar--like a 12% bond.

In the book, *The Davis Dynasty: Fifty Years of Successful Investing on Wall Street* by John Rothchild, *Chris Davis* of NY Venture Fund heard in 1999 Warren Buffett tell an audience he expected stocks to return **6% a year for the next 17 years**--less than half the payoff during the prior 17 years. Buffett based his sobering forecast on simple math: In 1999, the entire lineup of *Fortune 500* companies was selling for \$10 trillion, supported by \$300 billion in annual earnings. When the annual fees shareholders paid to own those assets--roughly, 1 percent of \$10 trillion, or \$100 million--were subtracted the actual payoff from their investing was \$200 million. Contemporary investors were buying Mr. Market for 50 times earnings. Because an entire market can't justify a multiple, of 50, Buffett surmised, stock prices would have to give. They might give slowly or give quickly, or meander until the nation's earnings caught up to them, but they couldn't rise at their former pace without violating the laws of financial gravity. A \$3 trillion price tag on a market with \$200 billion earnings might be reasonable--but \$10 trillion? No way. (Page-279).

When you start paying a premium, then the financial returns decline.

If there is one thing that Wall Street misses out on--I see almost no mention of it anywhere--is the **link between the financial characteristics of the business that you are buying and the return you get as a function of the price you pay for that business**. Don't forget that! The nonsense from Wall Street of X percent growth for 5x earnings. Life is not that simple. There are ways to look at valuing companies that are much more helpful to you.

So we talked about intrinsic value vs. market prices.

--

### The Specifics of What I Do

I am a **financial** analyst. I am very interested in the numbers. If you look at companies, there is a wealth of information in the financials.

If you speak to management and they have done well, they will say they will continue to do well. Or if they have not done well, then they will do well. Not all companies have superior financial characteristics. **As I have grown older, I am increasingly interested in only those companies that have superior financial performance.** The relatively few companies that generate high returns on assets and high returns on equity. These companies generate cash in excess of their internal needs and because of their excess cash generation have little or no debt. My personal choice within those types of companies, I restrict my interest to seasoned companies. These are companies that have an operating history of 10 to 15 years.

When I say seasoned, I don't mean mature or declining. I mean companies that have been around for a while. And these companies have developed a record that includes some periods of recessions and adversity or other periods of stress. I want to get some feel of the ebb and flow of the business. And the results of the company lend themselves to this normalization process. You can assess the company through difficult periods. Again a personal preference, I am interested in companies of a pretty large size. The amount of money that I manage does not require that I invest in large companies, but that is where my interest is. Very rarely will I invest in companies having capitalizations with less than a billion dollars.

I certainly don't restrict myself with a label like some money managers who say they are a large cap or mid-cap managers. **I find value where a find it--**given the other criteria right now for companies being seasoned and having a long track record and also having superior financial characteristics. If a company has been around for 10 or 15 years and has superior financial characteristics, it is not going to be a small company. There are many rewarding opportunities in those (smaller) companies with shorter, 5 or 6 years of operating history, but without the long track record or without the period of adversity—it is arbitrary--but I am adverse to investing in them.

In terms of the companies that pass through all of my filters probably..... If you look at *Value Line* with more than 2,000 companies there that are included in regular research coverage, there are no more than 50 companies that meet the criteria of size, length of record and superior financial characteristics. **I would argue with any of you that it would be possible to have a wonderful career, make a lot of money and be very satisfied in every way if you excluded all but those 50 companies.** None of you, of course, will take that advice, but it would be possible. Many investors would be better off if they stuck to those companies.

Also, I would say the bigger companies are like super tankers, they don't change rapidly; they don't change overnight. What we see in the papers, a company will miss by a few pennies and the stock will drop 15% to 20% overnight. That is crazy. The value of the company hasn't changed, and therein lies your opportunity. The value of the company almost certainly hasn't changed. There is much more price volatility than is appropriate for companies like *Coke, Intel, Cisco* and the like than the underlying values.

Again I am looking for:

- (1) companies that are not very volatile (in their operating and financial characteristics) and



- (2) produce consistently good results that lend themselves to normalization. To identify very big companies where there is an attractive opportunity.

Even companies that are so widely followed--they have so much research coverage that they have got to be efficiently priced--I would argue that there are opportunities that present themselves.

#### There are a Couple of Big Ideas I Want to Talk About.

I gave you an excerpt from *Berkshire Hathaway* (1996) where *Warren Buffett* says that the long run performance of the stock is linked to the long run performance of the business. This is not unique to *Berkshire*. The long run investment return that you make is linked to the long run performance of underlying business in which you are investing. This is where the element of margin of safety comes in. If you can buy a business at a 30% discount and the underlying value is growing, then you will benefit from that underlying growth of the business but also from the narrowing discount between the price discount and the intrinsic value. The market prices the discount in your favor.

If you buy something at 70% of value and the value grows over time then in 5 years then you will benefit by the growth in the underlying business and the accretion of the discount. In five years you will get 6 points a year of narrowing discount ( $5 \times 6\% = 30\%$ )—that is the margin of safety. Once you get to 100% of value, your investment will track the growth of the business as long as the relationship holds.

Understanding ROE.  $ROE = \text{Net Income} / (\text{Beginning Equity} + \text{Ending Equity}) / 2$

Example: *Microsoft* had above 30% ROE with no debt in the early 1980's

Year	Beg. Equity	Net Income	End. Equity	ROE	Net Inc. Growth
2000	\$8,000	2,825	10,825	30%	
2001	10,825	3,825	14,650	30%	35.4%
2002	14,650	5,179	19,829	30%	35.4%
2003	19,829	7,012	26,841	30%	35.4%
2004	26,841	9,491	36,332	30%	35.4%
2005	36,332	12,847	49,179	30%	35.4%
2006	49,179	17,390	66,569	30%	35.4%
2007	66,569	23,540	90,109	30%	35.4%
2008	90,109	31,865	121,974	30%	35.4%
2009	121,974	43,130	165,104	30%	35.4%
2010	165,104	58,380	223,484	30%	35.4%

The key to understanding ROEs, *Buffett* notes, is to make sure that management maximizes use of the extra resources given it. (Source: *How to Pick Stocks like Warren Buffett* – *Timothy Vick*)

*Robert Bruce*: I find it an irony. *Warren* works so hard to keep his shareholders informed so the market value of *Berkshire Hathaway* stock does not deviate far ever from the intrinsic value of *Berkshire Hathaway's* business. I think that is an admirable goal for him.

The irony for him is that his vehicle of wealth creation has been to buy companies where the market price of the stock is trading below the company's intrinsic value. The idea here also ties into *John Maynard Keynes* who talks about the long term yield of an investment over its life. An investment held for its full life. This is the same idea that *Warren* is talking about.

When you think about the stock market that way, what the stock market is affording you is liquidity. You make an appraisal of the company and an appraisal of the future cash flows for the business, you like the outlook for the business, you like the price and you make an investment.

Now you have two choices:

- (1) You can hold the investment for a very long period of time as the cash flows are realized or...
- (2) On the other hand, the stock market gives you an opportunity every minute of every day to say, "I won't wait around for the long run for this business to develop but I will sell it to someone else who will wait around and I will take the present value of the cash flows today."

In the long run, incorporation has a very long life. So what we try to do in assessing businesses is to figure out which ones we have the capability to figure out the long run cash flow projections. As I said at the outset, some businesses lend themselves to that and others don't. The idea being this price to value.

If I could offer anybody here a perpetual risk less cash flow of a dollar per year, you would understand that the price you pay for that cash flow would be a significant determinant of the return you would receive. And let's say you said you would pay me \$2 to receive \$1 per year for 3 years. This is the important assumption about reinvestment.

**The important concept of reinvestment assumptions at a certain rate—Yield-to-Maturity.** The same thing is true with common stocks. With stocks the cash flows are unpredictable, but once again, **the price you pay determines your return.**

Stocks Are Bonds with Less Predictable Coupons

Year	EPS	Coupon Return on \$20 Price
2000	\$1.00	5.0%
2001	1.25	6.3%
2002	1.56	7.8%
2003	1.95	9.8%
2004	2.44	12.2%
2005	3.05	15.3%
2006	3.81	19.1%
2007	4.77	23.9%
2008	5.96	29.8%
2009	7.45	37.3%
2010	9.31	46.6%

If you must buy a stock, *Buffett* says, make sure that the company's earnings coupons:

1. Can beat inflation
2. Can beat govt. bond yields, which are priced to reflect inflation
3. Can rise over time

Assuming a constant return on reinvestment, the price you pay determines your return. Compare returns when paying \$40 per share vs. \$20 per share.

Year	EPS	Coupon Return on \$40 Price
2000	\$1.00	2.5%

2001	1.25	3.1%
2002	1.56	3.9%
2003	1.95	4.9%
2004	2.44	6.1%
2005	3.05	7.6%
2006	3.81	9.5%
2007	4.77	11.9%
2008	5.96	14.9%
2009	7.45	18.6%
2010	9.31	23.3%

Once again the reinvestment assumptions of how the company uses its cash flow are the ultimate determinants of return. Of course, as a fixed income investor, you know the reinvestment assumptions are very important in determining your yield to maturity. The same is true with common stock because, instead of buying a predictable cash flow, you are buying an unpredictable cash flow. **Once again, the price you pay determines the return you get.** The investment assumptions are the ultimate determinate of the enterprise. But the idea here is to think of being an owner, owning a piece of the enterprise. You are buying for the long haul. The idea being that you will probably not sell it unless it (the price of the stock) gets sufficiently above its intrinsic value.

--

#### IV. Now, what kind of company to look for?

One thing that comes up all the time is how do you screen stocks, what is the first thing you look for? What I look for ideally is for **good businesses**. These are businesses that are consistently above average in profitability because of that they generate free cash and because of that they have low or no debt--all of these things go together. If you find a business that is superior in profitability, you will find it has nothing but good choices as to what to do with its cash: pay out dividends, buy back stock, reinvest, etc. A company generating free cash doesn't have to borrow money.

**So look for companies that consistently earn superior profitability.** When you find a company that earns consistent superior profitability, then you need to look a little further. What is it about this company that allows it to earn superior returns and prevents competitors from coming into their market and pressuring those above average profits? This is the idea of a franchise business with a moat around it or a niche business.

What is it about *Clorox* that allows the company to sell a toxic chemical at a larger mark-up than a generic brand? The answer is advertising, the brand coupled with customer captivity. There are companies with patents that have great efficiencies, they control a regional geographic market. Less so than in the past, but there are one paper towns--monopoly newspaper. *Warren Buffett* said of the *Washington Post*, that if you gave him a billion dollars to compete against the *Washington Post*, he would fail miserably and he wouldn't be able to dent the franchise. This is an example of an entrenched franchise with a moat around it.

The reality is in the very competitive world we live in, there are very few businesses, which have permanent moats. Franchises are under constant attack. Rarely do you have a business that has a franchise value and also the opportunity to grow. Companies fortunate to have a franchise business, they reinvest as much in that business as they can and still earn a superior profit. Rarely do they have the opportunity to reinvest their cash and earn the same returns as their original business. Probably the greatest success of my career and one of the greatest successes ever in one generation is *Wal-Mart*. In the space of one

generation, a fortune of close to \$100 billion was created. *Wal-Mart* was extraordinary, something I have never seen again, *Wal-Mart (WMT)* earned 25% or more on its equity and it had the opportunity to reinvest all its profits every year in new businesses, in new stores and continue to earn 25% or more--a wonderful compounding went on for a long, long time.

In contrast, *Microsoft* has huge cash flow, but there is nothing they can do with that excess cash to earn the high returns of their core business. *MSFT* has a core business that is a monopoly with a very high wall around it and they work very hard to protect what they have, but *MSFT* has nowhere to grow or reinvest their cash.

The reality is that the kind of businesses that combine these traits to be superior businesses are rare, and I will mention a few names here--we are not talking about multiple names--*Liz Claiborne*, an apparel manufacturer. There is *Superior Industries*, which makes wheels for the automobile industry, *Rayco* that makes paint sprayers. There are probably 50 to 100 in this category.

**Buffett on researching a company:** *Buffett* told *Bob Woodward*, the investigative reporter who uncovered *Watergate*, that, "Investing is reporting." ...."A sensible story to assign yourself would be, 'What is *The Washington Post Company* worth? Now, if (Editor) *Bradlee* gave you that story to work on what would you do for the next week or two? You would go around and talk to people in the television business. You would try to figure out what are the key variables in valuing a television station and you would look at the four that the *Post* has and apply those standards to that. You would do the same thing to newspapers. You would try to figure out how the competitive battle between the *Star* and the *Post* is going to come out and how much different the world would be if the *Post* won that war. All of these things are a lot easier than the problems *Woodward* would be working on. Usually people would want to talk to him but on this subject they would be glad to talk to him, and then I said when you get all through with that, add it up and divide by the number of shares outstanding. All he had to do was assign himself the right story and I assign myself stories from time to time."

If you want a really easy way to identify some of these businesses, go to the 13-D or 13-F filings of *Berkshire Hathaway* and look at some of the companies owned by a great investment manager, *Lou Simpson*. Then wait for the prices to fall from time to time. These are businesses, which generate cash, they generate more cash than they need. Companies, which have little or no debt, which buy-back stock, and pay dividends. This is the preferred type of investment, the preferred option in my opinion--a good business that appears to have a wall around it.

**LOU SIMPSON: The Oracle of Rancho Sante Fe (Of Permanent Value, 2004 Ed.)**

Geico in 2000 Held Shares in	Other Stock Picks:
Dun & Bradstreet	Manpower
First Data	Burlington Northern Sante Fe
Freddie Mac	Mattel
GATX	International Dispensing Corp
Great Lakes Chemical	Apache Medical Systems
Jones Apparel	CollaGenex Pharmaceuticals
Nike	Cohr
Shaw Communications	
US Bancorp	Comcast
	Fair Isaac
	DSM.com

*Buffett on Lou Simpson:* He has the ideal temperament for investing. He derives no particular pleasure from operating with or against the crowd. He is comfortable following his own reason.

Simpson was picked for three qualities: intellect, character and temperament. Temperament is what causes smart people not to function well. Like Buffett, Simpson is a voracious reader of annual reports, newspapers and magazines. Plowing through 15 corporate reports in a row is his idea of a satisfying day.

## V. Research Management

If you find an investment and the value makes sense, then the next thing is to find out whom you will entrust your money to. Look hard at management. Find out how much stock the management owns, how management acquired stock in the company, how much each Director owns of company stock and find out about the relationships between the Directors and the management. Is management incentivized to build value for the shareholders?

On the one hand, we are talking about financial analysis and looking at the numbers but on the other hand in an investment in a company, you are becoming a *silent* partner or junior partner in that company. So before you make an investment in the company, you should do the best you can to ensure that the people running the company are people you can trust. If you look at the people in the companies involved in the front-page scandals in the business press, like *Enron*, *Computer Associates* and *Imclone*, the principals were involved with shady dealings long before those scandals erupted. Remember that you are entrusting a lot of responsibility to management when you invest your money.

If you are not a professional money manager and can't talk to management, then **read the proxy carefully** and read the last 4 or 5 annual reports--read them sequentially to ascertain their candor and if they are self-critical and you have some comfort that you know what they are trying to do. All too many times, if you read the annual reports, there is no connection at all. The goals, tone and message change year to year--without explanation. It is very much an ad hoc kind of thing. Sometimes it is just a matter of what is popular at the time.

### *Example of ROAC annual reports*

What I like to see is a company that sets forth its goals and objectives. The company says what it is trying to do, it says, this is what we are good at; this is what we are not good at. This is where we are trying to improve. Then at the next opportunity the same manager gives himself a report card. This is what we tried to do, this is what we accomplished this is what we have to do. It is honesty, candor, and admission of failure--a constancy of goals.

We have talked about the financial characteristics of the companies to look for. We talked about making an effort to identify the kind of people who are running those businesses. Whom we are partners with.

One of my pet peeves is the **Imperial CEO**. The idea that we have corporate CEOs as national heroes. Some of the publicity is unavoidable and some of it, quite honestly, is sought after whether it is *Jeff Immel*, *Sandy Weil* or *Carly Fiorina*--they may or not may not be good people, but that is not what I am talking about. The idea that *CNBC* or *Bloomberg* can say, "*Jeff Immel*, he is your friend. He is one of us." I am talking about the CEO who may be a very rich man, a very successful man but no one outside his industry knows about him. So the idea those individuals are important--*Bloomberg* says, "Today, *Sandy Weil* went out and bought a bank."--The news media personalize the CEO. *Sandy Weil* didn't buy the bank, *Citibank* did. *Citigroup* is much bigger than *Sandy Weil*.

**Buffett on choosing people.** *Buffett* describing how he would choose a leader (to run *Salomon Brothers*). "They all had the IQ, just like everybody in this room (Columbia Business School students). It doesn't make any difference whether your IQ is 140 or 160 if you're running Salomon or doing most things in this world. They all had energy level and the desire. So the question was: Who would be the best leader? Who was going to go into a foxhole with me?"

"I devised this little system in getting you to think about how you might attack that problem yourself, or how you might be the person that would be chosen under those circumstances. Imagine that you have just won a lottery I conducted. And by winning it, you had a very unusual prize. The prize you get is the right to pick within the next hour one of your classmates. And you get 10% of the earnings of that individual for the rest of your life.

What starts to go through your mind? Are you going to give an IQ test or look up their grades and take the person with the highest grades? Are you going to try to measure desire or energy or something? I think you'll decide that those factors tend largely to cancel. They could be important up to some threshold limit, but once you hit those levels, you're OK.

I think you'll probably start looking for **the person that you can always depend on**; the person whose ego does not get in the way; the person who is perfectly willing to let someone else take the credit for an idea as long as it works; the person who essentially wouldn't let you down; who thought straight as opposed to brilliantly.

And then, let's say there is a catch attached. For the right to buy this 10% interest, you had to go short 10% of somebody else in the room. So in effect, you get the 10% of the first person's earnings, but you have to pay out 10% of the second person's.

Now again, do you look around for the person that is a little slippery, the one that everything has to be his or her idea, the one that never quite does what is expected of them, or pretends to do things that they don't. You really get back to things that interestingly enough...are things that **you can control**.

You have these--what I would call--voluntary items of character, behavior. Essentially, you can pick out those qualities of behavior, and if you want them, you can have them yourself. And I would say that most if it's habit. It is just as easy to have good ones as bad ones, and it makes an enormous difference.

## VI. Waiting for the right price

I just want you to be aware that this personalization of corporations is recent in the last five or ten years. Now, in terms of finding franchise companies to invest in, checking to see if the managers of those companies are the type of people you want to be with.

Then what do you do? You want to wait for the stock to trade at a price discount to value. Nearly all the companies we are talking about have great financial characteristics, they are well regarded and nearly all of the time they will trade at or above intrinsic value. They are easy to like. So what makes the opportunity occur? Sometimes the company fails to make its earnings expectations or the company recalls a product. There is some type of disruption, something goes wrong, that the market is worried about in the short run. My experience has been that you have to have done your work in advance, that you don't have time to react. Chances are you won't have enough time to do a good enough job to take advantage of the opportunity.

The image I have is **shopping for shoes and waiting for them to go on sale**. I know what I want and I wait for them to go on-sale. You go to a shoe store and you walk up and down the aisles and look at all the shoes. You like that one and that one, but they are too expensive. I think I will come back when they go on sale.

So what I do is I look for companies that fit my financial characteristics, my perceptions right or wrong of the quality of the company. I have a lifetime experience of getting to know 200 or 300 or 400 companies that might fit my description. And I never know when any one of them stumbles, but if it does, I would like to be prepared. I got my eye on a lot of different stores, but I have my eye on enough shoes that if any of them go on-sale, I am ready to act quickly.

## **VII. How do you know if the problem is a blip or the beginning of the end?**

It is not an easy question to answer. The cliché of momentum investors is that there is never only one cockroach. The first piece of bad news is never the ultimate bad news. That isn't my theory. In the kind of companies that I look at, if I understand the business well, if I understand what makes them work, if I have a reasonable understanding of its business model and the environment in which it operates, I should be able to distinguish if it is a long run or short run problem. If it is indeed, in fact, a long-run problem, then I exclude it.

The best example I have for that was what happened when *Hillary Clinton* had her health care scare. When she put her study group together to socialize medicine, it caused all the major drug companies to be targets, the stocks sold down to levels that in retrospect were extraordinarily attractive. But the investor had to know the prospect of her bill/act passing. I didn't know at the time, but if I had, then this would have been an opportunity.

There is one other type of company, speaking for myself, I like to find companies rich in assets. **Companies with hidden assets.** These may be companies, which may be a little more difficult for the casual investor to understand, but the companies are rich in assets and may not have extraordinary attractive operating characteristics. For example there is a company--I am not long now--called *St Joe Corporation* which owns 4% of the state of Florida. It is a fascinating business. The operating characteristics are not particularly eye-catching. Other companies may have natural resources--timber, ore in the ground, oil and gas, real estate. These are assets that are not recorded accurately in GAAP financial statements. So you have to read the company's footnotes.

Remember that when a company invests a million dollars to drill an oil well and the oil discovered is carried on the balance sheet for a million dollars whether the well produces 1000 barrels or a million barrels of oil. The GAAP numbers don't tell you enough. You have to look behind those numbers. The same thing is true in regards to timber assets. The market value may have little relation to the cost of the timber purchased 30 years ago.

## **VIII. When do you sell?**

Always be aware of intrinsic value. What happens when you buy at \$70 because the intrinsic value is \$100, but now the stock is \$50 but the intrinsic value is \$70--it is still selling at a big discount. What do you do? Your confidence might be shaken in your ability to judge intrinsic value. There is no easy answer. *Warren Buffett* in his 2003 Annual Report expresses regret in not having sold some of his large marketable securities--his *Coke* and *Gillett* during the bubble.

I am not dealing with companies, which go up and up and up for 10 years. Because I am sensitive to intrinsic value, because of the types of companies I am dealing with. If I buy a company at a big enough discount, I sell when it reaches intrinsic value. As a result I have almost never had a security that goes up several times.

*Buffett* has said he has identified companies that are so intrinsically wonderful, that he will hold them forever. Now, he is saying there is a time to sell. (*Buffett mentioned this in his 2004 annual report to Berkshire shareholders*).

Short selling based on this intrinsic value analysis, for whatever reason, does not work. On the upside, there are times when companies are selling at 20 times their intrinsic value.

There is no right multiple for a company. When you look at a company, you have to answer two questions? **What am I looking at?** That is my financial analysis part. Will this business grow rapidly or slowly? Is it sensitive to the business cycle more or less? Is there another cycle it is responsive to? Does it have a franchise? Is it a commodity business? Does it generate cash or consume cash?

Once you have a handle on the nature of the business, on what you are looking at, then you must decide **how much am I willing to pay for it?** It doesn't make a bit of difference what other people think, you are the one making the investment. Given my understanding or what I have just analyzed and in order to earn the return that I want to earn, this is what I am willing to pay. Every choice is particular to you.

Security selection and stock selection are what I am interested in speaking about vs. portfolio management. For those of you who haven't looked, my partnership is very concentrated. We have major illiquid positions held for a number of years.

MANAGEMENT CO INC.			
13F-HR 07/25/2003			
Holdings		(\$000s)	Shares
HOLLINGER INTERNATIONAL INC		604	56,100
LONE STAR TECHNOLOGIES, INC.	??	163,414	7,715,472
MCMORAN EXPLORATION COMPANY		32,812	2,945,423
MCMORAN EXPLORATION COMPANY	5%	17,183	260,400
MESA ROYALTY TRUST		36,567	698,516
PHOSPHATE RESOURCE PARTNERS		35,425	28,115,300
SAN JUAN BASIN ROYALTY TRUST		131,270	7,313,100

I will talk about *Hollinger International Inc.* briefly. All the investing that I do is passive. I don't invest in a company in the expectation that I will change the management. *Hollinger* is a Canadian newspaper holding company controlled by *Conrad Black*, a controversial character. But the holding company holds very valuable assets.

The *Hollinger* investment has very valuable newspaper assets that are temporarily tarnished by bad management, *Conrad Black*. The company has a \$20 intrinsic value and it is trading now at \$19.50. The company was easy to value because newspapers trade all the time (*note private market values transacted for cash in a negotiated transaction*). There are many comparables. So why was a company selling at such a discount? The answer is *Conrad Black*. We determined that the valuable assets would dominate over the situation of *Conrad Black's* poor management and the size of the price discount adequately compensated for the risk of management. This investment is not plain vanilla. Newspapers have consistent profit. *Dow Jones* and *Washington Post* trade often at 90% to 110% of fair value. *Hollinger* traded at 40% of fair value. Note the 60% disparity.



As it turned out *Conrad Black* overstepped his bounds, *Chris Browne* bought 25% of the company and forced change. The company is in the last phase of an auction sale. Were it not for Chris Browne acting as he did, we might still be in a stock that trades at a big discount to its intrinsic value.

--

### Institutional Money Management

*One of the themes I want to talk about is the increasing influence of the institutions and how they are behaving. The behavior of the big institutions does tend to create opportunities.*

Why behavioral finance fascinates me.....I included a number of pages from *John Maynard Keynes'* book, The General Theory of Employment, Interest and Money. You don't need me to tell you that *Keynes* was a genius. **One of the manifestations of genius is farsightedness.** Most of the brilliant people I have known are those who can see the most moves ahead in the chess game. One of the fantastic things about this piece is that it was written 75 years ago, but it is 100% timely and appropriate for today. He talks about the idea that the institutional behavior is no different than individual behavior. I will read you an excerpt.

#### Quote from Keynes:

This battle of wits to anticipate the basis of conventional valuation a few months hence, rather than the prospective yield of an investment over a long term of years, does not even require gulls amongst the public to feed the maws of the professional; -- it can be played by professionals amongst themselves.

This is exactly what goes on.

Another Quote from *Keynes* that applies to the market even today:

...It might have been supposed that competition between expert professionals, possessing judgment and knowledge beyond that of the average private investor, would correct the vagaries of the ignorant individual left to himself. It happens, however, that the energies and skill of the professional investor and speculator are mainly occupied otherwise. For most of these persons are, in fact, largely concerned, not with making superior long-term forecasts of the probable yield of an investment over its whole life, but with foreseeing changes in the conventional basis of valuation a short time ahead of the general public. They are concerned, not with what an investment is really worth to a man who buys it "for keeps", but with what the market will value it, under the influence of mass psychology, three months or a year hence.

We should talk a little bit about institutional investors.

#### What are the institutional imperatives?

This may not be terribly original but most institutions behave the way most large institutions do. Whether they articulate it or not, they are in the business of gathering assets, generating fees, not losing investment funds, and not having clients leave is critical. Given such a set of factors what they do is they manage quite timidly. Many of them are closet-indexers.

I enclosed articles from the Economist showing the important influence of index trading. An excerpt from the Jan 28, 2006 Economist:

**Quirky and costly:** These results pose a puzzle. How can passive investing account for such a big share of American trading, when passive funds hold such a small share of investors' assets? The answer may be that actively managed funds are less active than they claim. Many may be closet trackers, departing from the index only at the edges of their portfolio. There are good reasons for such caution. A stock

picker, if he is to distinguish himself from the herd, must expose his funds to the idiosyncratic risks that rock individual companies and sectors. A passive investor, on the other hand, is vulnerable only to systematic risks that sway the market as a whole. ....

SOURCE: [Is Stock Picking Declining Around the World?](#) Utpal Bhattacharya and Neal Galpin  
Indiana University Bloomington - Department of Finance and Indiana University Bloomington.  
*Date posted to database:* November 18, 2005

**It means that money managers are obsessed with the short run and tracking error.** They do not want their portfolios to deviate far from their benchmarks in any short run period. They can't tolerate that and they do not wish to have to answer or explain the deviation to clients or why they have deviated in a short period of time. So these money managers put together a portfolio that closely matches their relevant index. The net result is that they are closet indexers. It means their behavior leads to counter productive investment results. I have two examples to cite to you.

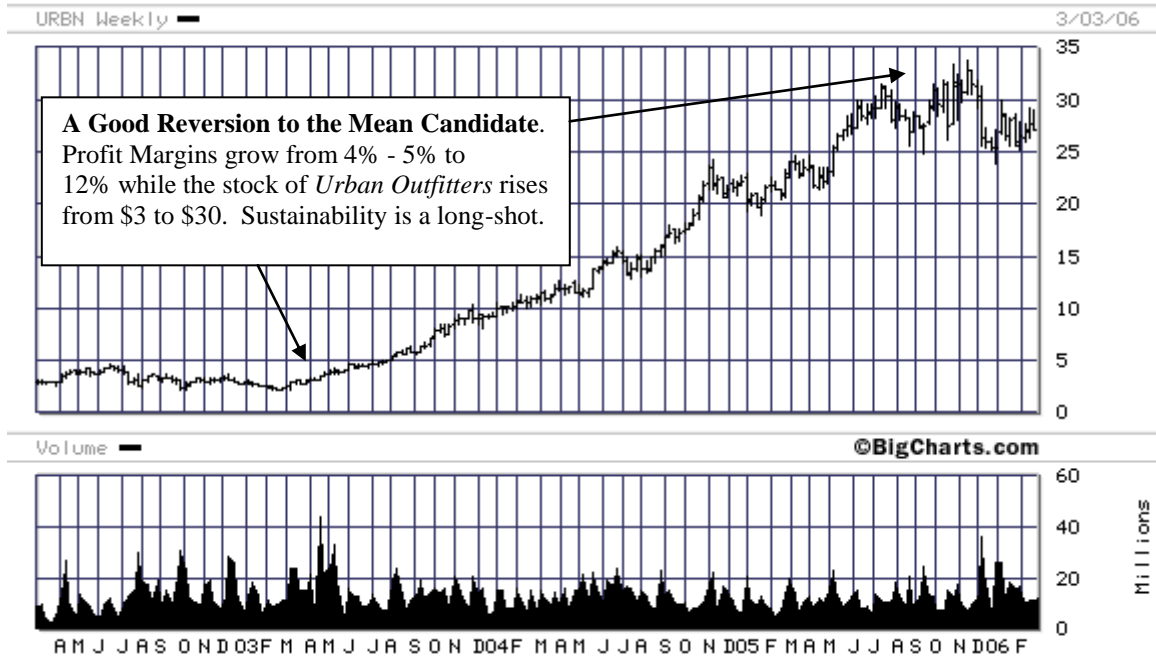
--

### **Reversion or regression to the Mean**

#### **Urban Outfitters (URBN)**

I included another nice company in here, *Urban Outfitters (URBN)*. I included this company as a wonderful example of a reversion to the mean candidate. Again, the stock traded as low as a dollar (\$1) in 2001 and it is now trading up to \$30 in the market. Its success has not gone unappreciated in the market. Yet, if you look at a bench mark period of late 1999 and early 2000, you see that *Urban Outfitters* had a net profit margin of 3%, 4% or 5% and now it has a 12% to 13% profit margin. The profit margin has doubled or tripled in five years and at the same time the stock has doubled or tripled in its valuation.

So this is a company, relative to its historical norms, is earning double or triple its profitability. The company is trading at double its valuation during a long historical period of time. This is a classic reversion to the mean sell idea. I am not making any prediction about *Urban Outfitters*; I have no way of knowing because I have no idea what this company will do in the short run or the long run. **But if you look at this company, the idea you get is that there is a lot that could go wrong here and not much that can go right** (*the odds are shifted against you*). *Urban Outfitters* can continue to do well over a long period of time, its sales and earnings could grow, but if there is any type of mean reversion, there could be very disappointed investors. That is one example.

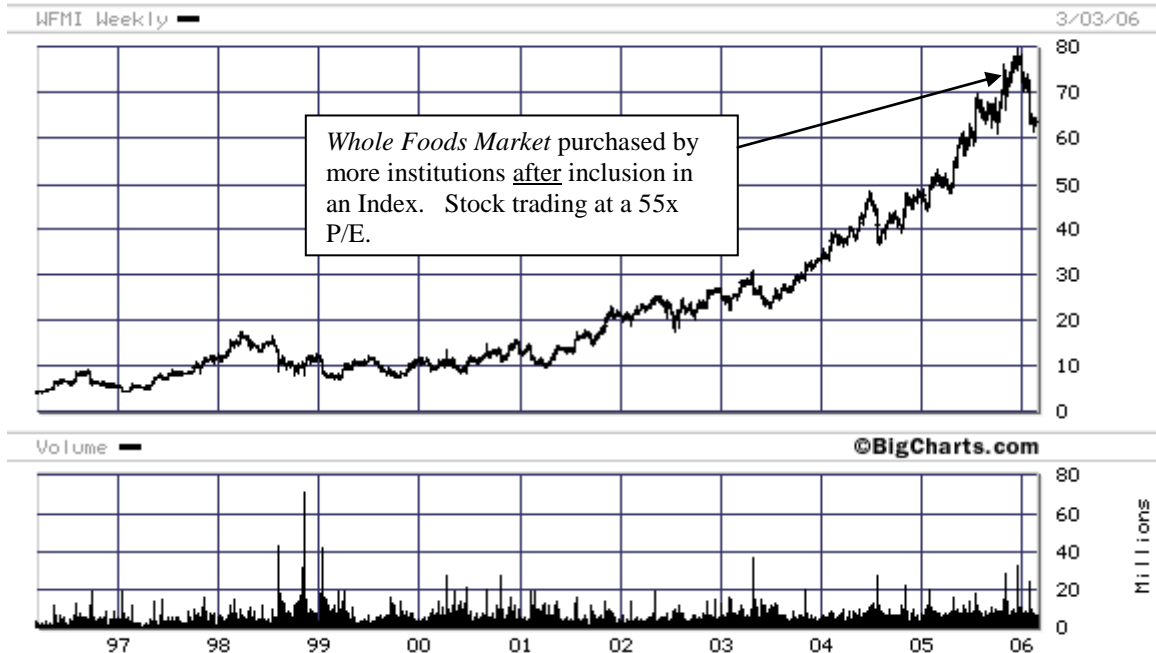


The punch line of all of this is that the institutions are big. The statistics that I gave you from *John Bogle's* book, The Battle for The Soul of Capitalism--he speaks about the incredible concentration of investment power in the hands of relatively few numbers of institutions. **What they think and what they do, it really does matter.** It is not surprising that from time to time they get carried away on the upside and downside. For those of us who are value oriented investors, who do the normalizing and who recognize that things are never as good as they seem and as bad as they seem, we try to take advantage of these trend extrapolators and their failure to normalize—the mistake that the big institutions make.

I think an important element of being a value investor is having a longer-time horizon than the very short time horizon that many of the largest institutions have. How often do you hear on *CNBC* that they say, "I would get out of this stock because they will have a bad quarter." That is the mindset. Whereas any of the astute value investors in this class would say, "Well, I would first figure out the value of this company regardless of what it will earn in the next quarter or two. If, today it is selling at a discount to the normalized fundamentals, then maybe I would buy it today even knowing or expecting the next two quarters will be bad. You don't hear much of that from main street.

--  
**Whole Foods Market (WFMI)**

One of the examples that I gave you (*Value Line Tear Sheet*) is *Whole Foods Market (WFMI)*. It is a wonderful company with a fabulous record and a great future ahead of it by all accounts. If you look at the price history of *Whole Foods*, the stock has gone up this decade 10 fold. Very recently and with the stock trading at 55 times earnings, it was included in the S & P 500. And the institutions who index and the de facto index funds bought the stock at the very top—the price in the high \$70's.



Let me ask the rhetorical question, “**Whose interest is served by that?**” I cite that as a recent example of investment behavior that seems to work well for institutions but not well for their investors or their clients.

They (institutional investors) also are trend extrapolators. Businesses that are bad are going to stay bad forever, and businesses that are good are going to stay good forever. Institutions are not good at normalizing investment results or in practicing reversion to the mean thinking. I have a couple of other examples in here about that.

--

**I tried to explain and put forth to you the plain vanilla way of value investing.** Lot of what you see in my portfolio is not plain vanilla and is probably beyond the scope of this lecture at this time.

In summary in talking about value investing, in general, the rules of the game and the synthesis of what I know:

- **Stick to what YOU know.**
- **Determine intrinsic value.**
- **Prefer superior businesses.**
- **Have a margin of safety.**
- **Look for Insider Ownership.**--significant to the needs of mgt. Be careful of too much inside ownership where a public company is treated like a private company.
- **Try to make an honest judgment.**
- **And be prepared to act contrarily.**

I tend to act slowly. I stick to investments within the US/Canada.

## New Subject

I would like to touch on another subject that is dear to my heart. Rather than give you the idea that there are no opportunities in the market. **There always are opportunities in the market.** They just are not in places where there are a large number of other people looking.

I highly recommend: read the book, Irrational Exuberance by *Robert J. Schiller*. This book helps to explain why value investors have struggled since 1998. (2005, 2<sup>nd</sup>. Edition is now published)

**Buffett's Reading Suggestion:** Bull! A History of the Boom, 1982-1999. What Drove the Breakneck Market--and What Every Investor Needs to Know About Financial Cycles by Maggie Mahar.

Here is a chart of P/E ratios early in the book that shows the real S&P composite from the 1850s and the chart goes up and up from the year 1996. That has been a problem all value investors have been dealing with since the late 1990's. I could offer you a reasonable, plausible explanation for how the stock market trades from WWII until the late 1990's using the Warren Buffett's type of analysis in the article that I gave you (Fortune, 1977): what corporate America was earning, what competing interest rates were and make an assumption about the general type of attitude of the tolerance for risk.

I and others like me could make a reasonable explanation of how the stock market acted up until late 1998. At which point, the market went completely outside of historical context. That is the jist of this book; it is what this book addresses. A logical examination of what happened and why.

After 1996, valuation went beyond all historical context. Some say that what happened in 1998 to 2000 was reasonable and correct, that people have been wrong in evaluating the stock market for 100 years. I conclude that is not the case, but that is why value investors are having such a hard time finding stocks. **Everything I look at today has unacceptably high risk.**

The one area I want you to think about, an area, which raises a lot of questions and no answers is **inflation** an old fashioned idea. In the early part of my career, I spent a lot of time with this problem. The kinds of companies and investments that are good in inflation and are not good when inflation is not around and vice-versa.

Define terms again to make sure we are on the same page. Definition: inflation is a rise in the general price level. Inflation is not caused by the rising price of oil or rising commodity prices. It is a rise in the general price level. Or another way of saying it is the depreciating value of the currency. It is a monetary phenomenon.

I had lunch with General Partner of *Lazard Freres* and he pointed out that if you had held Czarist Bonds or French Bonds, you would have lost 99.9% of all your money. It gives you an idea of the insidious effects of the long-term effects of inflation. Even if you have a currency that is losing 3% of its value per year, you can lose tremendous real purchasing power over time.

When I was at *Fireman's Fund* speaking almost every day to *Warren Buffett*, he used to use terms like dollars as bananas. Buffett said, suppose you could use a printing press down in your basement to print undetectable counterfeit dollars. But you are honest and you would never print such dollars. But one day your favorite Grandma needs an operation and you don't have the money, what do you do? Go to the basement.

The parable shows that when the choices are difficult, then the govt. will turn to printing dollars. The parable of Central Banking.

Given the huge budget and trade deficits that we have, it seems highly likely to me that the country, sooner rather than later, will resort to inflation as a way out of its problems.

**Buffett on inflation:** "If you forego the purchase of ten hamburgers and place those dollars in the bank for two years, you will receive back an amount equal to the number of dollars in the original deposit but which will only purchase eight hamburgers. You will feel richer but you won't eat richer."

If you look at the last paragraph of the Fortune, May 1977 (pgs. 250-267) article, How Inflation Swindles the Equity Investor by Warren Buffett that I gave you, he says, a well-chosen portfolio of stocks is still the best protection against inflation.

The purchasing power value of the Dollar was \$1.00 in 1940 and on 1992 it was \$0.09.

There used to be a raging debate over whether stocks were protection against inflation. Be aware of the possibility of inflation. If I am right about the re-emergence of inflation, then people will begin to look at which companies are better than others--helped and hurt by inflation. **KEY POINT.**

Note the Dividend Discount Model for valuing stock:  $Price = Dividend/(r-g)$ . The growth of the dividends relates to the growth of cash flow then this is subtracted from the demanded rate of return. You would think that inflation would cancel out in the equation (r-g) and in that simplified analysis stocks would be an inflation hedge. The model oversimplifies and that the incidence of inflation can, in fact, have a negative impact on the availability of distributable cash. Inflation leads companies to under-invest and under-depreciate, leading to overstatement of profits and overpayment of taxes. This leads to loss of cash available for reinvestment or distribution to shareholders. *(That is why as an analyst you must use true maintenance capex rather than the company's depreciate rates)*

You want companies that are not capital intensive. You want to invest in less capital-intensive businesses--depreciation is not a big issue. You want businesses with pricing power. We are looking for businesses with pricing power--a franchise company like Coke Enterprises. The customer is willing to pay more for the product.

When I visited the Chairman of *Coke* and asked him if he feared a price rise in aluminum due to the cost of his soda cans, he replied that it would help him disguise his raising of prices. This is an example of a company with pricing power, which would not be hurt by inflation. Coke could raise prices faster than the cost of their inputs.

The other type of company would be finance companies where the assets and liabilities are in dollars so they are hedged. (*Granite Bank*). Other examples include companies with fixed rate debt, companies with hard assets. Processing companies with a lot of through-put that get a rake-off such as oil refineries like *Exxon* or agricultural processing companies like *Archer Daniels Midland*. Others are exporting companies that benefit from a falling dollar.

**The worst companies are non-franchises in capital-intensive commodity markets subject to pricing pressures. (Airlines, Trucking, Steel Mills).**

Generally, looking forward the market does not seem to be prepared for the emergence of inflation. This is the one area to look.

**Post Lecture Q&A:** "I know a lot about Oil and Gas." I have a concentrated portfolio in *Lone Star Technologies (LSS)*. I own 25% of the stock. The best-managed company that I know of is *Exxon-Mobil*.

**Buffett Lecture on Franchises, Brands and Competitive Advantage: Coke vs. Generics.**

I think brand names with the right ingredients are enormously valuable. Sometimes infrastructure is a problem for the generics (private label Cola). The worldwide infrastructure for *Coca-Cola*, for example, is very impressive and very hard for a generic provider to duplicate. (*Huge fixed costs create a barrier to entry*)

Wal-Mart's selling Sam's Cola. And Wal-Mart is a very, very potent force. One thing that's helpful is that they were selling it as cheap as \$4.00 a case here. And I don't believe that is sustainable. That is 16 2/3 cents a can. I think the aluminum can is close to a six-cent item by itself. The can is far more expensive than the ingredients....Distribution costs, trucking, stocking and all that sort of thing have to be fairly similar. In a 12-ounce can, there's 1.3 ounces of sugar--which at the domestic price, would be around 1 3/4 cents per can. And that's got to be the same whether it's Sam's Cola or *Coca-Cola*.

The *Coca-Cola* Company sells about 700 million 8-ounces servings--largely of *Coca-Cola*, but also of other soft drinks--worldwide every day. If you take 700 million and multiply it by 365 days, you come with 250 billion or so 8-ounce servings of Coke or its products in the world each year.

The *Coca-Cola* Company made about \$2.5 billion pretax last year. That's one penny per serving. One penny per serving does not leave a huge umbrella. The generic is not going to buy the can any cheaper. And they're not going to buy the sugar any cheaper and so on. Their trucks aren't going to be any cheaper.

....The simple reason for our unwavering belief in *Coca-Cola* Company is no secret: People desire quenching their thirst--even in air-conditioned rooms. *Note: the thorough, simple analysis from the micro level on up.*

Notes from Irrational Exuberance

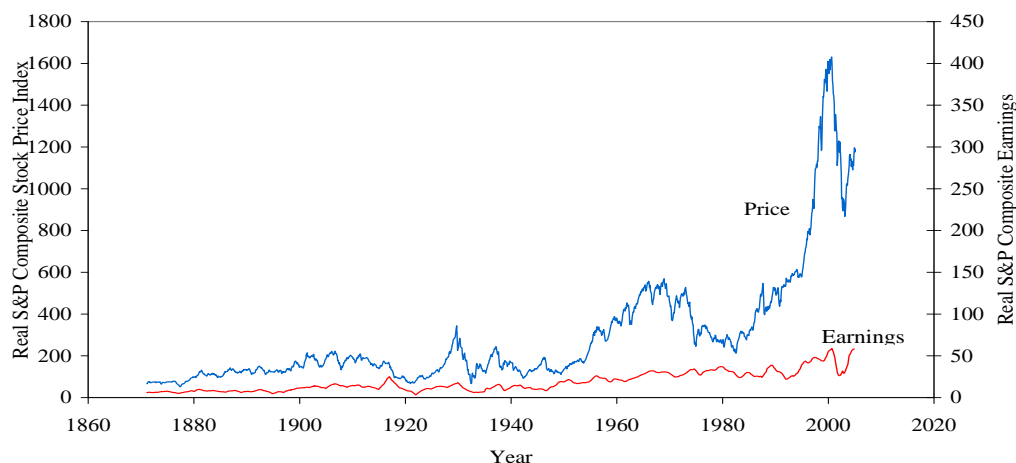
Since the late 1990's the stock market's P/E has risen up to 45 and not gone below 20 since that time. Why?

### **Chapter 1: The Stock Market Level in Historical Perspective.**

Between 1994 - 1999, stock markets doubled in Europe while the Dow went from 3,600 to 11,000 in the US. P/E ratios went from 22 in 1998 to 45. The higher the P/E ratio, the lower the subsequent 10 returns.

Another book, which is often referred to as a counter point to *Irrational Exuberance* is Stocks for the Long Run by Jeremy J. Siegel, (2002).

Robert Schiller Home Page: <http://www.econ.yale.edu/~shiller/>



-

## SEARCH

The Theme I Wish to Talk About Tonight is Value Hiding in Plain Sight.

Institutions, I believe, have collective blind spots. They are not constant, because they practice group think, they think the same way at the same time. They fall in love with the same things at the same time. And they lose interest in the same things at the same time.

I cited an example of *San Juan Basin Royalty Trust* oil and gas. The punch line here--this is the one of embedded options. This is one you are always looking for. You get a lottery ticket for free or cheap.

### Question #1: Where in general would you look for free options?

Anywhere there is a commodity element. The idea about investing as a value investor in a commodity producing company is to seek out where you have a low cost, unlevered low cost producer and where the underlying commodity is trading at or under the replacement cost. Because what you have to be careful of in commodities: as I said in *San Juan Basin Trust* ("*San Juan*") there was an option in a rise in the price of natural gas, but there is also an option on a fall in the price of natural gas. So the way you protect yourself against a fall in price is where the underlying price of the commodity is at or below the cost of production so there are no substitutes or threat of substitutes.

For the whole life of the investment (until now) it has traded 15% to 30% less than cash flows with a free option thrown in. Now it trades at a 120% to 140% premium and the price of the underlying commodity is trading way above the price to produce it. There is No Margin of Safety and the option value of the company is actually a risk right now.

*Bruce Greenwald:* Bruce, could you explain how you calculate that?

*Robert Bruce:* What I know about natural gas is how much it costs an efficient producer to find a MCF such as the costs in finding a prospect, hiring a rig, drilling a hole in the ground and adjusting for the risk. Over a long period of time there have been finding costs studies for oil and gas. Some of the big auditing firms actually publish big thick books every year. They take a couple of years to assemble the data. But



for a long time it takes \$1 or \$2 to find an MCF. All of a sudden the price of a MCF for Natural Gas went to \$6 to \$8 and then to \$12 to \$15 an MCF.

This was an extraordinary situation (investment) because there are very low risk options while you wait for something good to happen, but very rarely do you get paid so well while you wait. In this particular case, you were being paid 7% to 8% to 12% in cash while the opportunity materialized.

### Convertible Securities

In general, in investments for this type of opportunity—where you get paid while you wait—has been in convertible securities. Where you buy a convertible preferred or convertible debenture. You get paid a substantial coupon while you are waiting for something to happen. Many years ago, *Warren Buffett* made his convertible preferred investment in *Salomon Brothers* (“*SB*”) and it had a 9% coupon. It was very lightly taxed.

He referred to his investment in *SB* as a treasury bond with a lottery ticket attached. That is the term and he learned it from *Ben Graham*. In general, convertible preferred securities allow you to get paid but you do give up something. You pay a premium. But there are some convertible preferred securities there is a lottery ticket attached.

Concurrently, you might expect to find a free option. Now convertible preferreds are insanely expensive. The game has changed. The idea that you get paid to wait for an improvement in the underlying business, that opportunity just doesn't exist. Coupons are miniscule and premiums are huge.

### Merger Arbitrage

Another area where historically you can get cheap options is an area where I am not knowledgeable or skillful, that is the area of merger arbitrage where there will be a bid for a company, let's say, at \$20 per share the stock will go to a premium to \$21. If you are capable of assessing the probability of a second, higher bid, you can buy an option on the higher bid. You are paying a \$1 dollar premium over the existing bid and you are hoping that you will get a higher bid. It is a specialized area of investing. I know some people who are very good at it. It is an area that requires a lot of specialized knowledge.

The only area I think you will find a free option and today where you might find one—an option on a person or a group of people. The question I ask people about: options on people. If *Warren Buffett* were younger, instead of being in his 70s, he was in his 50s and he started a modestly sized, closed end mutual fund, how big a premium to net asset value (NAV) would it sell for? Clearly it would sell at a substantial premium because there would be a finite opportunity to ride on his coat tails for a long period of time. **An option on *Warren Buffett*.**

### Options on People

Other opportunities exist. There are managements who have extraordinary skills and track records. And where it is possible to buy a ride on their abilities for modest prices. These are options that I am fascinated by. There are winners and there are losers, and a vast sea of mediocrity in corporate America. But if the small number of winners, people who have long track records may be within the same company or they may be in other companies, but there are ways to buy options on the future of individuals.

I have a significant investment in a company right now where the man is a leading shareholder, less than 50 years old, he has made a billion dollars, and he has had multiple successes. All the checking I have done on him—his honesty, his hard work ethic—I am willing to pay a small premium which I have done relative to the underlying business which I have done to make a 20 year shot for the value I think he can create. I am sure there are other option opportunities out there. I think if you think about businesses as the here and the now and the option for the future, sometimes you can buy the future for not very much.

### Value Hiding in Plain Sight

Final Idea: If *San Juan Basin* was a value hiding in plain sight in front of value investors, are there such opportunities today? If so, where are they? Where is this value hiding?

Even though generally it is foolish to offer any opinion about the general stock market, **I think the stock market is priced to yield a low rate of return whether it is 6%, 7% or 5%--it is some low number like that.** It is a level of return I find very uninteresting. Even though it offers a risk premium to the long bond rate. The risk premium may be enough, but the absolute risk premium is unattractive.

*Buffett* in his 2005 Annual Report to Shareholders:

The Dow increased from 65.73 to 11,497.12 in the 20<sup>th</sup> century, and that amounts to a gain of 5.3% compounded annually. (Investors would also have received dividends, of course) To achieve an equal rate of gain in the 21<sup>st</sup> century, the Dow will have to rise by Dec. 31, 2099 to—brace yourself—precisely 2,011,011.23. But I am willing to settle for 2,000,000; six years into this century, the Dow has gained not at all.

The area where I think value is hiding in plain sight is some very large companies and very high quality companies which everybody knows, but for some reason or the other, where they are not fully appreciated. Specifically names like *Cisco*, *Coke*, *Intel*, *Nokia*, and *Novartis*—these are huge companies that everyone knows. I can see your eyes glazing over—**what can we/he know about these well known and over-followed companies?** I will try to explain it to you.

### Share Buy Backs

I have in here *Warren Buffett's* excerpt from his 1999 annual letter to shareholders where he speaks about annual share repurchases.

Now share buy backs are widely misunderstood. There are all sorts of half truths about share buy backs. When I speak to corporate managements I never bring up the subject of share buybacks. It is an argument I could not convince a management who wasn't already committed to it. There are some companies where share buy backs are part of the culture. Some companies do it consistently, some talk about it and some companies never do it.

So much of what *Buffett* writes, it is the clearest, neatest explanation about the right reasons for companies to buy back stock and under what circumstances he thinks it is a good idea. In your package here there are two lists of companies where the share count has dropped over the past 10 years and another list of companies where the share count has dropped over the past 5 years.

The share count reduction is important but you look at the share count and it doesn't go down. They are issuing stock faster than they can buy it back. It is a treadmill.

**Companies where there is a steady share count going down is a fruitful area for in-depth research.**  
Quote:....Charlie and I often...

Indeed, during the 1970s (and, spasmodically, for some years thereafter) we searched for companies that were large repurchasers of their shares. This often was a tip-off that the company was both undervalued and run by a shareholder-oriented management. *1999 Annual Report to Berkshire Hathaway Shareholders*

There are only six companies here who have reduced their shares for 10 years in a row.

Companies with Market Capitalizations in excess of \$1 billion for which share count declined every year 1996 – 2005

<b>Company Name</b>	<b>2005 year-end share count/ 1995 year-end share count</b>
NVR, Inc.	0.388
RadioShack Corp	0.543
IBM Corp	0.708
Reynolds & Reynolds Company	0.751
Anheuser-Busch Companies	0.758
Lancaster Colony Corp	0.765

The list is greater for the companies who reduced share count from 2001- 2005.

<b>Company Name</b>	<b>2005 year-end share count/ 2000 year-end share count</b>
AutoZone, Inc.	0.630
NVR, Inc.	0.677
Astoria Financial Corp.	0.702
RadioShack Corp.	0.721
Auto Nation, Inc.	0.747
The Principal Financial Group	0.762
Republic Services, Inc.	0.785
Westwood One, Inc.	0.812
Torchmark Corp.	0.819
The Timberland Co.	0.820
The TJX Companies. Inc.	0.820
Cigna Corp	0.822
Dun & Bradstreet Corp	0.826
TCF Financial	0.834
Imperial Oil, Ltd.	0.841
Autoliv, Inc.	0.850
Harte-Hanks	0.850
Sherwin – Williams Company	0.852
Mellon Financial Corp.	0.857
Commerce Bancshares	0.858
Anh. Busch Companies	0.858
Reynolds & Reynolds	0.859
Allstate Corp	0.865
Kimberly-Clark Corp	0.872

IBM Corp	0.879
H&R Block	0.885
Exxon Mobil Corp	0.887
Ross Stores	0.888
Hershey Company	0.892
Intel Corp.	0.893
Lancaster Colony Corp.	0.902
Federated Investors, Inc.	0.909
Oracle Corp.	0.916
BP, PLC	0.920
Wal-Mart	0.928
American Express	0.934
Aflac, Inc.	0.941
Altera Corp.	0.950

Be mindful, the last 10 years includes the bubble—the 1999 to 2001 period. Maybe some companies decided it was not a good value to buy their shares back then. Without ascribing motives to each of these companies, I just presented it to you as a fact that some companies buy in their shares. There are some companies year after year such that through share buybacks they are reducing their share count.

I digress now, but in all of your studies of the stock market, that over the long term the stock market will return less than 10% to 11% and of that 10% or 11% returns a big part has been dividends--a half to a third. Now, of course, the S&P 500 yield is 2% or less. One of the arguments that stocks will likely have lower returns in the future as high as we have had in the past. I would argue that, in general, that is true but **in specific examples, the payout to shareholders is much more than what is apparent on the surface.** A company that is paying a dividend and buying back a lot of stock is effectively returning money (capital) to shareholders. Some would say, “Well if I am not selling shares to the buy back, I am not getting anything.” I would say you can sell pro-rata to the buy back, what is tantamount to a dividend and your percentage ownership in the company is unchanged.

So yes, you can sell and maintain your proportional interest and get cash or you can hold and increase your percentage ownership. **So in looking at companies in this light, you find some interesting themes.**

#### Value Line is a Great Tool to Use

The first one that comes to mind. For those of you who are not familiar with *Value Line*, you should become familiar with it. There is absolutely no better single piece of paper to help you with your analysis. The amount of information included is tremendous.

#### *CISCO (CSCO)*

Let's look at *Cisco (Cisco: Value Line Chart)*. We all know *CSCO* was a bubble stock. As a public stock, *CSCO*, traded at \$82 with a valuation of \$600 billion—the highest market capitalization of any company then by 2002 it fallen 90%, and then rebounded. It has been trading from the high teens to low 20s.

If you look at the common shares outstanding line beginning in 2001, you see something quite amazing.

#### *CISCO*

Year	2001	2002	2003	2004	2005
Shares	7,324 mil.	7,303	6,998	6,650	6,274.7

<b>Pct. Decline</b>		0.29%	4.2%	5.0%	5.7%
---------------------	--	-------	------	------	------

They really have got with the program in terms of reducing the shares. I believe they have bought back gross 1.7 billion shares of stock. The percentage share count reduction is very significant. These are all just facts.

The question then becomes, "Have they hurt themselves in any other ways?" Are they depriving themselves of any opportunities? I would argue almost certainly not. This is a company (if you look at the text down here) not only is the company a huge cash flow generator, earning high returns on capital with no debt. But the high cash flow comes after spending 13.5% of revenues on R&D (*see Value Line text box under Business*).

So they are investing more in their business, more than their depreciation. They are expensing R&D. They are still earning operating margins of 34% to 35% and earning 25% on unlevered equity and generating tons of cash. In the case of *Cisco*, the numbers are mind boggling. *Cisco* has \$1.08 of "cash Flow" per share minus \$0.11 of capex, leaving **97 cents of discretionary cash flow per share on 6 billion of shares. \$6 billion of discretionary cash flow or \$500 million a month of cash.** This is a company that has no debt and it already has \$13.5 billion of cash (look at balance sheet) or more than \$2.20 per share of cash. .

So when I spoke to you earlier about companies with extraordinary financial characteristics, this is one of them. What about *Oracle* and *EMC*? No, they do not. Take a look at them; compare them. They are not all the same. There is something special going on here. Moreover, I have never spoken to the company about what they are doing. I don't know what is motivating them. But I am a financial analyst and **the numbers speak**. Bells go off—ding, ding, ding, ding! Something happened here. *Cisco's* management wakes up and says if Wall Street is not going to value us properly or at a level where we think it is a low level; we are going to get the share count down through our free cash flow. We are not just buying stock to offset options, we are going to get the share count down.

Let's look at the flow of funds for *CSCO*. \$1.08 of Cash Flow and \$0.11 for capital spending or \$0.97 per share of FCF or \$6 billion of free cash. What did they do, they got the share count down by 400 million shares in 2005. The average price for the year is about \$20 per share (average of the price during the year) so they spent approximately \$8 billion buying back shares. So they spend all the \$6 billion of FCF and then some getting money back to the shareholders. Now, you could say, didn't management have something better to do with the money (*reinvestment options*)?

### Argument Against Share Buy Backs

#### **INSERT DISCUSSION**

One of the facile arguments against share buy backs is this: Isn't it an admission of not being able to redeploy the capital productively? Your growth prospects are limited, therefore you have nothing better to do but buy back stock

Well I would argue that any opportunity this company has, they have abundant resources to exploit them. There is no evidence in any of these numbers that they are in any way burning their furniture (*returning their seed corn*). They have all the money they need to invest in attractive returns, and this is after big R&D expenditures and a rapid depreciation schedule. They are returning \$6 billion plus a year to those shareholders who choose to leave the party. If you say I would like to sell off some *CSCO* because they are going to buy in 400 million shares out of 6 billion or 6.67% of the outstanding shares—that is tantamount to a 7% dividend. So *CSCO* is not paying a cash dividend but it is returning cash to shareholders equivalent to a cash dividend. And there is no reason to believe from the past few years that

they will not continue to buy back shares. The only reason I hesitate to make a stronger statement than that because I don't know more about their business.

Is there someone working in a garage somewhere who will make a widget that will obsolete their business, their technology, their router? My strong belief is probably not, not with the R & D spending that they are doing. Not with the size, scale and scope advantages that they have.

I cite *CSCO* as an example of a stock that has fallen back to a level on a cash flow basis....where the valuation on a CF basis makes the most sense that it has ever made in its future.

### Intel (INTC)

By the way, the argument against these companies is that they are over-owned, that they are too big. Everybody knows them; they don't grow fast anymore, etc. None of which is germane to the thinking I encourage you to do, which is try to come to grips with determining intrinsic value and price relative to intrinsic value.

Just recently *Intel* had a down draft. On *CNBC* some analyst came out and downgraded *Intel*—"the bottom is nowhere in sight. Because they (*Intel*) are going to have a bad quarter or two so he doesn't know where the stock will go. He recommends selling the stock and getting out of the way until the dust clears. Again, this gets back to the *John Maynard Keynes* argument of not holding an investment for its long term yield but rather speculating about changes in short run opinion. And not sticking with the investment.

### *What no one on Wall Street says?*

Nobody says, "**This is what I think the intrinsic value of *Intel* is worth.** I know at this price it is selling well below that." No, they are going to have a bad quarter, so get out. That is the kind of opportunity you as value investors should be prepared to capitalize on.

The argument for *INTC* is much the same as *CSCO*'s. Surprise, surprise. Here is a company with high operating margins earning high returns with \$14 billion of cash on the balance sheet and no debt with high returns to capital. 14% of sales being spent on R&D. Let see what happened to share count:

2000	2001	2002	2003	2004	2005
6,721	6,690	6,570	6,487	6,253	6,000
	-0.46%	-1.79%	-1.26%	-3.61%	-4.05%

In 2005, 253 million shares were bought. Go through the same exercise as you went through with *CSCO*. How much money was spent buying back shares? *Intel* does pay a small cash dividend of 1.6% on a \$20 share price. Again, there is no evidence *Intel* is failing to spend money on productive, high return opportunities. It is generating a large amount of excess cash, and they are returning it to shareholders via share buy backs and dividends. So the cash return is much higher than just the nominal dividend.

### Coca-Cola (KO)

*Coke* has a problem. They generate 5 billion of FCF, but they have no place to put it. Year after year they have the same problem. \$5 billion a year. What are they going to do with it? The **conventional wisdom is that *Coke* is a disaster**. *Coke* can't grow; they are asleep at the switch, look at all the opportunities they have missed. The business is stumbling and fumbling. Then you look at the record here. Every year sales

go up, every year cash flow goes up, and every year earnings go up, every year the dividend goes up. They earn 31% on un-levered equity. If that were a bad business, I would like to own a lot of bad businesses like that.

What people are upset about is that its valuation has been coming down to \$40 to \$42. It first traded at \$42 in 1995 when dividends were 44 cents a share and this year, eleven years later, the dividend is \$1.19 or almost triple while earnings have gone from \$1.19 to \$2.30 or almost double. The price is the same \$40 - \$42 per share. The underlying fundamentals (financial results) have been improving and now we are at a point where the cash dividend yield on the stock is about 3%. The underlying company, *Coke*, has been spending slightly in excess of depreciation--10% on capex and \$200 million a year on purchasing international trade marks and little bottling plants around the globe. Basically 90% of FCF is returned to shareholders in the form of dividends and some is buy backs. The share count has been falling slowly, **but now it is going to begin to fall more rapidly.**

They (management) plan to buy back \$2.5 billion worth of stock this year (2006) and the good news here with the stock having gone nowhere for more than 10 years and most corporate stock options are granted for ten year terms so there are almost no options in the money. So we have little risk that the share buyback is going to be offset by option dilution. (*\$2.5 billion in share buybacks at \$41 per share equals 61 million shares bought back or 2.6% of the float assuming 2370 million shares beginning of 2006. Cash returned to shareholders 3% dividend and 2.6% buyback or 5.6%.*)

In the short run, *Coke* is returning 5% of the company's value per year to shareholders. So that is what you get upfront. Then you get, in addition to that, you get the growth in the underlying business which hasn't been starved in any way. The general market has embedded in it a 5% to 6% to 7% rate of return. **But if you buy *Coke*, you get 5% in hand (3% dividend and 2% share buy back shrink) and you get the growth in the cash flow on top of that.** The management says they will grow earnings and cash flow 8% to 10% per year. The market is skeptical; it is a bit of a reach. But you don't need the company to grow at 10% in order for the company to earn a very satisfactory return if you are getting 5% in cash every year upfront. I know some of you are skeptical, but think about this.

If *Coke* gets \$5 billion in FCF per year, so if they scrapped the buy back of their shares they could afford to pay double the dividend or almost a 5.5% to 6% yield. Would that make a big difference in the valuation? I don't think so. In essence, what they are doing is that they are using the \$5 billion of their discretionary cash flow to buy back stock, pay a dividend, and they do it consistently each year. Like *Cisco* and *Intel* the last few years, *Coke* has been picking up the pace and it appears that its share buy back program will accelerate.

But even if they do half that you are talking about: 5% in money up front + 4% to 5% in growth rather than management's belief in their ability to grow *Coke* 8% to 10%, your return is approximately 9% to 10%.

### General Electric (GE)

I have put several other *Value Lines* in your packet of material for this class. Everyone talks about *General Electric*. Note the difference of the financial characteristic with the three other companies. GE is earning satisfactory returns (17%) but with huge debt employed.

COMPARE	GE	CSCO	KO	INTC
ROE	17%	21% to 25%	31%	20% to 24%
Net Debt	\$217 billion	\$0	\$0	\$0
Debt to Tot. Capital	66%	0%	0%	0%
Operating Margin	66%	34%	32%	44%

With tremendous amount of leverage part of that is due to the consolidation of its financial businesses with manufacturing businesses. Despite that, we are talking about big companies earning high returns with no debt compared to GE which is earning satisfactory returns of 17% but using \$360 billion of debt with a market cap of \$373 billion. I am not saying there is anything wrong with that (debt). I am just saying it is very different (in terms of financial characteristics) from what we have been looking at before.

When you start lumping these big companies together: what about *Triple M (3M)* and *Caterpillar (CAT)*? I am saying to you, when you get looking at the financials of each, the numbers are huge. In some of the highest regarded companies, the financial characteristics are very different than what I am citing here.

### Timberland (TBL)

The next company is *TBL*. Has the subject of *Teledyne* ever come up in this class? There was a conglomerate in the 1970's called *Teledyne* where the CEO, *Harry Singleton*, was the driving force to buy businesses and used the cash flow from his diversified businesses to buy back stock aggressively. He didn't just use operating cash flow period he would periodically, was consistent. He would offer debentures for stock in the paper. He wanted to get the share count down. It was a spectacularly successful investment--\$12 to \$900 per share.

*Lee Cooperman* was closely associated with *Teledyne*. If you are paying attention to share buybacks, where is the next *Teledyne*? The closest I can find is *Timberland*.



Let's take a look at the numbers. Everyone knows the shoe business is a crummy business. I wouldn't say it is a crummy business. I look at *TBL*'s numbers and something good is going on here. Well it is a fad, one year it is the brown boots and the next year it is out of fashion. That may be but I don't see any faddishness in these numbers. No debt but huge profitability.

Now the market reflects this bias of being a shoe company (*TBL trades at 14x earnings*). The company is not valued very highly. There is no visibility, the numbers speak to me. Something good is happening here. I don't see other shoe companies like this.



Let's take a look at the share count. The share count is going down and down here—from 90 million in 1997 to 65 million in 2005. This is in essence a Tontine.

Do you know what is a Tontine? It is related to a life insurance policy. A long time ago, centuries ago, there would be pools of money and there would be a 100 people and they each put in \$1,000 and at the end the last person would get \$100,000. That was called a tontine. There were all kinds of moral hazards to that.

With aggressive buy backs—it is in essence a Tontine—you want to see who owns the last share. In the case of *Timberland*, it is controlled by a family named *Schwartz* and they actually own outright control, but they also own super voting stock. *TBL* has two classes of stock. Here you have a company with big insider ownership, they do a wonderful job running their company. They are shareholder friendly; they are not the least bit concerned about anyone making a hostile bid for the company or threaten them in any way. Yet they keep buying back stock, buying back stock. Over time the compounding of having the share count go down like that is profound. You could have a 5% dividend. You could have a slow motion going private.

I bring this to your attention, this is a company I know nothing about; I do not own this company but reading through *Value Line* looking for companies with superior financials, this is extraordinary. **I would encourage any of you to study this company.** Even though the stock has never traded at a market P/E multiple, it is right now trading at a 14 multiple.

#### Last subject: Assessing Management

Companies are managed by people. There is a tendency as a society to glamorize the people who run corporations. They have the same enlightened self-interested as everyone else. Very few people go to work for *IBM* who say I am going to be a monk or work for *IBM*. There is self-selection process at work. You shouldn't expect these people to be saints. They are working hard, but they are working for their shareholders and for themselves.

When I was younger working as a securities analyst, I traveled extensively. I thought it was very important. I did it for years and years and criss-crossed the country. It was very helpful. But it is not necessary anymore. **With Regulation Full Disclosure (“Reg D”) every pronouncement is given to the public.** Moreover, managements have been coached by their lawyers about what to say. They don't say, “We make widgets.” They say, “We are in the business to create shareholder value for shareholders.” They have been coached to say that. Then you say, “If someone came in and offered to buy your company, would you sell it?” They reply, “Well, the company is not for sale but since we are working for shareholders we would investigate offers.” The kind of questions you would want to ask, they all have boilerplate answers assuming you could get to them to ask questions.

So how are you going to get insight into management and the company? Not withstanding the PR. Is the person honest and competent? Beyond that you don't need to know much more. The numbers will tell you about the quality of the business. **The one last area to look is at proxy statements.** They are sources of information that are not well explored. It is a document that is rarely mentioned by sell side analysts.

The first thing you want to do is find out all the financial incentives in place for all the key managers.

Increasingly, they are spelled out. The old idea about economics is that people respond to incentives. Well, if you want to have a good idea of how a manager will react. **Read the proxy carefully to see what management's incentives are.**

I included several proxies in your package which I find amusing.

Heartland's Express Proxy statement

I included the proxy of *Heartland Express, Inc. Heartland* by its record and its performance is an extraordinary good business. Note how the CEO of *Heartland Express, Inc.* is compensated in an excerpt from the 2005 Proxy.

## EXECUTIVE COMPENSATION

The following table sets forth information concerning the annual and long-term compensation paid by the Company to its chief executive officer and the three other named executive officers of the Company (the "Named Officers"), for services in all capacities for the fiscal years ended December 31, 2004, 2003, and 2002.

Summary Compensation Table

Name and Principal Position	Year	Annual Compensation		Long-Term Compensation				
		Salary (\$)	Bonus (\$)	Awards			Payouts	
				Other Annual Compensation (\$)	Restricted Stock Award(s) (\$ (1))	Options/ SARs (#)		All Other Compensation (\$ (2))
<b>Russell A. Gerdin</b> Chairman and President (Chief Executive Officer)	2004	300,000	-	-	-	-	-	-
	2003	300,000	-	-	-	-	-	-
	2002	300,000	-	-	-	-	-	-

The members of the Compensation Committee prepared the following report on executive compensation:

The Compensation Committee reviewed, and recommended to the entire Board of Directors for approval, the compensation of the Company's executive officers for fiscal 2004. In conducting this review, the Compensation Committee evaluated the compensation of Mr. Gerdin, the Company's chief executive officer, differently than that of the other executive officers. A summary of the considerations for each is set forth below.

**Chief Executive Officer. Mr. Gerdin receives a base salary only**, with no bonus or long-term incentives. The Compensation Committee recognizes Mr. Gerdin's substantial responsibility and contribution to the Company's operating performance, operating margin, revenue and net income growth rates, and attainment of Company goals, as well as his large stockholdings. At Mr. Gerdin's request, his salary has remained the same since 1986, and he has never been paid a bonus. The Compensation Committee believes that Mr. Gerdin's salary is reasonable compared to similarly situated executives, and that as a holder of approximately 40% of the Company's outstanding stock (*now worth \$600 million*), Mr. Gerdin receives an incentive through appreciation in the market value of the Company's stock. Because of Mr. Gerdin's request, the Compensation Committee did not consider or recommend an increase in annual compensation or any incentive compensation for Mr. Gerdin. Thus, corporate performance directly affects Mr. Gerdin, but not through his compensation by the Company.

He owns 40% of the stock and he is in his 80s. I have not invested in the company. I am just a student of what I stumble upon. The wonderful thing about every proxy stmt has a report from the comp committee to the shareholders explaining the criteria for bonus compensation particularly the CEO.

What it says is that he hasn't had a raise for 30 years. He has basically said to his compensation committee that **he is aligned with his shareholders by owning 40% of the company**. I think that is just terrific, but sorry to say the only example of this I can find. Now contrast this to *Mr. Michael Dell* of *Dell, Inc.* I have met *Mr. Dell*, and I think he is a fine person. I do find fault with the fact that he has 10 billion dollars of stock and nonetheless he accepts stock options. I think it is inappropriate. This is a contrasting example.

### Summary Compensation Table

The following table summarizes the total compensation, for each of the last three fiscal years, for Mr. Rollins and the four other most highly compensated executive officers who were serving as executive officers at the end of fiscal 2005. These persons are referred to as the "Named Executive Officers."

Name and Principal Position	Fiscal Year	Annual Compensation			Long-Term Compensation Awards		All Other Compensation <sup>b</sup>
		Salary	Bonus	Other <sup>a</sup>	Restri cted Stock Awar ds	Shares Underlying Options	
Kevin B. Rollins President and Chief Executive Officer <sup>c</sup>	2005	\$ 869,231	\$ 2,086,154	—	—	1,200,000	\$ 14,013
	2004	797,115	1,721,768	—	—	800,000	8,123
	2003	770,962	2,012,210	—	—	500,000	8,073
<b>Michael S. Dell</b> <b>Chairman of the</b> <b>Board<sup>c</sup></b>	<b>2005</b>	<b>950,000</b>	<b>2,280,000</b>	—	—	<b>400,000</b>	<b>7,825</b>
	<b>2004</b>	<b>950,000</b>	<b>2,052,000</b>	—	—	<b>800,000</b>	<b>6,973</b>
	<b>2003</b>	<b>950,000</b>	<b>2,479,500</b>	—	—	<b>500,000</b>	<b>6,973</b>
James M. Schneider Senior Vice President and Chief Financial Officer	2005	535,385	822,351	—	—	300,000	7,530
	2004	500,000	720,000	—	—	650,000	7,419
	2003	417,692	643,507	—	—	400,000	7,064

The following table sets forth certain information about the stock option awards that were made to the Named Executive Officers during fiscal 2005.

#### OPTION GRANTS IN LAST FISCAL YEAR<sup>a</sup>

Name	Number of Shares Underlying Options Granted	Percentage of Total Options Granted to Employees In Fiscal Year	Exercise Price Per Share	Fair Market Value on Grant Date	Grant Date	Expiration Date	Grant Date Present Value <sup>b</sup>
Mr. Rollins	400,000	0.77%	\$ 32.985	\$ 32.985	3-4-04	3-4-14	\$ 4,196,000
	800,000	1.54%	35.595	35.595	7-16-04	7-16-14	10,216,000
<b>Mr. Dell</b>	<b>400,000</b>	<b>0.77%</b>	<b>32.985</b>	<b>32.985</b>	<b>3-4-04</b>	<b>3-4-14</b>	<b>4,196,000</b>
Mr. Schneider	150,000	0.29%	32.985	32.985	3-4-04	3-4-14	1,573,500

**Lesson: Read proxies and read them carefully, especially now this year going forward.** If you think about owning part of a company then understand how management is incentivized.

Remember that the stock does not know you own it. You can buy a stock at a 30% discount and the discount could widen.

*Bruce Greenwald:* If you listen closely to his style of investing, what he is looking for are companies where he is happy with or better than happy with their current rates of return. So if it is *Coca-Cola* he gets a good cash return while the value grows. If it is the options he talked about before, he gets a good cash return for the company and there is always the opportunity that his free option will be realized. It is a style of investing to hold these stocks. You are perfectly comfortable to hold these stocks until their value is realized.

*Mr. Robert Bruce:* this is an argument for diversification because some companies will succeed while others will lag.

### Investing in Dell Computer.

This is an area for independent research and thinking on your own. For years *Dell* was earning 50% on unlevered equity, and it sold as low as 6 times earnings. How can this be, look at this valuation. I asked experts in the computer field about *Dell*. They said, "Well you don't understand. *Michael Dell* is not going to last. Direct selling won't work. **I listened to others and did not invest.** I missed the big move.

When I say look at company incentives, is there enough incentive for the management likely to agree to sell the company. An important part of that-- Will management get rich if they sell the company? The vesting of the stock, the golden parachutes. Are there no incentives in place for management? Or else management will say I prefer my salary and my jet to realizing value for shareholders.

There is a very controversial company in Long Island called *Computer Associates*. There was a bizarre incentive in the company that if the share price got above a certain level for a short period of time, the top two or three people would get approximately 1 billion dollars in cash. How is that for a very weird incentive. If I said there is a billion dollars here if you can get something to happen, you would work pretty hard to get it to happen. Sure enough, they cooked the books to make it happen. They got the billion dollars and have never given it back. **It is people responding to incentives.** It is an invitation for chicanery.

**END**

### **A philosophical kind of approach.**

It is important for value investing is that you develop a certain mindset. *WEB* said that these ideas are so simple that either a person grabs them right away or he or she never does. The ideas are elegantly simple but people can't seem to help themselves from making them more complicated than there are.

I am pathologically cheap. I went "Dutch" on my honeymoon. But the straw that broke up my marriage was my search for the best deal on funeral services for my Mther-in-Law. Driving around in the Summer heat with the corpse strapped to the roof of my clunker caused my wife a bit of stress. Little Johnny kept asking, "Daddy, what's that smell!"

**I have evolved.** I am constantly thinking of what I am doing, mistakes I have made. How I can do things better? How I can become more efficient? The whole time management idea.

They will all embody the value philosophy but the particulars of what they have to say to you should be quite different. Because there are many ways to apply the value principles. So what I am going to talk to

you tonight is my approach and by no means is it the only way to do things. I have a little narrow style that I try to apply and there are others who have styles that may be just as valid as mine.

What I have done is to try to generalize the investment problem. The risk is that speakers come to you and they talk about stocks in their portfolio: I own *Kraft*, *Coke* and *Comcast*. Usually they talk about successful investments. There is a narrative that goes with it—why I like it, management is great, but the idea about how you could find such an investment today is kind of glossed over.

*Bruce Greenwald* tells each class—he coaches them—to ask the speakers what their search algorithm? Business school talk. People/speakers won't give explicit answers to that question. If I were to give you detailed information of my search algorithm, you would find the exact same stocks that I already own. And you would buy them at the same prices that I determined that they were worth buying.

But I am not going to tell you my search algorithm, but that is what you should demand from the speakers who come here.

The screening/analytical part of what I do can be done by computer. This is not all that hard to do. What is necessary is to organize one's thoughts to be able to instruct the computer to do the task.

I will talk about what I do, a little narrow subset of value investing. I am pretty sure that everything I tell you will be generally true; it stood the test of time and my own experience—and the reading and studying that I have done. I don't think I will tell you anything that will lead you far astray.

Defining what value investing is. There is a difference between price and value. We are looking for favorable differences to pay for value and then decide if price is sufficiently less than the ascertained value to allow for a margin of safety to make an investment.

*Warren Buffett* talks about circle of competence. Know your own special areas of expertise, competence and focus your efforts within those. Be humble, there are lots of smart people in this business. Your analytical skills are not generalizable across many industries and many asset categories. Stick to what you know.

Try to be confident that when you make an investment decision, it is in an area where you have an edge. Go where the playing field is not level. *Bruce Greenwald* talks about all the time—what is your edge? Why does this investment opportunity manifests itself to me, but other people don't see it?

You have to be tough with yourself in asking that question because it is easy to delude oneself that an opportunity is as easy as picking money off of the sidewalk. Very seldom does that happen.

I think you have read the Intelligent Investor by *Ben Graham*. You have heard of the mental construct of Mr. Market, this moody person offering to buy or sell. You don't have to deal with him unless you want to. If he is euphoric and bids up you can sell to him. If he is depressed and sells low, you can buy from him. But in the middle you can do nothing.

When *Ben Graham* was writing about *Mr. Market*, the market was individual investors back then. It is easier to understand people who have mood swings. The world has changed. Mr. Market still exists, but he is in an extremely different form—now it is highly institutionalized market. 75% to 85% of all equities are held by a number of giant institutions. We like to think these people are supremely professional, but they aren't. Moreover, they have institutional imperatives; they have careers within these organizations. People don't want to take chances to jeopardize their job.

They are asset gatherers. They constantly want to grow assets to generate fees so it leads them to cluster in the same path. It leads them to group think. They like the same things together and hate the same things together.

I was astonished to read yesterday:

### **Calpers' investments in commodities to impact the U.S. economy**

Posted Feb 28th 2008 3:03PM by [Joseph Lazzaro](#)

The commodities fad took a major step toward becoming an investment trend when investment giant Calpers -- the \$240 billion California Public Employees' Retirement System -- announced it may increase its commodities investments 16-fold to \$7.2 billion through 2010, [Bloomberg News reported Thursday](#).

**Calpers, the largest pension fund in the United States, said it would hold between 0.5% and 3% of its assets in commodities. Last year the fund invested \$450 million in commodities.**

Strong emerging market growth, particularly in China and in sections of Latin America, has created a bull market in oil, commodities and raw materials, and many economists say these assets are likely to outperform both inflation and selected investment classes in 2008, and possibly for a longer time period.

The [Standard & Poor's GSCI index of 24 commodities](#) is up **10% so far in 2008, following a 33% gain in 2007**. Meanwhile, the [Standard & Poor's 500 Index](#) of stocks is down 6% this year, while U.S. Treasuries have netted a 2% return.

### **Calpers: Twofold impact**

Economist Glen Langan told BloggingStocks Thursday Calpers' decision will impact the U.S. economy twofold.

"First, there's the direct impact of Calpers moving money toward commodities, which is bullish. Second, and perhaps more significant, there's the symbolic impact of having a major buy-side institution say it's going to commit more money to commodities. That decision will no-doubt encourage other institutions and money managers to do the same, and put more fire under commodity prices for 2008," Langan said. "That suggests commodities will perform well in 2008, barring a major slowdown in global growth."

Still, Langan is quick to point out the downside to the United States to double-digit commodity price growth, particularly as it relates to energy and raw materials. Rising commodity prices will continue to exert inflationary pressures in the U.S. economy, raising costs for businesses and consumers. Some companies (and individuals) will benefit from the rise, as will institutions who invest in the investment class, but the net effect for the U.S. economy is decidedly negative, he said.

"The U.S. economy is just beginning to see the inflation effect of various commodity price increases, particularly oil, but also corn and wheat. That should add about 1 percentage point to retail inflation," Langan said. "If the commodity bull market continues in 2008, it could add another percentage point to retail inflation. On a practical level, are U.S. consumers' financially prepared for \$5 a gallon gasoline, and businesses prepared for raw material costs that increase by, say, another 20-30%? Probably not, which is why policy makers are going to have to prepare potential solutions, should commodity prices reach unacceptable levels."

*Calpers* has now, now has decided to drastically increase its allocation of assets into commodities—where have they been? This is the way big institutional investors work. I submit to you that it is quite

possible to make money off their idiosyncrasies just as it was for *Ben Graham* to take advantage of individual investors who together made up the market when he was writing.

So I define for you the term Intrinsic Value. Then we come to the term a **margin of safety** or how much of a discount should we expect or demand in order to make the investment attractive?

Certainly if you find something in the market worth X and it is trading in the marketplace at 95% of X, that is not a big margin of safety. Moreover, you must not kid yourself, that your appraisal of x is anything other than some central tendency within a range.

The margin of safety must be big enough to give you confidence so that even if you are off slightly of your appraised intrinsic value estimate that you are getting, you are making your investment at a discount.

So when people ask me how big a margin of safety should I aim for? I say as big as you can, but the reality is that the higher the margin of safety you demand or expect, the fewer investment opportunities you will find. If you say I will only invest in companies with a 50% margin of safety, then you might have to wait around for a long, long time—until 1932 comes along again. There is some trade-off between finding investment opportunity and demanding a very big margin of safety.

My long experience, is that I almost never have found companies trading at little as half their value. I have friends who say I have found this or that trading at half value. My experience is that when I come up with a margin of safety of 50%, I usually redo my work because usually I am wrong about the appraisal value. My experience is that rarely do you find things at a lot less than 30% of intrinsic value.

Moreover, this is where my thinking has evolved over the years. I used to be a contrarian by nature. I was what is called a deep value investor. I bought businesses way out of favor, usually cyclical, commodity businesses—buying them when they were most out of favor and depressed. Those kinds of investments you can find at deep discounts. You have to be tough to buy them; you have to be really tough to go against conventional wisdom during the time when people say these are down and they are never coming back.

But what I have found—getting back to what I call this institutional element—even though I would have many of these stocks that over time would generate 10 times, 29 times their return—I found that my investment partners could not stomach it. The investments would be so out of favor for so long. It is just the reality. That is not to say you can't do that type of investing for yourself if you are temperamentally inclined to do it.

I will tell you from personal experience that it is a tough slog to get other people to entrust their money to you when you buy such out of favor investments. Moreover, let's get to an interesting comment that *Warren Buffett* made, **“I would rather buy a great company at a good price than buy a good business at a great price.”** It took me a long while to figure this one out, but when you get into this idea of margin of safety; the really great companies rarely get cheap or sell far below intrinsic value. Never do they sell far below intrinsic value. But if you take any of these companies like *Coke* or *IBM* or something like that—big, well-known, superior companies—I think it is unreasonable to expect that these companies will trade much below 20% of intrinsic value. Most of the time they are at or above intrinsic value; these are the well-loved, widely owned, security blanket element of careerism to them. Institutional investors say that if I own *Coke* and it does poorly, I probably won't lose my job over that. These are all biases that keep these stocks close to IV. Moreover, the idea--it seems reasonable to me that the bigger companies, the bigger capitalization companies, do have more research coverage and they do tend to be more efficiently priced.

**What Mr. Bruce does?**

## Search Algorithm

I pretty restrict my search algorithm to companies that are **demonstrably superior as demonstrated by their financial characteristics**. I focus on what I call seasoned companies. These are companies that have a long enough history of 10, 15 or 20 years at least such that it is possible to examine that long-term financial record and see how that business has performed under various business conditions in times of recession, in times of inflation, cycle down turn, low and high commodity prices. You can see the company under stress and various cycles over time.

You look for a company with a significant cash generation. Those are companies with long enough track records that there is little doubt that there is something fluky or temporary about the results they have achieved. If you look at those kinds of companies or set your screenings to ROI, ROIC, ROE, profit margins, ROE you will find that if a company has a long history of those superior performance measurements and has been in business long enough to qualify as seasoned, then by that time it is usually a pretty big company. If a company has been around for 15 or 20 years generating high rates of return, it will be noticed and it will be a large company.

I don't restrict myself to certain type of investments. I don't have a label like small cap value or mid cap growth or what have you. I am looking for companies that fit this financial description and by and large they are big companies. Pretty much arbitrarily I cut them off at the bottom at \$1 billion market cap. I tend to focus on companies that are much bigger than that.

These are superior businesses and by focusing my attention on them, it makes my life easier. If you would get your Value-Line out—this has 2,000 to 3,000 companies—there are no more than 60 or 80 companies that meet this criteria of consistently high profitability, consistently high excess cash generation. These are the characteristics that you would look for. These consistently high or excellent financial characteristics or performance measurements usually shows some evidence that there is some kind of moat there or franchise in the business.

I would say that if you look at a company with consistently high returns over ten years, you are safe in assuming that a moat exists because if there was not a moat (barrier to entry) the returns would be competed away within a ten year time frame.

So if you see a company with a long record of superior profits, you should assume there is a moat and then set to find out what is the moat? It usually not hard. There are common threads that run through these companies. So in these good businesses we look for high rate of return and high rate of return businesses always (*an exception being Wal-Mart, for example, in its early growth years*) generate more cash that can be reinvested in those businesses. Usually a moat around a business is finite in size. **All franchise businesses are under constant attack.** Any kind of high return business is always subject to competitive attack like innovation or substitution or competition. When you see a company that consistently maintains high returns over a long period of time, there is a moat operating. You want to see that the company is being well run so the moat is preserved.

But business with moats around them are rare. They don't have great reinvestment opportunities. A great example today would be *Microsoft*. *Microsoft* has the most profitable legal businesses in the world. They generate zillions of dollars of cash which they don't know what to do with and they have a long history of making poor investments. They lost billions in Junk bonds. Nobody missed it. In the case of Yahoo!, if it goes through, it remains to be seen whether it will work out or not. They don't have a outlet for their gusher of cash. They work very hard to protect their franchise as you would to if you owned the Windows franchise; it generate way more cash than they have use for and they have demonstrated over a long period of time that they have no idea of what to do with their cash.



These good businesses that generate cash have good choices. *Charlie Munger* says they wake up in the morning and say should we raise our dividend today, should we buy back a little more stock? They are in control of their destiny. Bad businesses—things happen to them. They don't make things happen.

Right now we are at the beginning of a serious reemergence of inflation. One definition of a good business is the ability to raise prices or float along with the inflationary tide.

So when you read on Wall Street that such and such company is being temporarily being squeezed or their raw material costs have gone up and they have not been able to pass them through—warning lights should be blinking; sirens! That is like saying we don't have a good business here. If prices go up on us, we can't raise our prices or pass them through. That means that there is no moat.

I have no idea what *Warren Buffett* is thinking about when he invests in *Burlington Northern* or *Kraft Foods*, but it appears to me that he sees in those businesses that they both have the ability to raise prices or pass through price increases. It is something he is very concerned about, so therefore, it is something that you should be concerned about.

Focus on businesses that can raise prices and preserve their margins. It is beyond the scope of this lecture, but are common stocks protection against inflation? I will relate what *Buffett* said to me many, many times. He said a well selected, well diversified portfolio of common stocks is not a perfect inflation hedge, but it is the best one he can find. It is not good; it is the least bad.

If you look at the businesses that he has invested in over many decades, the common thread is that they are inflation “pass-throughs”. If you wanted an inflation pass through, the exception being Burlington Northern, you don't want a lot of fixed investment or a lot of bricks and mortars and factories because in time of rapid inflation, you under depreciate those assets and you wind up with overstated earnings because at the end of the day your depreciation is not enough to replace your worn out assets. You look for *WEB* businesses that are not hard asset intensive and a lot of them are financials like *American Express* (AXP) where if prices rise 3% or 4% then revenues rise 3% or 4% which is a gross oversimplification.

If you look at the *Berkshire* portfolio name by name, you will find the common thread is an inflation pass through and protection from an emergence of inflation.

With regard to my style of investing:

I look for superior companies as measured by financial characteristics, seasoned companies with a long term track record to be meaningful enough so you have confidence in the moat. You are not buying into these businesses when their competitive advantage is about to be lost.

So what edge do you bring to this party? If you look at these companies, what edge do you have? What do you know about *Coke* (KO) that the whole world doesn't know? I will be candid and say to you that I don't know anything about *Coke's* operations that isn't widely known by someone who is doing a careful study of the business. Where I have chosen to focus my work in recent years is on valuation.

Valuation has something to do with this emerging area of **behavioral finance**. The bias that people have; the mistakes they make; the misunderstanding they have. I don't need to know what the misunderstanding is; I just need to know there is a mis-pricing. How do these mis-pricings occur? This gets back to price versus value. **We as value investors are always looking for opportunities where price is significantly less than value.** Think in a general sense, “How can such favorable gaps open up?”

With only one exception I conclude that those kind of favorable opportunities arise when a stock price is either flat or down. It means that the bad news is over discounted in the stock price or there is bad news that in some way is over emphasized in the price of the stock. The only exception to this is good news that is so good that the market doesn't recognize it. *Apple Computer*. When the *IPOD* came out, the stock went up but if you had been smart enough to recognize how big the *IPOD* was going to be, you would say the stock is way up but it has not begun to discount the how big and how good this will be. So a valuation gap opened up. By definition that was a value opportunity but not for me. Unless you had some profound insight, it generally was not available. (*One problem with betting on the IPOD's success would be in the longevity of the product cycle. How wide would its moat be and for what period of time?*)

The idea of finding opportunities in stocks to invest in—the punch line here is that you must be looking for stocks that are out of favor, that have not gone up, or maybe they have gone down; they have been flat for a long time. These are the preconditions for the price value disparity. The other related point, I suggest to you that you read *Robert Schiller's* book, *Irrational Exuberance*. It was published just before the dot-com bubble burst. The second edition came out and included a lot of references to the housing bubble. He is a very serious economist, not a sensationalist. There is a lot of history, there are a lot of behavioral ideas in the book. It is written for a general audience.

I consider it essential. I think it is a good read. In it he makes the point that share prices even the big companies are much more volatile than the underlying cash flows of those companies.

Wall Street has a hair trigger. A company will report earnings within a penny of Wall Street estimates and in response to that the company may gain or lose tens of billions of market value. Now for these big battleship companies, the intrinsic value doesn't change that much. But Wall Street in its jittery, short run obsessive ness exaggerates the significance of these short run fluctuations. It creates opportunities for value investors.

Now I will wrap up here. I have asked each one of you to avail yourself of four Value-Lines. I want to make a couple of points. First of all is *Coke*. By the way, if you are not familiar with Value-Line, you should be. It is a wonderful compendium of data.

*Coke* traded at 1998 at \$88 per share and fell steadily until 2003 where it traded at \$37. During that period of time, *Coke's* sales and earnings went up every year. Cash flow went up every year. The stock went down, down and down. The company continued to perform, but the stock fell steadily. Now what does a value investor think about that?

My conclusion is that the market collectively was reassessing *Coke's* future. The market came to the realization that the market got carried away in 1998/99. *Coke's* future was not as rosy as predicted or implied by market prices. With the passage of years, there was this constant ratcheting down of expectations. Finally, at the bottom there are these articles in the *Wall Street Journal* or *Business Week* that *Coke* has lost it or *Pepsi* is killing them. This always comes late in the game after the adjustment has taken place.

*Coke's* performance was pretty constant through that time period, but it was investor's expectations that changed. Investors were wrong. They were wildly optimistic in 1999 as they were with a lot of companies like the high tech and Internet companies. My calculation which I can't prove to you supports this idea, if *Coke* which sold in 1999 at \$88 and it had \$1.69 of cash flows or 50 times CF. Earnings of \$1.62 or more than 60 times earnings. Plenty of people went along.

My analysis of *Coke* was that when the stock was at \$89 then \$15 of that was present value and the rest (\$75) was future value. By the time the stock bottomed years later at \$37, I estimated that the present

value was \$27 or \$28 per share and the future value (franchise value) was \$10. So the market had reevaluated *Coke's* future. This was roughly on 2.5 billion shares.

So the market was saying that *Coke*—if my numbers were right and I believe they are roughly right—but 75 points on 2.5 billion shares is 187 billion dollars. The market is saying that *Coke's* franchise value is worth \$187 billion. By the bottom, it was saying it was only worth \$25 billion. So you see these exercises that consultants do or read articles in the general business publications where people try to assess what are the valuable franchises in the world. *Coke* is usually number #1. But no one would have said it was worth \$187 billion but that is what the stock market said it was worth in 1998.

It took a long time for the market to reassess, but at the bottom, I believe, it overshot. The franchise was then only priced at \$25 billion which was too little. Now there has been more of a move to within fair value (\$60).

***Coke's* 10 year chart. High in 1998 at \$88 per share and low in 2003 at \$37.**



Now I want to talk about *IBM*. *IBM* is almost beyond any one person to understand. Even for people who work there or run it. These multinational companies are beyond any one executive to understand.

### Five-year Comparison of Selected Financial Data

International Business Machines Corporation and Subsidiary Companies

(\$ in millions except per share amounts)

FOR THE YEAR ENDED DECEMBER 31:	2007	2006	2005	2004	2003
Revenue	\$ 98,786	\$ 91,42	\$ 91,134	\$ 96,293	\$ 89,131
Income from continuing operations	\$ 10,418	\$ 9,416	\$ 7,994	\$ 7,497	\$ 6,588
Income/(loss) from discontinued operations	(00)	76	(24)	(18)	(30)
Inc. bef. cumulative effect of change in accounting principle	10,418	9,492	7,970	7,479	6,558
Return on stockholders' equity	36.6%	30.8%	24.5%	24.4%	24.5

AT DECEMBER 31:	2007	2006	2005	2004	2003
Net investment in plant, rental machines and other property	15,081	14,440	13,756	15,175	14,689
Working capital	8,867	4,569	10,509	7,357	7,205
Total debt	35,274	22,682	22,641	22,927	23,632
Stockholders' equity	28,470	28,506	33,098	31,688	29,531

But if you look at the *financial characteristics of IBM*, they are remarkably stable. The balance sheet shows low leverage. If you view *IBM* as a battleship and say it will not change drastically in the short run. The revenues grow in some relation to global GDP (3% to 5%) and then if you take a normal margin on those revenues, you can normalize earnings and make a reasonable estimate of its long run cash generating capability. But Wall Street lets the price fluctuate widely. Again, Value-Line shows that *IBM* sold as low as \$73 and as high as \$121. So it went up 50 points in one year times 1.4 billion shares so a \$70 billion fluctuation in the market value of *IBM*. I submit that it is impossible for the intrinsic value of *IBM* to move that much. Thereby an opportunity presents itself.



Last I want to talk about *Motorola* and *Nokia*. These are cell phone companies. For people who would argue for efficient markets you should look at the financial characteristics of *Nokia*. It is one of the great, great companies. It is a company that earns from 25% to 40% per year on unlevered equity. It generates huge excess cash; raises its dividend each year. Buys its shares back every year and always sells at a modest valuation.

Now *Motorola* is a perpetually troubled company with very weak financial characteristics. Always next year. From a valuation perspective, at the end of 2006, *Motorola* and *Nokia* were trading at the same dollar price. *Motorola* has activists like Carl Icahn threatening it or rattling the cage to restructure, but *Nokia* was sitting there at \$20 and it turns out they earned \$2 in 2007 and earned 42% on equity but this is not a surprise because this is just a continuation of what *Nokia* has been doing for more than a decade.

So while the activists and Wall Street activists are agitating for *Motorola* and talking about all the potential, they say that *Nokia* is just a commodity company. There is nothing special going on. They didn't give them the *Benefit of the doubt* after more than a decade of great performance and unbroken financial brilliance. So what happened in 2007? *Nokia* went from \$20 to \$40 and *Motorola* went from \$20 to \$10.

The idea that the market is efficient and the idea that great companies like *Nokia* that jump off the page at you can never be cheap is just not right.

***Nok vs. Mot over a one-year time frame—Nok up 35% vs. Motorola down 45%!***



I want to end cold-turkey here and I hope there is enough time now to answer questions that you might have.

**Q:** How do you decide when to sell?

**RB:** That is a tough question.

The idea is that if you buy a good business at a fair price, as *Warren Buffett* has said in his shareholder letters, if you buy a *Coke* at a fair price, you will earn the return of *Coke's* business on a one-for-one basis. Your share price will rise in line with the accretion of value in the business. If, on the other hand, you are clever enough to or lucky enough to buy it at a discount of say 20%, you will earn the accretion of value and the accretion of the discount if it goes from 0.80 to 1.00.

If you open the *Berkshire Annual Report* and look at his big holdings—he gives you his cost basis—then you can see the compounded rate of return over time that he has gained. This is just a rough number because shares have been bought at various times. What you find out is the CAGR is 13% or 14% and what that is the accretion of value of the business plus the accretion of the discount when he bought the shares originally. He never sells. He says his favorite holding period is forever. He has a unique situation which does not hold for many individuals.

First of all he is a corporation so he faces a high tax rate on capital gains. The value of a long term tax deferral compounding over time is much more valuable to him than to us where we have in theory a 15% tax rate. The other problem that he has is a huge inflow of cash so the last thing he needs if he is holding \$40 billion in cash is to sell something that is marginally overvalued, pay the tax and then just add it to his cash hoard where he is not earning very much anyway.

I would argue for individuals, people with normal tax situations, you should buy a stock well bought is half sold. If you buy a good business at a discount and hold it for some period of time, you will make both the accretion of the discount (your margin of safety) and growth in the business over time. You have earned your return as the discount is closes between price and intrinsic value. You should sell when the price reaches fair value and that is your reward for choosing well.

Many people will stand before you and say, “That is a terrible way to invest—you sell your winners, cutting the flowers to water the weeds. Generally if you stick to this method and you don't have this gusher of cash, you will do well. Remember that *Buffett's* situation—I think he said he has a billion in cash coming in every month—is different from yours or mine.

You can't be too precise. Don't kid yourself that when *Coke* is at \$58 you know what its IV is down to the penny; you don't. But you have some idea of what *Coke* is worth and if it gets to be far enough above IV, you sell it and look for another opportunity.

Q: Big companies can fundamentally change every 25 years...for example, when *Gerster* took over *IBM*. Do great companies persist?

**RB:** Big companies. The first book on this subject was written in the 1930s about the life cycle of companies from periods of rapid growth, dynamic growth, then they mature and then many of them die.

I am saying that when I look at a company like *Nokia (NOK)* and see that it earns 30% to 35% on unlevered equity (ROE) year after year on unlevered equity, I am going to presume those characteristics will persist until I see evidence that it is not. We are not talking about just big companies like *General Motors*; we are talking about very superior companies. When you look at the financial characteristics of these companies....when you look at *IBM*, the business model changed from a mainframe manufacturer to a service company, and they also completely changed their financial structure and they have altered their cost of capital by borrowing a lot of money and buying a lot of stock.

By the way, I think that is a big opportunity for companies that I think are demonstrably overcapitalized. Look at a company like *Cisco* and *Intel*; they are more than 100% equity because they have big cash hoards too and you know that is a long way from an optimal capital structure.

I think in the end, these big overcapitalized companies will find some way to get their capital structure into sharper focus. I know for a fact that *Warren Buffett*, when he was on the board, agitated to have *Coke* buy back stock and lever itself. It made all the sense in the world when rates were low and *Coke's* share price was low. Certainly, *Coke* doesn't need much capital to operate. You look at an *Intel* or a *Cisco*, these great big companies—*Nokia* for that matter—and you have 5, 10 or 20 billion dollars of cash sitting around, investment bankers know what to do.

I think *IBM* is a role model for such companies. For example, if you look at *Eddie Lampert*, the Chairman of *Sears Holding*, and you look at the common thread of all the companies he has been involved with, he agitates for drastic changes in the capital structure—borrowing money and buying back stock. *AutoZone*, *Auto-nation*, *Liz Claiborne*. That is what he does, get the businesses to change to a more appropriate capital structure.

**Q:** Companies pass through inflation. How do you find a balance between the two--good businesses and commodity-like businesses?

**RB:** Well, commodity businesses have their own cycles. There are cycles of investment. The general reason we are having such a boom in Copper, Steel and Aluminum is because there were decades of underinvestment. And so we are in a situation where prices rise until new investment is stimulated.

In the example of a Wheat farmer, if the price rises, you can plant more and sell more after the next harvest. In the case of copper, you have to find the ore and spend a lot of money to develop so the investment cycle takes a long time.

But my message to you would be—I think that there are smarter and better ways to invest than in deep cyclical commodity companies. The idea is to invest when the market price is below the cost of production. Now you look and all the commodity prices are far, far above the cost of production which will stimulate new supply in just about everything and these are self-correcting cycles. *The doomsday scenario never happens*.

**Q:** What are your favorite recent picks? You look for large business that are established...

**RB:** The businesses don't have to be large, but they tend to be large because of their past success.

**Q:** At the same time in that world which is well publicized and well covered, you are able to find undervalued companies?

**RB:** I am using behavioral finance to discover what is discounted in the price. For example, I bought recently *Black and Decker*.

Now everyone knows about the housing slump and slowdown in homebuilding, but *BKD* has already fallen about 40% already so I would submit that the obvious news has been significantly discounted—entirely discounted? I do not know. What I have done with these behavioral models is to say it appears to me by my criteria that *Black & Decker (BKD)* is cheap as it has ever been. Does that mean it can't get cheaper? Absolutely not.

One thing to remember is that when the last big Bull market occurred in the 1960's there was a best seller called the Money Game written by *George Goodman*, ala Adam Smith. He was a brilliant man and a witty writer and I commend it to your attention for a light, fun read. **The stock does not know you own it.** People expect that when they buy a stock, it will stop going down and then go right up. You don't ever find a bottom unless you are lucky.

When you are investing, you are making a positive expected bet over a reasonable time horizon. *Ben Graham* never used the term, **Mean Reversion**, but a lot of what we are talking about here is reversion to the mean. That is the fallacy, the big flaw of Wall Street research—investment analysts are very predisposed to trend extrapolation. They don't think in terms of mean reversion. I am going to say that if *Black and Decker* is going to sell off from the high \$90s to the \$60s then a lot has been discounted already.



So I make some attempt even though the business has not turned south yet, the likelihood of that occurring is already reflected in the stock price. **The kind of market we are in right now is a wonderful hunting ground for value investors.** Volatility is where opportunities come from. I heard a statistic a few weeks ago so it must be more true now that 50% of the S&P is trading 50% below its 52 week high. That kind of reassessment of company prospects is going on. If you turn on CNBC today, you see everyone chewing their fingernails. What write-off is coming today? Who will miss earnings?

You are not in the game of predicting what the bank will do or what the write-off is going to be or what the bank is going to do. You are trying to find a stock with a margin of safety. The stock market will bottom out long before the economy bottoms out. I have been through many recessions in my career and throughout all of them the stock market did not go to zero. At some level they stop falling and it is always before the worst of the news is out.

**Q:** Do you invest in Global stocks like India, China?

**BG:** I don't. When I worked for *Sandy Gottesman*, the head of First Manhattan, I was a very junior, subordinate type of person while working for him. He had a rule for me: the farther the company headquarters is from 42<sup>nd</sup> and Fifth, the less interested I am. Not to diminish emerging markets or foreign economies, but we have big companies... *Coke* has stated publicly over and over again that within a few years 95% of their profits will be outside the US. So *Intel*, *Cisco*, big US companies, are de facto global companies. Other people know more about emerging markets than I do.



*Nokia* is a company I can understand. It is an international company. It happens to be stationed in Finland, but given its scope and international exposure it is unimportant to me where it is domiciled.

I read about the US becoming a less attractive place for a listing, but I don't know all the issues. There are companies outside the US that meet all the criteria that I have set out in terms of superior financial characteristics. I am not familiar with all of them. *Nokia* is one that jumps out at me.

**Q:** You look for seasoned companies of 10 years of more with superior characteristics. What happens next in terms of your strategic analysis? Life cycle?

**RB:** I don't spend a lot of time on that in depth analysis because I compensate for that by the sizing of the bet. This is a portfolio management decision which is a different subject form what we are talking about tonight.

The idea of money management and sizing of the bet should have some relationship to your confidence or your knowledge. Another change that I have made is that I now manage portfolios that are much more diversified than they used to be. **Many relatively small bets, each with a positively expected value.** I like to say independent bets, but due to the market there is a correlation. There is a market influence except for Gold stocks let's say. When the market goes down 300 points like it did today, everything goes down. There is no independent bet.

In my youth I used to travel across the country and talk to managements and get to know them. It was a good thing to do then, but since with Reg. D there isn't anything managements can tell you that you would really want to know. Also with the Internet, there is the tremendous availability of the SEC filings of the press releases and company presentations. I am way in favor of Reg. D. It was called for and needed—a good idea; there is an abundance of information.

I am more interested in the bet sizing and the diversification because you don't bring any edge to the party by talking to management. Managements are human. They are not geniuses. I am against all the lionization of CEOs like *Chuck Prince*, *Sandy Weil*. They are here today and gone tomorrow. The business is what is important. It is not the people. **I don't focus so much on the details of the business. I believe that the numbers speak.**

There a lot of companies that are praised but when you look at the numbers you say, "What is so special? What is going on here?" There is nothing to get excited here. It is the differentiation between sizzle and steak. You get a loquacious charming manager who spins a good story.

One suggestion if you are interested in a company and you want to be amused and informed, get a stack of annual reports, the last 3 or 5 or 8 years of annual reports on that particular company and read the message to shareholders and compare them and see if there is a continuity of purpose—one refers to another. Look for managements that degrade themselves. See if management is consistent and honest. "Last year we met two of our goals but fell short of...because many are not honest. Many managements are inconsistent or they change their focus from year to year. They will say revenues went up this year, but there is not there, there. They are living day to day and these are, by the margin, not good businesses.

**Q:** Can you talk about a recent mistake and how it changed your philosophy?

**RB:** Well, the nature of what I am doing now—this idea of **mean reversion**--the studies show that in the short run there is momentum, but in the long run, there is mean reversion. Stocks that have done well one year, tend to do well the next year. This flies in the face of EMT, but there is agreement that there is some short-run momentum at work.

The mean reversion is a longer-term thing where it takes three or four years. So the idea that I made a mistake---you have to be careful about that means. *Warren Buffett* has always talked about a permanent impairment of capital. If you buy a stock and it goes down, that doesn't necessarily mean you made a mistake. He likes to point out that when he made his investment in the *Washington Post Company* (*WPO*), he made his initial investment in *WPO* at 40 cents on the \$1. Within a year it had fallen in half. Does that mean it was a mistake? No. It just means that it was a better opportunity. If you buy something at 40 cents on the dollar and it falls in half, you don't have to sell it.

The mistake you make is an analytical mistake when you buy a business thinking it is something that it turns out it wasn't. That is where you get the permanent impairment of capital. That is where you buy a good business thinking it is a good business and then it turns out to be a poor business. **Or you buy—you deviate from your discipline—a bad business because you say, “this is so cheap.” It can't get any worse, but usually it does.**

**Q:** I have a question on implementation. *WEB* talks about not believing in the Beta or WACC. What thumb rules do you use for a discount rate.

**RB:** The discount rate has to do with your required rate of return, it is a personal discount rate.

If you look at your dividend discount model of  $D/(R - G)$  that is where you get your inflation pass through arithmetic. The growth rate is the real growth plus inflation. Your demanded rate of return is the risk free rate plus inflation rate plus the risk premium. So if you do the subtraction, the inflation comes out so the demanded rate of return for me may be higher than yours so you will find a stock that is attractive while I will not. That is why value investors are always groaning that stocks are not cheap. They say they can't find anything.

Well the stocks are priced; they are trading, they are pricing billions of shares every day. Implicitly what is happening there? People who are buying those stocks are willing to accept a lower return than the people who don't find them attractive to buy. Is that a fair answer?

**Q:** Do you use multiple models of valuation to get some range of value?

**RB:** I am looking for companies...that if you look at *Coke*, it is remarkably consistent business, and you can see how much cash is generated and how much cash is needed in the business. Then what is done with the cash—what is paid out in dividends or buy backs and how much is reinvested in the business. There is a fair amount of bottlers bought in the past few years if you look in the footnotes. *Coke* is a fairly simple business to model. Start with the idea of how fast does revenue grow? Obviously with these big companies, they are linked to GDP growth and the areas in which they operate. So if this is a mature company can it grow just as fast as GDP? Is it growing faster than GDP. Then you do the discounting of that.

We value investors want to get the future cheap, preferably free. *Ben Graham* believed in that. He didn't want to buy growth stocks. He wanted the here and the now and he wanted it at a discount. When I first came to Wall Street, there was a firm called *Tweedy Browne*, they made a living as recently as 1970 where they were buying stocks at 70% of net/net working capital stocks and then sold them when the stocks went to 100% of net/net working capital. Of course, net/net working capital stocks disappeared in the late 1970s. But that is how cheap stocks used to get.

Have I exhausted you yet?

One more Question?

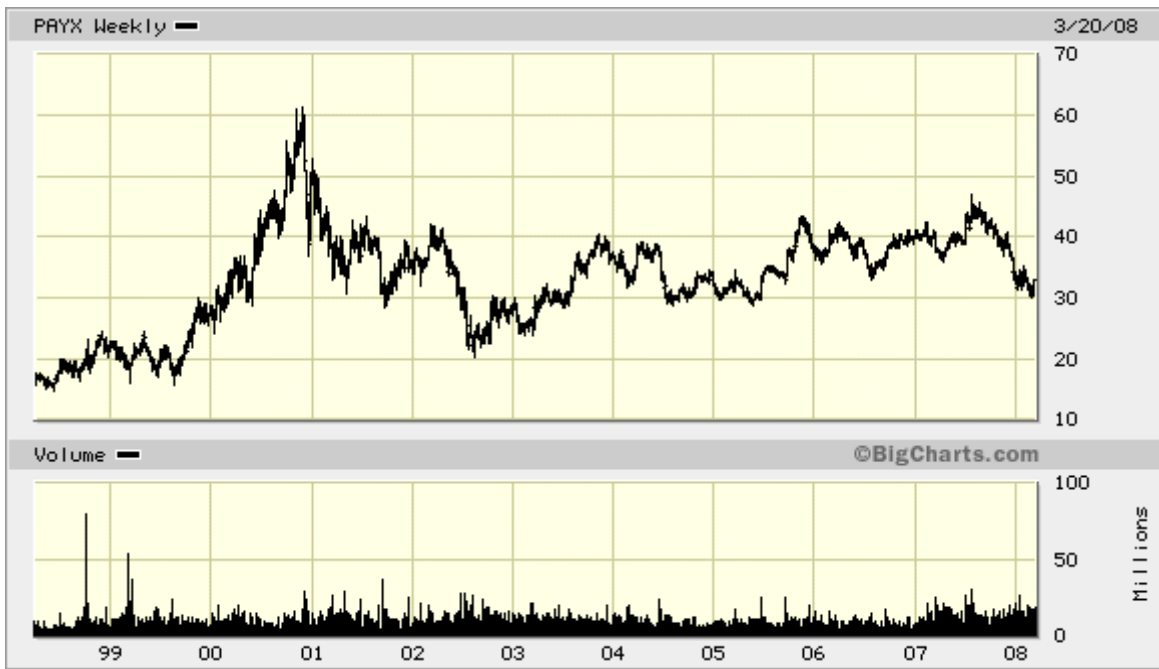
**Q:** When you separate the companies from the *Value Line*, many are trading at a premium so what type of situations or news you are looking for to make a buy?

**RB:** Here is the analogy I like to use. We value investors like to buy our shoes on sale. This one I like and if it ever goes on sale, I will buy it. If it is in my size, I will buy the shoes. But the underlying thought, you may not get the shoes; it may never gone on sale. *PATIENCE*.

I identify a subset of 50 to 75 companies or 100 companies at the most that meets the financial characteristics that I want, and I wait for them to go on sale. Sometimes they never do. A company called *McCormick (MRC)* that I would use as an example that makes the spices and it has a wonderful long term record, but it never, ever gets cheap. If you ever wanted to buy *McCormick*, you could never buy it with a margin of safety—at least by my reckoning.



The idea is to identify your candidates—these are the better companies—I would be happy to buy any of them if they got to my valuation level. You never know which company that will be. In the kind of market that we are now in, I am finding companies I never thought I would own. I bought a company recently called *Paychex (PAYX)*. They are a small ADP; they are a wonderful company. It is run by Tom Galisano. The stock is at 20 times earnings but it has wonderful, sensational cash generating features. A price it has never really been before.



**Q:** What do you think about long and short strategies?

**RB:** I have a lot of scares from short selling and I would just say that the valuation...the valuation methodology does not lead to successful short selling. *Benjamin Graham* wrote that himself, *WEB* has said that himself. Valuation ... I have never ever met any successful short sellers. When stocks are overvalued by my criterion, that doesn't mean they will go down a whole lot more.

I have an experience way back when. There was a fraud called *Baldwin United*. I perceived it at a fraud. I shorted the company at \$50, it went to \$100 before it went to \$1. That is a real world example of a short. You can be really right on a short but if you are not right on the timing, you can get hurt badly. The margin of safety, the ways we protect ourselves now is diversification, true diversification like different industries, different sizes and through the bet size and having a reasonable time horizon (of over three (3) years or more). If you own a stock right now in the kind of market right now, you are losing money. **There is nowhere to hide.** If you are long, you are losing money. That is just the way the world works from time to time. The money in the equity market has to have a long term horizon.

Whatever we are living through right now in 2008, in 5 to 10 years, this will be a little blip on the price chart, just like 1987 or 9/11 that seemed to be traumatic at the time.

**Q:** Can you use this strategy for new, emerging companies?

**RB:** No, because those companies have very little present value and little future value which very few people are capable of accessing. So by my criterion of seasoning, new technologies, I want to see them over a period of time and through adversity. How does a company do through a recession and tough times.

**Q:** What is the Strategy to get out? What is the typical holding pattern?

**RB:** Given the essence of what I do is mean reversion and the academic studies show that mean reversions take place over three or four years so that is the reasonable time horizon. Interestingly enough when *Ben Graham* in his later years tried to find a mechanical formula for stock picking and investing.

He would have a set of criteria and he would buy a stock when all of these criteria were met and then he would sell if one of two things happened either it goes up 50% or you hold it for three years. He was trying to avoid the value trap. If you buy it cheap and it stays cheap forever. I think that is still too short a time horizon, you run the risk of missing a really big move.

The kind of investing I am doing now does not lead you to make 3, 5 or 10 times your money. If you are dealing in these big companies like *Coke* at \$40, it is not going to \$400. **If it goes to \$60, then you have made 50% and that is a generous return relative to the risk you have taken.**

*John Chew: Note the evolution of a very experienced professional investor(35 years plus) who moved from deep value investing in commodity-like companies to investing with diversification in stalwart, superior companies. He moved from the difficult to the less stressful, more elegant approach.*

--

## Appendix

**Experience** [Bernard Condon](#) 02.11.08

**At 91, the man Warren Buffett famously dubbed a "superinvestor" is still picking unloved stocks.**

**Walter Schloss** has lived through 17 recessions, starting with one when Woodrow Wilson was President. This old-school value investor has made money through many of them. What's ahead for the economy? He doesn't worry about it.

A onetime employee of the grand panjandrum of value, *Benjamin Graham*, and a man his pal *Warren Buffett* calls a "superinvestor," *Schloss* at 91 would rather talk about individual bargains he has spotted. Like the struggling car-wheel maker or the money losing furniture supplier.

Bushy-eyebrowed and avuncular, *Schloss* has a laid-back approach that fast-money traders couldn't comprehend. He has never owned a computer and gets his prices from the morning newspaper. A lot of his financial data come from company reports delivered to him by mail, or from hand-me-down copies of Value Line, the stock information service.

He loves the game. Although he stopped running others' money in 2003--by his account, he averaged a 16% total return after fees during five decades as a stand-alone investment manager, versus 10% for the S&P 500--*Schloss* today oversees his own multimillion-dollar portfolio with the zeal of a guy a third his age. In a day of computer models that purport to quantify that hideous and mysterious force called risk, listening to *Schloss* talk of his simple, homespun investing methods is a tonic.

"Well, look at that," he says brightly, while scanning the paper. "A list of worst-performing stocks."

During his time as a solo manager after leaving *Graham's* shop, he was a de facto hedge fund. He charged no management fee but took 25% of profits. He ran his business with no research assistants, not even a secretary. He and his son, Edwin (who joined him in 1973), worked in a single room, poring over Value Line charts and tables.

In a famous 1984 speech titled the "The Superinvestor of *Graham-and-Doddsville*," *Buffett* said *Schloss* was a flesh-and-blood refutation of the Efficient Market Theory. This hypothesis holds that no stock bargains exist, or at least ones mere mortals can pick out consistently. Asked whether he considers himself a superinvestor, *Schloss* demurs: "Well, I don't like to lose money."

He has a Depression-era thriftiness that benefited clients well. His wife, Anna, jokes that he trails her around their home turning off lights to save money. If prodded, he'll detail for visitors his technique for removing uncanceled stamps from envelopes. Those beloved Value Line sheets are from his son, 58, who has a subscription. "Why should I pay?" *Schloss* says.

Featured in Adam Smith's classic book *Supermoney* (1972), *Schloss* amazed the author by touting "cigar butt" stocks like Jeddo Highland Coal and New York Trap Rock. *Schloss*, as quoted by Smith, was the soul of self-effacement, saying, "I'm not very bright." He didn't go to college and started out as a Wall Street runner in the 1930s. Today he sits in his Manhattan apartment minding his own capital and enjoying simple pleasures. "Look at that hawk!" he erupts at the sight of one winging over Central Park.

One company he's keen on now shows the *Schloss* method. That's the wheelmaker. Superior Industries International gets three-quarters of sales from ailing General Motors and Ford. Earnings have been falling for five years. *Schloss* picks up a Value Line booklet from his living room table and runs his index finger across a line of numbers, spitting out the ones he likes: stock trading at 80% of book value, a 3% dividend yield, and no debt. "Most people say, 'What is it going to earn next year?' I focus on assets. If you don't have a lot of debt, it's worth something."

## Schloss' Watch List

The veteran investor says buy Superior, but for now just track the other battered names. If they continue to fall, consider buying them, too.

COMPANY	PRICE		P/E	PRICE/ BOOK	COMMENT
	RECENT	52-WEEK HIGH			
<b>BASSETT FURNITURE INDUSTRIES</b>	\$11.05	\$16.70	NM	0.6	Consider buying if dividend is cut.
<b>CNA FINANCIAL</b>	31.68	51.96	8	0.9	Tisch family controls undervalued insurer.
<b>DOW CHEMICAL</b>	36.02	47.96	10	1.9	Accumulate if it slips further.
<b>SUPERIOR INDUSTRIES INTERNATIONAL</b>	16.43	24.52	NM	0.8	Car-wheel maker is worth at least book value.
<b>TECUMSEH PRODUCTS</b>	21.80	26.59	NM	0.6	Asian rivals hurt compressor maker for now.

Prices as of Jan. 15. NM: Not meaningful. Source: Reuters Fundamentals via FactSet Research Systems.

*Schloss* screens for companies ideally trading at discounts to book value, with no or low debt, and managements that own enough company stock to make them want to do the right thing by shareholders. If he likes what he sees, he buys a little and calls the company for financial statements and proxies. He reads these documents, paying special attention to footnotes. One question he tries to answer from the numbers: Is management honest (meaning not overly greedy)? That matters to him more than smarts. The folks running Hollinger International were smart but greedy--not good for investors.

*Schloss* doesn't profess to understand a company's operations intimately and almost never talks to management. He doesn't think much about timing--am I buying at the low? selling at the high?--or momentum. He doesn't think about the economy. Typical work hours when he was running his fund: 9:30 a.m. to 4:30 p.m., only a half hour after the New York Stock Exchange's closing bell.

*Schloss* owns a prized 1934 edition of *Graham's Security Analysis* he still thumbs through. Its binding is held together by three strips of Scotch tape. In the small room he invests from now, across the hall from his apartment, one wall contains a half-dozen gag pictures of *Buffett* (the Omaha sage with buxom cheerleaders or with a towering stack of Berkshire Hathaway tax returns). Each has a joke scribbled at the bottom and a salutation using *Schloss*'s nickname from the old days, Big Walt.

*Schloss* first met that more famous value hunter at the annual meeting of wholesaler Marshall Wells. The future billionaire was drawn there for the reason *Schloss* had come: The stock was trading at a discount to

net working capital (cash, inventory and receivables minus current liabilities). That number was a favorite measure of value at *Graham*-Newman, the investment firm *Schloss* joined after serving in World War II. *Buffett* came to the firm after the Marshall Wells meeting, sharing an office with *Schloss* at New York City's Chanin Building on East 42nd Street.

*Schloss* left the *Graham* firm in 1955 and with \$100,000 from 19 investors began buying "working capital stocks" on his own, like mattressmaker Burton-Dixie and liquor wholesaler Schenley Industries. Success drew in investors, eventually rising to 92. But *Schloss* never marketed his fund or opened a second one, and he kept money he had to invest to a manageable size by handing his investors all realized gains at year-end, unless they told him to reinvest.

In 1960 the S&P was up half a percentage point, with dividends. *Schloss* returned 7% after fees. One winner: Fownes Brothers & Co., a glovemaker picked up for \$2, nicely below working capital per share, and sold at \$15. In the 1980s and 1990s he also saw big winners. By then, since inventory and receivables had become less important, he had shifted to stocks trading at below book value. But the tempo of trading had picked up. He often found himself buying while stocks still had a long way to fall and selling too early. He bought Lehman Brothers below book shortly after it went public in 1994 and made 75% on it in a few months. Then Lehman went on to triple in price.

Still, many of his calls were spot-on. He shorted Yahoo and Amazon before the markets tanked in 2000, and cleaned up. After that, unable to find many cheap stocks, he and Edwin liquidated, handing back investors \$130 million. The *Schlosses* went out with flair: up 28% and 12% in 2000 and 2001 versus the S&P's --9% and --12%.

The S&P now is off 15% from its peak, yet *Schloss* says he still doesn't see many bargains. He's 30% in cash. A recession, if it comes, may not change much. "There're too many people with money running around who have read *Graham*," he says.

Nevertheless, he has found a smattering of cheap stocks he thinks are likely to rise at some point. High on his watch list (*see table*) is CNA Financial, trading at 10% less than book; its shares have fallen 18% in a year. The insurer has little debt, and 89% of the voting stock is owned by Loews Corp., controlled by the billionaire Tisch family. He says buy if it gets cheaper. "I can't say people will get rich on it, but I would rather be safe than sorry," he says. "If it falls more, I won't worry about it. Let the Tisches worry about it."

*Schloss* flips through Value Line again and stops at page 885: Bassett Furniture, battered by a lousy housing market. The chair- and table-maker is trading at a 40% discount to book and sports an 80-cent dividend, a fat 7% yield. *Schloss* mutters something about how book value hasn't risen for years and how the dividend may be under threat.

His call: Consider buying when the company cuts its dividend. Then Bassett will be even cheaper and it eventually will recover.

If only he had waited a bit to buy wheelmaker Superior, too. It's been two years since he bought in, and the stock is down a third. But the superinvestor, who has seen countless such drops, is philosophical and confident this one is worth book at least. "How much can you lose?" he asks.

NOTES: \_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

**END**

### **Am I an investor, or am I a speculator?**

During his recent visit to Fool HQ, business legend John Bogle argued that this is the very first question you must ask yourself.

The distinction is simple but powerful: Investors buy shares of *businesses*, then prosper over time as the company grows profits. Speculators, on the other hand, trade *wiggles* on a stock chart, hoping to sell shares at a higher price to other speculators within a few quarters.

### **Back to the myth**

Sadly, shortsighted compensation plans and business strategies *are* aligned with the time horizons of the vast majority of shareholders. After all, at the end of 2007 (the most recent statistical set), some 80% of shares were held by financial institutions. And the evidence shows that financial institutions are, by and large, speculators.

Given the explosion of mutual funds, 401(k)s, endowments, and the like, it makes sense that institutional ownership has steadily risen over the years. As institutional ownership has grown, however, the average holding period of stocks has shrunk:

<b>Year</b>	<b>NYSE Turnover</b>	<b>Holding Period</b>
2009 (year-to-date)	157%	8 months
2000	88%	14 months
1990	46%	26 months
1980	36%	33 months
1970	19%	63 months
1960	12%	100 months

Source: NYSE Group Factbook. Turnover = number of shares traded as a percentage of total shares outstanding.

It gets even worse when we look at the overall stock market, according to Bogle. Inclusive of exchange-traded funds, the overall market turned over at 284% in 2007. That means the average holding period for stocks and ETFs was *four months!*

OK, OK, but how does this speculative frenzy affect *you*?



**Wall Street's very dirty secret**

Simply put, when an institutional shareholder has a time horizon of four months, they should *want* management to pull out the stops *right now* to hit quarterly earnings targets. If they're not going to own the stock in five years, why would they concern themselves with the long-term effects of today's business decisions?

Consider the average holding period of these stocks in 2007 -- the year before the volatility-inducing financial meltdown:

<b>Company</b>	<b>Holding Period</b>
<b>Bank of America</b>	9.4 months
<b>AIG</b> (NYSE: AIG)	9.3 months
<b>Citigroup</b>	5.8 months
<b>Morgan Stanley</b> (NYSE: MS)	5.0 months
Lehman Brothers	2.5 months

Sources: Yahoo! Finance; Capital IQ, a division of Standard & Poor's; and author's calculations. Turnover calculated as total yearly volume divided by average shares outstanding.

**One appalling example**

From 2000 until the collapse of the firm, former Lehman Brothers CEO Richard Fuld received approximately \$350 million in total compensation. In part, he was rewarded for growing the company's earnings at an annual rate of 18% over that time frame ... except that those returns were produced using 30-to-1 leverage atop a shoddy asset base.

Since it would only take a roughly 3% decline in the value of Lehman's assets to render the firm insolvent, it seems as if Lehman operated with temporary gains in mind, but no thoughtful strategy for how to avoid blowing up. And on Sept. 14, 2008, it did, in the largest bankruptcy ever.

The shock of Lehman's failure froze credit markets, caused huge derivatives losses, and set off bank runs around the world. In just one month, the TED spread -- investors' "fear index" -- shot up to an all-time high. AIG needed to be rescued by taxpayers because of the billions it lost because of Lehman's collapse.

The run on Washington Mutual, which began the day of Lehman's collapse, led to the largest bank failure in U.S. history in mere weeks. One **Wells Fargo** senior economist estimated the employment fallout from Lehman's bankruptcy at 2 million job losses. Now, even strong companies unrelated to the financial industry are suffering from the economic fallout of this crisis -- **EMC** (NYSE: EMC) and **Texas Instruments** (NYSE: TXN), for example, have been forced to announce layoffs.

No one disputes that the outrageous risks taken at Lehman Brothers and similar institutions have had terrible effects on our economy. But despite Lehman's epic collapse, it's probable that most shareholders *benefited* from Lehman's more-than-200% rise over eight years. Refer back to the chart above -- the average holding period of Lehman stocks was less than three months!

Frankly, this upsets me. And I can't blame you if it makes you mad, too. The fact that a majority of business owners' interests *are unaligned with the health of their own businesses* runs completely counter to the well-being of our economy and the basic tenets of capitalism.

If capitalism is going to work, this ridiculousness needs to change.

### **Here's my plan**

One market-oriented mechanism would be a tax increase on speculation, combined with a tax decrease on investing. If it became less profitable for institutional shareholders to speculate on short-term price movements, and more profitable to invest for the long term, their holding periods might increase, and they'd likely care more about the financial health and compensation structures of the businesses they own.

This could take the form of a graduated 60% speculation tax on stocks and equity-based derivatives held for less than one year, which tapered down to, say, 5% after a few years.

I'm not the only investor who has thought of such a plan. Warren Buffett (perhaps facetiously) once suggested a 100% short-term capital gains tax, while John Bogle has advocated a 50% rate.

As someone who feels the economic impact of this crisis, you should love a higher tax on speculators, because it would align institutional shareholders with the long-term health of the companies they own. That is a necessary step to preventing another financial time bomb. Without such a shift in incentives, they would have limited reason to demand responsible management, and a crisis like this one would be more likely happen again.

### **The silver lining ...**

To be fair, not every corporation fits the Lehman mold. **Berkshire Hathaway's** (NYSE: BRK-B) shareholders are owners for more than *30 years* on average; they must be happy with Buffett's relatively meager compensation, large stock ownership, and long-term focus.

**Markel's** (NYSE: MKL) Alan Kirshner and **Costco's** (Nasdaq: COST) Jim Sinegal have compensation structures that look much more like Buffett's than those enjoyed by many of their CEO counterparts.

Just as we saw a number of disasters in the past year, I expect -- and history confirms -- that we will begin to see other companies benefit from their missteps. With stocks so cheap, making money now becomes a matter of examining every facet of a company -- including the competency of its management team, rewards and incentives, business strategy, and market environment.

These are just some of the factors we examine at *Motley Fool Inside Value*, as part of our quest to identify the best bargains in this market. Click here if you're interested in reading more about our favorite stock ideas, free for the next 30 days.

*Already a subscriber to Inside Value? Log in at the top of this page.*

*This article was originally published under the headline "Why You Should Love Higher Taxes" on April 17, 2009. It has been updated.*

*Ilan Moscovitz owns shares of Berkshire Hathaway, which, along with Markel and Costco, is an Inside Value pick and Fool holding. Costco and Berkshire are also Stock Advisor selections. The Motley Fool is investors writing for in*