Ruane, Cunniff & Goldfarb Investor Day

May 15, 2009 – St. Regis Hotel, New York City

Below is the transcript of the question-and-answer session that followed Bob Goldfarb's prepared remarks at Ruane, Cunniff & Goldfarb Investor Day on May 15, 2009 at the St. Regis Hotel in New York City. The text has been edited for clarity.

Bob Goldfarb:

Before opening the floor for questions, I'd like to introduce the members of our team. On my far left is Greg Steinmetz. Next to Greg is Jon Brandt. On my immediate left is David Poppe who is co-manager of Sequoia and president of our firm. To my right are Greg Alexander and Joe Quinones, who oversees the operations of the firm as well as those of Sequoia. Unfortunately, Rick Cunniff is unable to be here today because he's not feeling well.

To my left in the front row and to the right of most of you is the rest of our analytical team. In alphabetical order, they are Vish Arya, Girish Bhakoo, John Harris, Jake Hennemuth, Arman Kline, Trevor Magyar, Tom Mialkos, Terence Paré, Chase Sheridan, and Stephan van der Mersch. I'd also like to introduce Jon Gross who is our director of client services. With that, we're ready for your questions.

Question:

Given your opening remarks, can you talk about potential hedging strategies so that you don't have another 2008? And a second question — health care in the United States looks like it's going to become an entitlement. There's not a lot of exposure to it in your portfolios. Are you anticipating any investments in health care?

Bob Goldfarb:

On the first, you shouldn't expect us to hedge. And you probably shouldn't expect another 2008. As for health care, it's going to be a double-edged sword for many health care companies. We'll likely see more volume but some contraction in profitability or in profit margins emanating from price pressure from the government.

There's already been some of that in the past with Medicare setting prices, and clearly the HMOs have impacted prices as well. We'll continue to look at health care stocks, but we'll look at them with full consideration given to the likelihood of increasing volumes offsetting contracting margins. If we can find some that are going to enjoy the benefit of rising volumes but not suffer countervailing falling margins and prices, we'd be more favorably inclined or disposed toward those.

Question:

You mentioned that the United States has the ability to print currency that the rest of the world will accept. I guess Herbert Stein said if something is not sustainable, it will stop. Have you considered the possibility that although the rest of the world has been accepting our currency, that perhaps it will not?

Bob Goldfarb:

I consider it very unlikely that today our currency won't be accepted. Certainly when you go out a few years, it's possible. There have been some ideas floated for replacing or supplementing the dollar as a reserve currency. The ones I've seen that seem most practical involve a market basket of currencies which may or may not include the dollar — but probably would — replacing the dollar itself. The world needs a reserve currency.

But it's interesting that when the world sought a safe haven in the turmoil during the last year, it looked to the greenback. That's the best measure of a safe haven. Now you've also seen an increase in the price of gold, and you could argue that's an alternative. But at the present time, it's the dollar. In the future, if we continue to print money at a rapid rate, the world may well have to seek an alternative.

Question:

You covered Porsche in the annual report where you talked about the favorable risk/reward opportunity in a couple of paragraphs. Obviously there's been a fair amount of news recently about a potential merger with Volkswagen. I'm curious as to your current views and if anything has changed from what you described in the annual report.

David Poppe:

Porsche was the worst performing stock in Sequoia last year, and it's the worst

performing stock in Sequoia so far this year. So it's hard for me to sit here confidently and tell you what's going to happen next. We think the value of Porsche — and we've thought this for a while — is greater than the current stock price indicates. But it's extremely difficult for investors to get a good handle on what the intrinsic value of the business is when the company has been so opaque in its dealings with Volkswagen.

I think we probably erred analytically in not seeing just how difficult the auto market would be. Volkswagen is not GM, but that doesn't mean Volkswagen couldn't earn significantly less in this kind of economy. I think we maybe didn't take that prospect seriously enough. But I think the basic problem with Porsche right now is that the facts around the merger or the potential merger with Volkswagen are so unclear. Our view is — and I don't want to say that we have any special knowledge — but our view is that Porsche has alternatives other than being swallowed up by Volkswagen that would be better for the Porsche shareholder.

Porsche is controlled, 100 percent of the voting rights, by the Porsche and Piëch families. It seems doubtful to us that they would agree to a merger with Volkswagen that would destroy their families' net worth. As mentioned, there are alternatives for Porsche other than either being subsumed into Volkswagen or trying to buy 75 percent of Volkswagen stock so that they can get what in Germany is called a domination agreement and control Volkswagen. We don't think Porsche will end up with 20 billion euros of debt. We don't think Porsche will end up being sold to Volkswagen for 30-40 euros per share.

That said, the Porsche stock was 180 euros at the end of 2007 and clearly we got it wrong on the upside as to what Porsche's true value was because that would have been a terrific sale. Greg, do you have anything you want to add to that?

Greg Steinmetz:

I just want to point out that Porsche, as David said, is not without options. They still own 50 percent of what I think last quarter was the world's biggest car company, and there's value in that. The brands are still strong. What's frustrating is that the Volkswagen people are negotiating with Porsche right now through press releases and putting out all sorts of comments, which I think are designed to drive down Porsche's stock price and put more pressure on the family to agree to terms that may not be favorable to them. But I am confident that the Porsche family and management are going to hold out here and try to extract the best terms they can.

Question:

Could somebody tell us what is happening with Mohawk? Last year, I remember you were very gloomy. Maybe you can tell us about the fundamentals.

Terence Paré:

Mohawk sells floor covering. Its sales are driven primarily by existing home sales, commercial construction and remodeling and, to a lesser extent, new home sales. It's no news that we haven't been buying or selling a lot of houses, and we haven't been building many houses. In fact, we built way too many houses. And it's going to take a long time for that excess inventory to get sopped up.

One way to think about Mohawk today, and to put it into the context of Bob's comments, is to look at the pluses and minuses for the company as it exists now, given the way we feel about the economy. On the downside, of course, is this continuing contraction of consumers' spending and their being more thrifty — obviously, it's better if people are going to throw around a lot of money, buy vacation houses, and put flooring in — Mohawk will suffer from that.

But the structure of the company is such that it's in a pretty good position, even if people are going to be thrifty because its product line goes from goods that are very expensive to those that are very inexpensive. If the consumer moves down market, Mohawk still stands in a good position to capture a lot of that business. Carpet can be a relatively inexpensive or an expensive type of floor covering. Mohawk also makes high quality laminate, which is an economical alternative to wood flooring. So there's that. The price range for Dal-Tile's offerings like that of the carpet business goes from very affordable to very expensive. The company is well positioned for thrifty consumers, and if you want to spend a lot of money, they have expensive things to sell you as well.

On the other side, somewhat offsetting a longer-term contraction of consumer spending, is the fundamental driver of housing, which is household formation. And that is simply going to continue no matter how thrifty we are. If you just look at the demographics, the people who are alive today — college students — my son and daughter are eventually going to move out of the house — we would like them to be there forever, but they're going to move out. And they will have to form households. They will have to buy houses; and they will have to buy flooring.

If you just look at the numbers, there's a very big demographic wave coming to create demand for housing in the future. So it's very, very difficult to tell how long the recovery in demand is going to take, but the fundamental driver of housing is still there. It's alive and walking around. So I think over the long run Mohawk will be fine.

It will be difficult for it to produce the same volume of sales as in the past because there's not going to be a housing boom. But again, partially offsetting that, the business itself — the whole industry has contracted. Marginal players are strapped. They're going to be dropping out. Mohawk itself has radically downsized; management has laid off 20 percent of its workforce over the past year. And they've idled a lot of assets, the least productive assets first — which is what your common sense would tell you to do. When demand returns, Mohawk will be manufacturing with its most productive assets. So over the long run, it will be okay. When exactly that is going to happen I'm not prepared to say because I don't know.

David Poppe:

What I would add to that is Mohawk has a terrific family ownership. It's the kind of owner-manager whom we really like. It has a very good duopoly position in the industry. Shaw is the other major flooring company. With only two large companies in that industry, you should have very rational pricing over time. They are much stronger than any of the smaller companies.

But you could ask yourself ... in a horrible macro environment, we had the common sense to sell Bed, Bath & Beyond and Lowe's, which are two companies that would be oriented similarly to Mohawk in terms of their exposure to housing, but we didn't sell Mohawk. We could be second-guessed for that, and I suppose it comes down to sometimes the macro environment is very negative, and we made the decision that this is a management team that we think will manage through it, and be in a good position in the long term because it is a duopoly industry, and housing is likely to ... we are likely to have a million or a million-two housing starts per year over the long term in the US, even if this year we build 400,000-500,000 houses. In the short term, holding Mohawk has been a really poor decision. In the long term, we're hoping and expecting that it will be a better decision.

Bob Goldfarb:

I would also point out that sales of existing homes are much more of a driver of Mohawk's fortunes than sales of new homes. So if I were looking for an indicator or barometer of activity, that's the one I'd focus on. Terence, Mohawk has a lower share, doesn't it, in the builder market?

Terence Paré:

Yes, it does.

Bob Goldfarb:

Yes, they have a lower share in the builder market and a higher share in the remodeling market, which is driven by the sales of existing homes, and so I think we've seen some stabilization and modest uptake in sales of existing homes in recent months. That's about the first positive harbinger that we've seen regarding Mohawk and we would expect that there will be more to come over time.

Question:

What are the prospects for Expeditors in a world of contracting global trade?

Greg Steinmetz:

Expeditors experienced a 30 percent decline in volume last quarter, which is enormous. The global market contracted about 20 percent, but Expeditors consciously gave up some business because it wasn't priced properly. As a result, their profits didn't fall nearly as much and what they call their net revenue, which is where they make their money, fell only 10 percent. Their operating profit fell only about 13 percent. What they're able to do is really

optimize their network so that they can squeeze as much profit out of their operations as humanly possible. They're a terrific company.

Unlike other freight forwarders out there, they're wholly built from scratch. They haven't made any acquisitions. That gives them advantages in the marketplace because everyone is on the same page. If you're trying to ship a box from China to Los Angeles, a lot of things can happen with the paperwork. You want seamless handoffs, and Expeditors is very good at delivering that. They have the best service. They also have a cost advantage in China because they ship so much volume out of there.

What I think will happen is that we are going to have a few years when Expeditors doesn't grow. When things pick up they will begin taking share like they have been for the 30 years they've been in business. It's a terrific company. There's nothing that's happened there that makes us think otherwise. They're still the best operator in the business, and they have almost $900 million on the balance sheet and no debt.

Bob Goldfarb:

I'd add that it wouldn't surprise me if the unit volumes that we saw in the first quarter marked the nadir of the decline. Our retailers as a whole are big customers of Expeditors. In response to very weak sales in the fourth quarter, they ordered very, very little merchandise to be shipped in the first. We're beginning to see some of those retailers say that they're losing sales because they didn't buy sufficient inventory. I don't think it will be a quick turnaround, but again, it wouldn't surprise me if there were some improvement going forward.

Question:

Being aware of what's going on with real estate, I wonder whether it could be attractive for the fund?

Bob Goldfarb:

I'd say with regard to real estate itself, it has several characteristics that are almost antithetical to the characteristics that we look for when we make an investment. It has a pretty low return on capital. It's highly levered, and that means that it doesn't take a large decline in demand to cause real problems.

I noticed just yesterday that Forest City, which is a company that has been around for a long time and has been through many of these cycles — and it's controlled by the Ratner family — was forced to sell stock at very unattractive levels. We saw Vornado, which is considered one of the best REITs, sell stock just a few weeks ago at a fraction of the price they could have sold stock for a year ago. So I think real estate itself ... a lot of money has been made in real estate, and it will be made in real estate going forward. But a lot of money has already been lost and will be lost in real estate.

Question:

When you say low return on capital, could you explain what you mean by that?

Greg Alexander:

If you take a typical business that we own shares in and take the physical assets of the business and look at what the operating income is before interest expense or taxes, and you divide one by the other, it's a high return. I don't know what it is but I wouldn't be surprised if it was in the twenties or thirties at least.

In real estate, if you build a new shopping mall or buy an existing shopping mall, you're probably lucky if you get an 8 percent yield — you probably have built the most successful new shopping mall in the neighborhood for a long time.

Question:

In your shareholder's letter dated February 13, you refer to an insolvent banking system, which I guess demonstrates, if nothing else, that you're not an employee of the US government. But I wonder if following all the interventions and private capital raisings that have taken place in the last three months you would still use that adjective.

Jon Brandt:

That's a tough one. I haven't done an analysis of the system as a whole, but if you have a company which has anywhere from three to five percent equity-to-assets, and in the current market you can't sell the loans that constitute most of the assets for more than 97 cents or 96 cents, you could argue that the system is insolvent.

The other way of looking at it is whether you can earn your way out of it. Those loans may be selling for less than 97 cents now, but many of them may sell for more when

economic conditions improve. So the question is whether you look at banks as a static system, or a living, breathing, earning animal that, as the economy eventually gets better, will be able to earn enough to pay off the losses that are going to result from this downturn. There will be some banks that won't.

There are a lot of different companies and they have different circumstances. Some of them have very high earnings rates before losses — pre-provision, pre-tax profits — others don't. The ones with the higher margins and the higher earnings levels before losses should be able to earn their way out. I suspect that at the nadir of most recessions, it would look like the banking system is more or less insolvent.

The other thing is that so much of the lending that's going on in the economy or has been going on for the last 10-20 years has been in the securitization markets. So whether or not the banks themselves are solvent or insolvent is important, but it's not the only thing that is important in terms of restoring the natural functioning of the nation's credit markets.

Question:

Last year when we were talking about Rolls-Royce, I believe that you said that they had back orders of eight years' production of engines. I think later on in the year I spoke with someone at the office and they said it was down to five years. I wonder where that stands. I have a second question. Is there any thought of upgrading the website for the Sequoia Fund so that the shareholders will be able to access their accounts and see something other than that which is up there, which is basically a textbook?

Arman Kline:

I'm not quite sure that the data you mentioned for Rolls is correct. The latest figures we have for Rolls-Royce are for the end of the last fiscal year, and its backlog was up 24 percent year over year and up four percent over the first half. They have a constant currency reporting basis; so they do not benefit from the fact that the dollar has appreciated against the pound. The backlog is pretty good there. The civil aerospace business accounts for about half of the company's revenues. Its backlog is currently around seven years, based on our estimates of the value. The backlog gets booked at list prices, but they don't realize list prices. It's at almost ten years, based on list prices. But our estimate is closer to seven years, based on the discounts they give the carriers.

Joe Quinones:

About the website, we don't have a fancy one. For about nine months, we have been trying to get shareholders access to their accounts. We thought we had it all wrapped up with our transfer agent, but we have not been able to finalize it. But we do intend for shareholders to have access and be able to trade — just as at other funds — before the end of the year. But it's not going to be fancy.

Question:

Given the dominance of Berkshire in the portfolios, would you please give your assessment?

Jon Brandt:

The interesting thing about Berkshire Hathaway is that for most of the time we've owned it, it's had a lot of cash. There's always been a lot of dry powder since Berkshire acquired Gen Re in 1998. I don't know if rooting is the verb I want to use, but Berkshire was always very well positioned for a certain amount of distress, blood in the streets, credit being tight, stocks being down, and businesses getting cheaper.

Now, Buffett has basically put all his money to work, which is good. We have new sources of earnings from the preferred stock in GE, the preferred stock in Goldman Sachs and the loan to Wrigley, which also has a double digit yield. There is also a recent convertible debenture or, I should say, contingently convertible debenture in Swiss Re. He lent a lot of money to a lot of pretty good corporate credits from Vulcan, which we own, to Tiffany, Sealed Air, and Harley-Davidson. He's getting 10-12 percent yields on all these instruments.

Going into this crisis, there were some exposures to high yield bonds and the credit default swaps that Buffett wrote about last year. I'm not as worried about the S&P puts. I think there's enough time for corporate America over the next 15 years to increase its earnings to levels and valuations such that Berkshire would not have to pay anything.

But like many businesses in America, Berkshire's earnings have been suffering from the crisis and the recession. A number of its businesses have been affected. These include the lending businesses in which Berkshire is an investor such as American Express, Wells Fargo, and some other banks. Furthermore, many of the wholly-owned businesses such as the building products companies, the retailers and apparel businesses, Clayton Homes, Iscar, and NetJets have been severely affected by the economic contraction. As Bob was talking about earlier, it's very hard these days to know what the new normal is. Shaw earned ... I want to say $594 million pre-tax at the peak. The building products companies — Manville, Acme, Benjamin Moore and MiTek — I think earned almost $900 million at the peak. Whether that $900 million is going to be $500 or $600 million or $400 million in what we now think could be a normal environment going forward is a subject to debate. But the earnings will rebound. How much higher, it's a little hard to say. But the earnings of these businesses will recover when the economy comes back.

Berkshire is a very resilient corporation. The various insurance companies don't earn the same amount every year because their underwriting margins go up and down, but they are not really economically sensitive. And the utility business is mostly recession resistant, as is McClane. I think about half of Berkshire's peak earning power came from relatively recession resistant businesses whether they were these wholly-owned businesses or some of the stocks it owns like Wal-Mart, Coke, and Johnson & Johnson. There's a strong base of earnings that will see Berkshire through almost any kind of economic scenario. At the current valuation, I think you're paid quite well to hold on to the stock.

Question:

Do you think the companies in your portfolio have the pricing power to protect their earnings from inflation? Or should you put on hedges to cover you from that inevitability?

Bob Goldfarb:

I would say that pricing power varies. I think probably the strongest in terms of pricing power would be the rock companies, the quarry companies, namely Martin Marietta and Vulcan, which have continued to raise prices despite very significant declines in demand. You don't see that combination very often — maybe cigarettes or railroads.

But I'd also add that if you go back to Warren Buffett's article in *Fortune* about inflation and common stocks, I think he put more emphasis on the cash generating nature of the businesses than on their pricing power. That's not to dismiss pricing power, but as he pointed out, in an inflationary period what you want to avoid are capital intensive businesses that are forced to reinvest a fair amount of the cash that they throw off back into the business just because of increased inflation in working capital as well as plant and equipment. On that score of cash generation, we've had a strong emphasis for a long period of time and that should serve us well in a period of accelerating inflation.

Greg Alexander:

I would add one thing, which I think most people know. The problem with inflation is not just the direct problem of inflation. Bond investors are not stupid; fixed income investors are not stupid — if the inflation rate goes from two percent to six percent, they're not going to keep accepting two percent on their Treasury bonds and on their bank deposits. So interest rates will go up. And if interest rates were in the higher single digits, that would be bad for the economy and bad for stocks.

So that would be a secondary effect. It would make the economy weaker. I saw a pretty good comment in Jeremy Grantham's latest missive to the effect that he is worrying that the large deficits spawned by the — referring back to Bob's initial point in his prepared comments — that the large deficits spawned by the quote "stimulus plan" may have the effect of making the recession less severe at the expense of lengthening it. So I thought that was pretty well said, as it usually is.

Question:

A professor at Columbia University's value investing program has suggested that a large part of Wal-Mart's success has been due to the local competitive advantages it created by expanding geographically in tightly concentric circles. He suggests that Wal-Mart benefited

mightily from economies of scale especially with regard to distribution by dominating local and regional markets as it grew. I'm wondering if you agree with that and also if you feel that Target and perhaps Fastenal are taking a similar strategy with regard to their growth.

David Poppe:

I agree with that. Wal-Mart's competitive advantage, the reason Wal-Mart has the lowest cost, is in large part because it has a substantial advantage in distribution versus almost anyone. Target has not expanded in the same kind of tightly concentric circles because Target requires a little bit higher demographic neighborhood for the store to work and be successful. So it's not as simple an issue for them to just build them out two miles at a time across the country.

So Target's strategy is a little bit different. Target's got low cost but they will never be as low as Wal-Mart's. They will never have as many stores as Wal-Mart because Target has a narrower customer base. On the other hand, however, I would say Target has a pretty desirable store base because they opened a lot of stores in large metro markets that will be difficult for Wal-Mart to penetrate. I think they'll both be successful, but Wal-Mart certainly is and will continue to be the low cost provider. Bob talked about companies that are well-positioned for inflation — I can't think of too many companies that are better positioned for hyperinflation than Wal-Mart.

Chase Sheridan:

On Fastenal I would agree that it benefits from the same dynamic. They own their own logistics system, and they are always optimizing how they manage their logistics and distribution. Density helps them in that regard. They have a branch stock system, which allows them to pull inventory from one branch to another as demand requires. It's not a big part of their business but it helps them maintain their efficiency.

But density sometimes helps in some unexpected ways. I've noticed that the closer they get to home base in Winona, they tend to have more experienced managers and higher quality operations. If you look at some of the markets where they have wonderful opportunities to gain market share — for example, the inland empire in Southern California — they've had a hard time penetrating them in the past, although it's improving. If you ask management why, they'll ascribe it to the quality of the people who were running some of those areas in the past. But there also wasn't an example of a successful operation nearby for them to draw on. Those people have been replaced and management has been able to push the culture out more from the center. So I think it's not just the logistics and the distribution — it's also the culture that comes out from the center and which benefits from density.

Question:

I have a question about Knight Transportation. Last year I think you said very nice things about the company and its long term prospects. But you reduced your investment a little bit in that company. The stock held its own in 2008; so perhaps you reduced it because of valuation or you're worried about some long term fundamental problem?

Greg Steinmetz:

From a stock price perspective, Knight has held its value surprisingly well. The earnings are about two-thirds of what we thought they would be at this time. But because trucking stocks come back before other stocks in a recovery, people want to own these stocks right now. Knight is a great company in a very bad neighborhood. Anyone with a driver's license can go out and apply for a truck license, start driving a truck, and compete with Knight — the barriers to entry are very low.

What makes Knight appealing is that Kevin Knight is just a terrific manager and really knows the trucking business and knows how to make money in it. There's a nice growth story there because they can still open up a lot of terminals and make money doing so. But you're right — given its earnings and given the prospects for its earnings, it's a tough one. It's a very good example of how supply and demand work. Right now, there are too many trucks on the road and not enough freight to move and that's played havoc with pricing. Eventually, when we come out of this, Knight should continue doing very well.

Question:

I have a question about Whole Foods. If consumers are going to be more careful with their spending, why do you continue to hold Whole Foods?

David Poppe:

That's an extremely good question. I think probably the best thing to say is it's not our finest hour. It's a fine company. Again, we're kind of suckers for these entrepreneurial visionaries. We feel Whole Foods still has good growth prospects. There's no question in this kind of economy, the prospects are dimmer than we thought a year ago. Maybe a year ago — I haven't gone back and looked at my comments, I'm sure I would cringe a little bit — but the capital allocation over the last couple of years is just not up to the standard that we normally demand of the companies in the portfolio. So that's another issue that we have to think about with Whole Foods. They run a very, very good store. I think we made a mistake in that stock purchase.

Bob Goldfarb:

They had never gone through a recession before with negative comps. I think it truly surprised them when they did this go-round. It took them a while but in recent quarters, they've finally begun to attack operating costs both at the store level and at corporate as well. So with the focus on cost control, if their revenues start to come back on a same store basis, they should do pretty well.

Question:

Would you say there's any value in luxury retailers at this stage in the business cycle? It seems like you've historically stayed away from high-end retailers.

David Poppe:

We owned Tiffany and did very well with Tiffany. After 9/11, we accumulated a lot of the position, and owned it for about the next five years. Tiffany is near and dear to my heart; I feel like I know it pretty well. It's a great business in part because it's not exclusively a luxury retailer; it's a little more accessible than some of the others. I would say that at this point we're trying to find companies that are more oriented to needs not wants. I'm not sure that when Neiman and Saks are comping at minus 20 and minus 30 I have a lot of interest in the peer group at all. So we've been a little bit averse to luxury retail.

Question:

How about the apparel brands? Do they represent any value to you? Are there any standout companies that you find are well managed?

David Poppe:

What I would say is that apparel is extremely dynamic and the guy who's on top this year may not be on top next year. It's pretty rare for an apparel brand to last a generation. There are definitely apparel brands out there that do, but it's hard to handicap. Dumb analogy, but I don't like to try to handicap pharma pipelines either because it's really hard to figure out who is going to have the next great drug. It's hard to handicap who is going to be the next great brand in apparel, or who is going to be hot this year. There are people who can do it but we're not very good at it.

So let me say we've decided that we're not very good at it, as opposed to saying I don't think there's any value in apparel brands. It's a hard thing to analyze and as a dumb guy, I think that TJX is a little bit easier to analyze than an apparel brand in the same way that Walgreen is a little bit easier to analyze than a pharma company.

Question:

What do you make of the rally that has happened lately?

Bob Goldfarb:

I think some of the rally was clearly a reaction to the terrible stock market that preceded it. The composition of the rally has been interesting in that it's been driven by lower quality companies and by more cyclical companies. I think there was a fair component of short covering in it as well. But we're generally comfortable with the overall level of valuation in the market even after the rally. So on a valuation basis, it was probably logical, though it probably should have been a little broader.

Question:

Currently the deflationary forces seem to be quite powerful. With unemployment projected to go up, it's hard to see inflation in wages any time soon. It's hard to see inflation in commercial real estate any time soon. It's hard to see inflation in housing any time soon. Yet, you commented how you ultimately expect

some inflation. If you could give us your thoughts, please, on when you see the inflection point of the deflationary forces ultimately being counteracted by government actions and turning into inflation.

Bob Goldfarb:

I believe that the economy has begun to stabilize, albeit at significantly lower levels of activity than prevailed a year ago when we met. So I think stabilization is one inflection point that you look for that would suggest that contractionary forces remain significant but are no longer increasing. It wouldn't surprise me to then see some growth resume.

I know that some economists expect that growth might resume as soon as the third quarter. So those would be some indicators or data points that I'd look to and follow to see if they get stronger going forward. That's probably the best indication of where we're headed. Also, whether we can sustain an economic recovery without being on the ventilator of government support is also going to be pretty telling. The indicators that I was speaking about would suggest that with the help of a ventilator, there are signs of life. But at some point, we just have to get off the ventilator, and so I'd look to see if we can resume seeing an economy that can show some growth emanating from private demand as government spending and support and the Fed balance sheet hopefully contract.

Question:

Are you comfortable with the management succession at Brown & Brown?

Jon Brandt:

To give a little background, Brown & Brown is about 70 years old. Hyatt Brown has been the very successful CEO of Brown & Brown during much of that period. In July of 2009, his son Powell Brown is going to succeed him as CEO. Normally when you have a father passing the CEO's job to his son you want to be sure that he really is the right person.

I feel strongly that Powell is the right choice. I wouldn't necessarily say he is the only person who could have succeeded Hyatt. Jim Henderson would have been one of the possible choices. He's been Hyatt's number two for many years. Jim is in his early sixties. Powell is a year or two younger than me. I think Jim would have done a great job. But I think that the board believed that many better-run companies have the smallest number of CEOs over time, and I wouldn't argue with that.

I suspect Jim is a big fan of Powell's; so he's not going anywhere. He's going to help Powell, and Powell has a great team behind him with Charlie Lydecker, Tom Riley, and Ken Kirk. Cory Walker, the CFO, is also very strong. But Powell would have been my first choice as he was the board's.

Powell is an incredibly honest, incredibly hardworking, very smart guy who gets along well with the other managers. He has a very collegial attitude. There may be a little less power vested in the CEO role going forward, and, since it is a larger company, I think that's appropriate. He's a good delegator. I've talked with dozens of people at the company; everyone has endorsed the choice of the board. I like Powell. I think he's the right leader to run the company for the next 20-30 years.

Question:

What are the one or two most undervalued stocks in your portfolio? I'm going to qualify that — I'm a shareholder, but I'm not above cherry picking.

Bob Goldfarb:

I remember for years toward the end of December, Rick, Bill and I would try to make some assessment of which of our stocks were the most undervalued and likely to do best in the next 12 months. Our record on forecasting that was pretty poor. So I think I'll pass on that one.

Question:

Speaking of succession, with respect to Berkshire Hathaway, what are your thoughts on succession at that company?

Jon Brandt:

Let's stipulate that Warren Buffett is irreplaceable and also stipulate that I don't know who the next CEO is because it hasn't been announced. If it were to happen tomorrow, it would likely be David Sokol, Ajit Jain, or possibly Tony Nicely. The first two are probably more likely than Tony but I think Warren has more or less said the candidate is internal and they have three people. He hasn't specifically said those three, but that's what most people think, and I wouldn't discount it.

All three of those candidates have a lot of strengths. David would move into the job most easily since he's already been the CEO of a publicly traded company. He's comfortable with regulators; he's comfortable with doing deals. He's comfortable managing many employees. He's in Omaha. He spends a lot of time with Warren.

In the case of Ajit, probably more than anyone else at the company, he understands and has taken by osmosis through all the years with Warren — they speak on the phone every night — the culture of Berkshire and the way Warren thinks. He also obviously understands the insurance business. So between Ajit and David, you have two of the major legs of Berkshire — insurance and utilities — covered.

I don't think a co-CEO arrangement is ideal, but if for instance David became the CEO, you could see Ajit having a certain amount of authority over not just National Indemnity Re, but he might have some supervisory responsibility over the rest of the insurance businesses. However, I'm not implying that Berkshire will be any less decentralized than it is today.

I don't know Tony as well. He's done a fantastic job at Geico. He's a little older than the other two, so maybe he wouldn't be as long serving a CEO. But I don't know, and it's not beyond the pale that it could be somebody who doesn't now work for Berkshire because Warren could be there another 15 years. But we know that the board is thinking about this on a frequent and intensive basis. Bill Gates will probably effectively be the lead director. He's made a commitment to Warren to stay on the board and to help with CEO succession.

There are a lot of smart people on that board right now and I think they're going to choose the best person. But there's nobody who's got the IQ, who's got the personal charisma that Warren has, which is important when dealing with the Berkshire managers and the potential sellers of businesses. Warren said in Omaha that two of the softer qualities that the next CEO will need to have are being able to attract sellers and being able to deal with the different personalities of the various Berkshire managers. But no one can do derivatives, junk bonds, stocks, buy businesses, the way Warren can. None of the possible successors is Warren, but they're all excellent candidates.

Bob Goldfarb:

Given Tony's age and Ajit's expressed total disinterest in the job, I would bet on David Sokol.

Question:

What is Sequoia doing to research the new developments in environmental products? Many of us are looking for companies in solar power, wind power, toxic clean-up — all of those issues that are of enormous concern to those of us with grandchildren and great grandchildren.

Bob Goldfarb:

We're clearly aware of those trends. We have a summer intern coming and we plan to assign one of those companies to him. One problem is that we invest in companies, not in technologies. There aren't a lot of companies that are exclusively in those businesses and that are public and have the market capitalizations that would allow us to invest a meaningful amount of money.

I also would say that we're not accustomed to owning businesses where the model at the current time does not yield an economic profit and is totally dependent upon the existence of subsidies that can be given and taken away. There was an article this week that Conoco had an operation in biodiesel and the subsidy was being reduced in half, and that was the end of the business. So we're aware of these trends. We'd like to participate in them, but there are some barriers to our doing so.

Greg Alexander:

I would add that just because something is good for us or for society doesn't necessarily mean that it's going to be profitable for investors. If you look around, we're all thankfully wearing clothes, and the apparel business is not very good. We're sitting on fabric chairs — the textile business is really pretty bad. The table business is not a good business. The glassware business is not a good business. The paper business is not a good business. The water business is not a good business. I mean, just because it's useful and we like it doesn't mean that it's going to make a lot of money.

Jon Brandt:

The classic example of a great growth business is airlines. Whenever they flew the first airplane, you could have predicted the growth in the number of passengers all around the world and the growth of the number of airplanes and you could have said, "I'm going to invest in airlines…." But airlines have been one of the worst businesses ever invented. They have destroyed just about every cent of capital in them. That doesn't mean we're going to exclude these environmental businesses. But just because there's growth doesn't necessarily mean there will be good returns on capital and a chance for investors to make a lot of money. It could well be that the companies that do profit the most don't exist right now and that all the ones that exist now will have tombstones in the cemetery.

Bob Goldfarb:

There are some pretty profitable companies out there already that are doing what you're talking about. So it's going to be a huge industry, but it's not really a single industry. We've looked at companies that have divisions that are addressing those problems and those divisions are quite profitable and have good prospects. So you're singing the right tune. We've just got to find the right conductor and the right orchestra and we'll be on board with you.

Question:

Following that environmental note, I know where I live, about every fourth car including our garbage trucks are hybrids. So as I see GM and Chrysler shutting down and Toyota all over the place, aren't there established companies that are already going green that would be interesting to look at?

Bob Goldfarb:

Absolutely. For instance, we own Paccar, which is a large manufacturer of heavy duty trucks. They're going green; they're experimenting with hybrids.

Greg Steinmetz:

Paccar wrapped up a deal recently with Coca-Cola Enterprises, the big Coke distributor, to sell them a fleet of hybrid trucks. Paccar would like to sell a lot more. Coke has thousands and thousands of trucks; they've only bought a couple hundred so far. Paccar is there ready, willing and able to sell more of these trucks. Wal-Mart is very, very much interested in pursuing a green agenda. They're testing some hybrid trucks. Paccar has a pilot program now with Wal-Mart.

The problem is the economics for taking a truck cross-country. You don't get much benefit out of a hybrid because it only works in stop-start situations. It doesn't work when you're rolling down the highway for hundreds of miles. In the Coke example unfortunately, it only works because the government heavily subsidizes hybrid trucks in the medium duty sector.

Volkswagen has the lowest emitting vehicles out there, and they are doing it with diesel. If you pencil it out, diesel in many ways is greener than hybrids. VW is working as hard as anyone to come up with electric cars and the company vows to have the best electric fleet before GM and Toyota and everyone else. So yes, we have companies that are going down this route. They're wrestling with how to make money in it, but they're trying.

Jon Brandt:

Greg, leaving aside the last year of the economy and auto sales going down, have the economics of hybrids been a plus or a negative for Toyota?

Greg Alexander:

I don't really know. I don't want to be too optimistic. In our lifetimes, I mean in the coming couple of generations, there's going to be widespread use of biofuels and wind. Wind is used already, but I don't want to be too optimistic. These alternative sources of energy are not at the cost level yet where they're competitive with coal and other fossil fuels. As I said at this meeting last year, the key thing about alternative energy is that the projects are very capital intensive, most of them — wind, solar, biofuels, everything — it's a lot of capital up front.

The main thing that businessmen don't want is to invest billions of dollars and then not only not make money, but have cash losses every day on top of that. That's exactly what would have happened if you had spent the billions of dollars necessary for most energy projects because the price of natural gas and the price of coal have plummeted. The natural gas

price has gone from $13 to $3.50 in the last year. But as I said last year, if we as a society really want to develop these projects and not just talk about them, we have to have some kind of minimum price for traditional energy so that the business people feel comfortable investing the hundreds of billions of dollars that are required to implement any of this stuff.

When the natural gas price goes to $3.50, it renders all these green energy installations massively money-losing on an operating basis without subsidies, on top of the initial billions of dollars of capital costs that are also out the window. So it's just not going to happen until we have a minimum price for traditional sources of energy like oil. In every one of our companies, if there's money to be saved by doing something — people used to ask about the Internet — if there's something intelligent that companies can do with the Internet and now with green energy and conservation, and shutting down an inefficient factory ... that actually makes money, believe us, our companies are in the vanguard there. There's no grass growing under their feet.

Bob Goldfarb:

It's a massive trend, and it's going to get bigger. I would argue that subsidies are warranted economically when you have negative externalities or external costs that a lot of conventional fuels have. So this is a big mega trend, and we're not going to ignore it at our own expense and at your expense.

Question:

Given the oversupply of trucks at the moment, what are your thoughts on Paccar and Cummins?

Greg Steinmetz:

Paccar is just a wonderful company run by wonderful people. The trucking segment — it's a lot better than the car business because you only have four competitors in the US and they each get a quarter of the market. It's a similar dynamic in Europe.

US truck sales started declining in 2007 after we had an enormous run-up the year before. Frankly, I thought that by the time Europe started to slow down the US Class 8 market would be recovering.

Paccar made money last quarter, which is amazing considering that their sales were down 50 percent. It's a great company, but it's not making much money now. When trucking comes back and there's more demand for goods and people start buying trucks again to move those goods, Paccar will get back to a decent level of earnings and we should be able to make some money from here.

Question:

What effect will a contraction of consumer spending have on your thesis?

Greg Steinmetz:

Well, it would slow down the recovery. But Paccar is gaining share, particularly in Europe. In the US, they're coming out with a new engine that they're making themselves; so they're not standing still. We already talked about hybrids. It would just take longer to get back to a normal level of earnings.

Question:

What are your valuation parameters? When do you start getting interested in a stock? When do you start getting uninterested in it? Number two, have you looked at any beaten down corporate bonds or obligations? Number three, I don't see any energy in the portfolio. Do you have something against that?

Bob Goldfarb:

Valuation — I can't give you a single parameter without knowing some other data points. What we would pay for our fast-growing companies with very high returns on capital, and 100 percent free cash flow and lots of growth in front of them is going to be a significantly higher multiple than what we'd pay for a company that had much more modest growth prospects. So it's hard to give you a single answer on that.

In terms of energy, we are interested. When you see the next Sequoia report, which will go out in a couple of weeks, you'll see an energy stock in there. As far as corporate bonds, you're spot on. We've looked at them, but we've had two problems. One has been that the quoted prices are not necessarily the prices that you get when you try to buy the bonds, wouldn't you say, David?

David Poppe:

It's a much less liquid and transparent market than the stock market, part one. Part two, we're in the item business on the stock side, and we're picky. We only own 25 stocks. On the bond side, we're the same. So we tend to look at individual issues instead of buying a basket of bonds. When you look at individual issues, a lot of times even if it's a $500 million or a $1 billion issue, maybe it's trading at 80 cents — there's really not that much volume to go get. You're lucky if you can get $30 million of the bond in the marketplace. When we start looking at Sequoia with $2.5 billion in it, it's hard to move the needle, so we've really struggled with that.

We've tried. We've identified in some cases some of our portfolio companies where we're positive the bonds are a good value and still struggled. One, to get the quote — the machine gives you a quote, but that's not actually the price that you pay. And two, even if you can get a price that you agree on, it's very, very difficult to source a lot of volume.

Bob Goldfarb:

John Harris, you've had a fair amount of experience in the last year in that world. What's your thought?

John Harris:

What David said is right. It's hard when you're managing as much money as we manage to access those markets because they're not very liquid. We run a mutual fund and managed accounts that have to stay liquid. So it could be construed as irresponsible of us to park a large portion of our assets in securities that just aren't that easy to sell and if you need to sell them in a hurry, you can get a very bad price.

There are also lots of parts of the debt markets that aren't accessible to us for other reasons. The bank loan market is a much bigger market today than it was ten years ago. But trading bank loans and owning bank loans create a whole host of legal problems, and all the lawyers that Joe doesn't like dealing with start calling you regularly if you get involved in instruments like that.

So we've looked at it. There were excellent opportunities in those markets if you had a vehicle that was perfectly suited to participate. But one interesting thing is that whenever there are good opportunities in the fixed income markets, typically there are also good opportunities in the stock market. So if we just focus on our natural neck of the woods and do our work the way we ought to do it, there will be more than enough opportunity for us.

Question:

Do you have plans to close the fund?

Bob Goldfarb:

We don't have any current plans to close it.

Question:

In the last six months, did you get the inflows that you were expecting?

Joe Quinones:

I have the numbers. I don't know what Bob's projections were. But since we opened on May 1, 2008, we took in an extra $300 million.

Bob Goldfarb:

I didn't have any plans or any expectations, and the money has come in on a measured basis, which we prefer. If it had come in on a less measured basis, we might have been forced to deal with the issue of closing the fund. But as long as money comes in on a measured basis and we're at the percentage invested that we currently are, we don't have any thoughts of closure.

Question:

In the world of private labels and in the consumer discretionary companies, to what extent do you think that foreign market exposures may trump some of the factors that you fear will erode brand franchises in traditional markets?

Bob Goldfarb:

Not all foreign markets are created equal. I think a number of the European markets have much higher penetration rates in private label than we have in the United States; so you'd have that foreign exposure to offset the foreign exposure of the emerging markets where I suspect private label is less of a factor and demand is growing faster.

Question:

It's just a question whether the growth abroad in new markets passionate for brands

will offset some of the erosion elsewhere. And that's a hard one to know.

Bob Goldfarb:

Exactly.

Question:

The '73-'74 experience of Sequoia Fund was followed by such a spectacular period for investor returns. The thing I continue to scratch my head about in this downturn is that the values coming out just don't seem as compelling as they may have been then. I'm curious about your historical perspective about what you saw then compared to what you see now.

Bob Goldfarb:

It was awfully painful, but gosh, multiples of two and three times earnings at the end of '74 — as you said, we haven't seen anything comparable this go-round. Given the pain that we experienced in '73 and '74 — we probably experienced enough pain in the last year or so — I'm not sure how many of you would be willing to pay the price for the opportunity.

Question:

With all the talk of the government printing money, I'm surprised no one has asked about the printing business you invested in.

Arman Kline:

De La Rue is the world's largest private printer of money. Most of the big economies in the world — the United States, China, Russia — print their own money. But the smaller countries in the world don't. They have to outsource it. They can't justify spending the money and the capital to do it. There's a trend now where even some larger countries are outsourcing it. It is a very nice way to play an inflation hedge. It's not one for one, but currency in circulation grows. The nice thing about it is that De La Rue's clients tend to be in more emerging markets and exposed to commodities. So if you think that commodities are going to be more expensive going forward and drive inflation, the economies that are exposed to that should circulate more currency.

Question:

You talked before about how hard it was to predict earnings. Even though private label has made incredible inroads on a lot of consumer goods, I'm wondering why food and beverage stocks have been conspicuously absent among your holdings, particularly now that so many of them are selling between 10 and 12 times earnings.

Bob Goldfarb:

You're spot on. The rally that we were talking about earlier left these stocks behind. Now we have very, very strong companies where you have a pretty good sense of what normal is, selling at very reasonable multiples. It is a pretty good area to be prospecting in. So, it's certainly possible. But there is nothing on the front burner.

Question:

If this isn't too broad a question, can you discuss what you were personally going through and what was going through your mind work-wise through the worst days of the last year or 2009 as we hit the lows. Did you second guess value investing? Did you second guess your own competence? Did you think maybe things didn't work?

David Poppe:

I wish we weren't on the 47th floor. I don't think that we second guessed the discipline. I guess I shouldn't speak collectively. I think there's been a lot of kicking yourself because it was pretty obvious that some of this would happen. We failed to see the magnitude. Many people saw that there would be a correction and housing would turn down and we might build a million houses for a while instead of two million houses. But I don't think people saw that we might build 400,000 houses or that large percentages of all the homes in Las Vegas, Phoenix, and Southern California would be in foreclosure.

I don't think we saw the magnitude of it; so when it hits you it's frustrating because we just underestimated how severe it would be. I think Bob in particular was anxious about what could happen. Yet when it did happen, we weren't as well aligned as I think we could have been.

Bob Goldfarb:

I was just shocked by the magnitude of the decline in demand that affected much of American industry in the fourth quarter of 2008 and the first quarter of 2009. And as indicated by ITW's results, which I mentioned in my prepared

remarks, it's continuing. Chase, a year ago, were Fastenal's daily sales up about 15 percent?

Chase Sheridan:

They were up 16% in May 2008. December was the first month in Fastenal's 42-year history when they did not have a positive year over year comparison for daily sales. That has turned into, in April, a 25 percent year over year daily sales decline. So it went from positive 12 in October to negative 25 in April. It was very severe and very quick.

Bob Goldfarb:

We were just astonished. If you had asked us a year ago at this time what was the likelihood that Fastenal would see a period where sales would be down 25 percent, Chase, what odds would you have given?

Chase Sheridan:

I couldn't have imagined it. The same thing happened with the rock companies. It's much worse than what I considered the worst case scenario in volumes. I never would have guessed that rock volumes could drop 40 percent in this cycle. Rock volumes for Martin Marietta in the first quarter were down 39 percent versus their peak first quarter, which was in 2006. Yet, amazingly, prices were up 25 percent over that period, which is the real reason we own those companies, resilience in pricing. But it's been astonishing.

David Poppe:

This gets at the futility of modeling. We get questions all the time about discounted cash flows and things like that. Chase ran all these great models, and I'm standing over his shoulder, "What would happen if the volumes went down three percent? What would happen if they went down five percent?" We never even dreamed that we would have minus 40 percent. We spent so much time on this. I think minus five or minus 10 was our doomsday scenario. So we were thinking about it but we weren't thinking about the magnitude that turned out to be reality.

Question:

As we think about the fund in the years going forward, and think about your comments in the beginning, Bob, how should we think about returns in the fund going forward relative to where they've been in, say, the last ten years?

Bob Goldfarb:

Does anybody have the ten-year returns?

David Poppe:

The ten year returns have been quite humbling. If we use the end of '08, the ten years ended December 31 '08, Sequoia was up 2.0 percent compounded annually and the market was down something like 1.4 percent. So it's a 3.4 point annual spread, which is not bad over ten years. But these are horrible absolute numbers — 2.0 percent versus minus 1.4 percent. Looking forward ten years, the one good thing is you don't have a very tough comparison to the last ten years. I think we can be pretty humble and say, "Hmmm, not sure we're going to generate spectacular returns, but we ought to do better than the last ten years."

Question:

The cash position of Sequoia in round numbers — how much does the fund have? And collectively, you've made some very favorable comments about the companies that you own, their management, their prospects and so on. Given their depressed prices, are you investing more in the ones that you already own?

Bob Goldfarb:

Yes, we did add to one position in the first quarter. Were there others, David?

David Poppe:

We added to a couple positions in the first quarter. But we didn't do a lot. Overall we've probably been net sellers. There's probably a slightly higher cash position today than there was at the end of the year.

Bob Goldfarb:

We were buyers earlier in the year, and we turned modest net sellers into the rally that we discussed earlier. But we've been about 80 percent invested. I don't think we've varied within more than 3 percent of that number. So there hasn't been a great deal of variance in it. The cash percentage has been pretty uniform.

Question:

How do you determine when you're going to sell a stock? Do you have specific guidelines that you follow?

Bob Goldfarb:

We don't have any specific guidelines that are written down or any rules in that sense. But valuations, especially in the last year, have been fluctuating a lot. And our ideas of normalized earning power are also changing quite a bit. So when those two forces are at work, you're going to be thinking about doing more selling, as we have been, than you would usually. But there's no single strategy. We assess the valuation of each stock one stock at a time. The question is what is the normalized earning power of this company, what's the likely growth rate and then compare it with the valuation. Or in some cases, when we're seeing the trends that Chase was talking about where you have declines both in the top line and bottom line that you thought were just impossible, you're constantly rethinking valuations. But it's on an item basis.

Question:

I think maybe 10 years ago at this meeting Mr. Ruane made the comment that the cash had been an anchor on performance. Then it appeared we saw a much smaller cash position. Do you think going forward that you have a sense of where you want cash to be?

Bob Goldfarb:

I've referred to the '80s as the lost decade because our stocks performed magnificently but our overall performance matched that of the S&P because of the drag of the cash. I think we averaged something like 40 percent in cash during that decade. One of the reasons it was a lost decade is that we kept waiting for the valuations, the single digit multiples that we saw in the '70s for outstanding companies, to return, and it wasn't going to happen except under conditions of very high interest rates.

But we entered 2008, 97 percent invested. And that was one of the reasons that we decided to open the fund; at that time we weren't contemplating selling any of our stocks. We didn't want to be forced to sell stocks merely to generate liquidity. As the year developed not too long thereafter, we decided that we were over-exposed to consumer discretionary stocks and that we would make an effort to reduce that exposure.

As we've said in our letters, that decision, together with the decision to sell the remaining Progressive, which was having problems on the investment side, in tandem with the inflows that were coming in after we reopened, caused the cash to increase toward the 20 percent level. But our ideal is to be almost fully invested.

Question:

So that would be the ideal situation going forward?

Bob Goldfarb:

Yes, we'd love to find enough stocks and own enough positions in large enough quantities so that we could be fully invested.

Greg Alexander:

We're not targeting a certain amount of cash. If you let us determine the stock prices, we could be invested by this afternoon.

Bob Goldfarb:

I would also say we're constrained in adding to the larger positions in Sequoia because of an IRS rule regarding concentration. No more than 50 percent of the fund can be invested in positions that account for 5 percent or more of the fund except by virtue of appreciation. Because of that restriction we just don't have the latitude to add to most to our larger holdings.

Question:

We're in the midst now of a somewhat cyclical recovery. But on a secular basis, unemployment is going to be higher going forward. And with jobs leaving the United States, with the manufacturing base eroding, there will be fewer and fewer industries which employ a lot of people, and there will be fewer and fewer jobs. In other words, when an automobile factory closes, it's thousands of people who lose their jobs. When a service company closes, it's much fewer people. And as a result, there will be less and less demand for goods. Are you taking into account this possibility, of demand being much, much lower over time?

Bob Goldfarb:

Automobile plants have to close because there's excess capacity and not just with regard to

current demand but with regard to what I'd consider normalized demand. But I think the overall contraction in demand has largely peaked. It's going to vary by sector and by company. There are some late cycle companies that probably haven't seen bottom. I think aggregate demand has stabilized at very low levels and at some point should begin to grow. So I would not bet on a contraction in demand from these levels. If that's your thesis, you probably shouldn't be long stocks or long Sequoia.

Greg Alexander:

When we look at manufacturing companies, the first thing we always ask ourselves is could this be made cheaper somewhere else. So on that side we always do think about it. But we don't really think about the macro issues that much overall.

Bob Goldfarb:

It's been a number of years since we established the position in Fastenal. We were concerned at that time about the decline in the manufacturing base and the extent to which their customer base would erode. I think partially because of the decline in the dollar many manufacturing companies that exported goods fared pretty well.

But I think a lot of the manufacturing base that was noncompetitive has already gone. A lot of the high value-added manufacturing will remain in the United States and prosper. Longer term, I would be concerned about the prospect of China developing the capability to become competitive in that space. The one big area of manufacturing where cost inputs are just not competitive now is the domestic automobile industry. Clearly, the government is trying to wrestle with that at the present time. But we own some very strong manufacturing companies such as Paccar. Paccar is going through a cyclical decline right now but they're going to be around and they'll prosper.

Question:

I guess if you look at the last five years, who would have thought that the US furniture industry would go from being a very viable and well respected industry to nothing — that it would all go to China.

Bob Goldfarb:

It happened very fast, but if you look at the heart of our manufacturing base, excluding Detroit and Detroit's suppliers — there are pretty darn strong companies with competitive advantages. Mohawk would be another example of a strong manufacturer. One of its advantages is the cost of transport that insulates it from foreign competition. We own Fastenal. Its customer base is industrial America. We do think about these issues but we think our companies will do just fine over time.

Question:

Could you please comment on Ritchie Brothers?

Arman Kline:

Ritchie Brothers is the world's largest auctioneer of industrial equipment, trucks, and trucking equipment. We're recent shareholders in the business. This is a good example of a company that we followed for a long time, but had a problem with the valuation. In the pullback we were able to initiate a position.

Used industrial equipment is about a \$100 billion global industry. Ritchie Brothers has two to three percent of it. The great majority is still done through brokers and dealers. Historically, the problem with brokers and dealers has been that they can only operate on a regional basis. They haven't been able to attract global prices and global customers. The Ritchie model allows you to sell equipment and source equipment globally. They've proven that they can get better pricing in their auctions because of that ability. We're very happy shareholders of the business.

Question:

I noticed in your portfolio that you don't really have any health care companies or pharmaceutical companies. Have you looked at or thought about something like Johnson & Johnson, a well diversified health care company, or something in pharmaceuticals, Merck or Glaxo or any of the other major companies?

Bob Goldfarb:

When you said diversified, that's a key factor. J&J clearly does have that benefit. We owned J&J in the early '90s and its nature changed somewhat during that period. What

attracted us to J&J was that it had a large base of pharmaceuticals that were pretty darn nichey and that dominated niches where there wasn't much competition. They might have $100 million in revenues; so they weren't blockbusters.

But as we owned the stock, several of these drugs became blockbusters and made the company's earnings, particularly its earnings growth, dependent on a few drugs. So we became less comfortable even with J&J and we sold it. I think you have this problem with the Mercks of the world even more — there's very large dependence upon a few blockbusters subject to the risk of more efficacious drugs being developed by the competition. It's not a model that appeals to us.

As I think I have mentioned before, Warren Buffett said a couple times in the past that he wished he had bought a basket of these companies to offset this concentration risk. But by and large, the basket of pharmaceutical companies has not worked for a long time. That doesn't mean that it won't work going forward. But I've really been surprised by how difficult it has been for the small-molecule pharmaceutical companies to develop successful new drugs and just how many of the new drugs that have been blockbusters have come out of biotech. Now you see conventional pharma trying to jump on that wagon and buying some biotech.

Question:

Two quick questions. Has the resolution of the Chrysler situation, as proposed, given you any cause for concern about a fundamental shift in the government's attitude towards private capital, private enterprise?

The second question is about Berkshire — obviously the stock portfolio has been an important component of growth and value over the years. I know it's considered sacrilege to suggest this, but there is presumably a fairly reasonable argument that can be made that the investment portfolio has not — excluding the issues of the market of course — done particularly well in the last decade. Coca-Cola's stock price has not moved in 12-13 years I believe — and the earnings haven't exactly grown stupendously. Conoco has been acknowledged publicly by Buffett as a mistake. Burlington Northern was bought right into the jaws of the recession. So I wondered if you have concerns about that, both the historical performance and also perhaps going forward.

Bob Goldfarb:

I would say that part of the answer to your question was made by the gentleman who was talking about how reasonable current valuations in the food and beverage area are. Jonny, what was the multiple on Coca-Cola ten years ago?

Jon Brandt:

About 40 maybe.

Bob Goldfarb:

Coke has come from 40 and what is it now, about 13?

Jon Brandt:

Thirteen.

Bob Goldfarb:

Yes, so the valuation was just excessive ten years ago. Coke's stock will do much, much better in the next ten years than it has in the last. So I'd look forward rather than backward in terms of assessing the portfolio companies of Berkshire.

With regard to Chrysler, I don't think there's anything that affects us directly. First of all, personally, I don't believe that Chrysler should have been kept in business. It should have been allowed to fail. As we've said, there's just way too much capacity in the US automobile industry, and the market is the best mechanism for rationalizing capacity. I think the market forces should have been allowed to work. So I think it was a mistake for the government not to let the market forces work and let Chrysler go through a bankruptcy without government aid.

Jon Brandt:

Bob, I think the question was also about the settlement where the government was criticizing the bondholders.

Bob Goldfarb:

The bondholders should have had their day in court and should have had their contractual rights honored. I don't think their contractual rights should have been taken from them. I've heard the counterargument that they would have gotten less in a settlement than the government was offering them. But clearly they believed otherwise. And the best way of resolving those disparate views is to have a bankruptcy proceeding. The courts should be

adjudicating those contractual rights, not the executive branch of the government.

Question:

At the Berkshire meeting — David Sokol and Charlie Munger talked a great deal about BYD Company — do you have anything to add on that or any insight?

Jon Brandt:

This is a company that makes batteries for laptops, cell phones, and electric cars. It was apparently Charlie's idea to invest in it, and I give him credit for finding it. What was the market cap when Warren invested, Stephan?

Stephan van der Mersch:

Two billion.

Jon Brandt:

Berkshire will own 10 percent of the company. They haven't put the money in yet. The Chinese government has to approve it. It's going to be owned by MidAmerican which Berkshire owns 89.5 percent of. So maybe at market now it's $400-$500 million. Even if it's very successful for Berkshire — I hope that it will be and I know that Warren is very enthusiastic about it and certainly Charlie and David too — it's not one of their larger investments. But they're enthusiastic about it, and Charlie just loves the CEO.

I met the CEO at the meeting out in Omaha. I had a chance to try to talk to him but he doesn't speak English and I'm not very good in technology or Chinese. So it wasn't much of a conversation

Question:

How do you go about generating ideas?

Bob Goldfarb:

We're very unstructured. There's no investment committee. The ideas are almost all internally generated. David?

David Poppe:

Our analysts travel a lot and are expected to visit a lot of companies over the course of a year. We attend a lot of conferences, trade shows. I like to think that we're kind of always trolling for ideas. A lot of the ideas end up bubbling up from the analysts. While we're all generalists, over time the analysts develop some expertise in various industries and have some confidence when they come forward: "I've been looking at XYZ and I see another company in that field that seems terrific, maybe we should take a look at it." Bob and I are typically going to say, "Go ahead, go for it and let's see what we find out."

We kick tires very hard. Each idea, an individual idea that we're vetting for Sequoia could take a week or two to decide, no, it's not for us, to several months before we probably decide yes, this could be for us. The process is going to involve certainly meeting the management but also learning as much as we can about an industry and a company. We talk to the competitors, to the dealers, distributors, franchisees if that's the kind of business it is — all sorts of third parties who can tell us what they know about an industry and a company.

Then Bob and the analysts too are careful, careful readers of the financial statements. You can tell a lot about the ethics of a group of people by what they put in the proxy and what they don't. Arman talked about Ritchie Brothers earlier — it's not uncommon for us to follow a company for five years and really, really be a pest before we finally get a valuation that we like. Then we're hopefully going to be able to own it for some period of time.

So it's a pretty rigorous process. It's an independent study work environment here in terms of the analysts having a lot of freedom to pursue things. It's pretty hard to get something into Sequoia — we reject many, many more than go in. I would say — before someone asked about the sell discipline — that for our kind of investing, the buy discipline tends to be greater than the sell discipline. On the sell discipline, you've already decided that you like it and you might even have decided that you love it. Then it becomes very hard to ... divorce is really hard. Divorce is really hard.

So that gives you the flavor of it. We tend to like what we own because we've spent a lot of time figuring out that's what we want to own. Then we need to have that same discipline on the sell side as well.

Question:

Speaking of the sell discipline, you sold some of Wal-Mart last spring at a loss. I have a problem understanding that since so many people have said such good things about Wal-Mart.

Bob Goldfarb:
What price did we sell that at, David?

David Poppe:
I think we sold Wal-Mart at $50.

Bob Goldfarb:
Yes, we sold it at $50 and you can buy it a little cheaper than that right now. So there hasn't been any opportunity cost to date.

David Poppe:
It went up from $50 after we sold it. I think $57 or $58 was the high last year. We got frustrated with Wal-Mart. The core duty of a retailer is to run a clean store where it's easy to do your transactions. For a long time, Wal-Mart's store standards were really deteriorating. That was really it. Management finally got on top of things. The stores today look much, much better than they've looked in years. So you could argue that we missed that. But I would also say that on the price side, as Bob said, there was no loss there by having sold the stock. You could buy it back today for less than we sold it for a year ago.

Bob Goldfarb:
It's comparable to the food and beverage companies that the gentleman was asking about before. It appears to have a very reasonable valuation and you can have a pretty good idea of what its normalized earning power is. So it wasn't a great sale but so far it hasn't cost us anything and we could replace it.

Question:
Due to their impact on consumer spending, as well as building materials, I was wondering if you could touch on housing prices and when you project them to bottom out or do you think they already have?

Greg Alexander:
We don't have any insight on that. Just as a casual observation, it seems like the prices bottom out when there is a large number of foreclosures. So if you look at the states where prices are down, by almost as much as half, which are to wit Florida, Arizona, Las Vegas, parts of inland California — it's just like the real estate equivalent of the stock market last November when there were forced liquidations. A foreclosure is a forced liquidation.

Here in New York prices are down but it's not so much because the goat is going through the python of foreclosures. But as a general statement, when foreclosures hit, that seems like it's usually the bottom.

David Poppe:
I thought Warren's comments at the meeting were probably smarter than anything we could say. If you weren't there, what he said is the US is going to form something like 1.1 or 1.2 million households per year going forward, 70 or 80 percent of those people probably are going to be homeowners, 70 percent maybe. As long as you're building 400,000 homes per year, you're working off excess supply. At some point in the not too distant future, prices will hit equilibrium. Whether that is a year or two years or three years, I don't think we have any great insight. But the math is what it is. We're far under-building what the ultimate supply needs are going to be. We far overbuilt for a few years prior; so it will take a while to work it off.

Question:
A couple years?

Jon Brandt:
It will take longer in Florida than other markets. In some markets it will not take as long.

David Poppe:
I would agree with Buffett — I'm not sure I see a ten year Japanese-style real estate depression, at least in homes. Unlike in that country, our population is still growing.

Question:
I think this is kind of a lazy question because I should know more facts than I do. But this morning in the *Washington Post* I read a column by Mr. Pearlstein taking exception to Mr. Buffett's comment that he wouldn't buy a newspaper at any price — any newspaper at any price.

Bob Goldfarb:
Jake or Girish, do you have any comments?

Jake Hennemuth:
I think it's a good question, it's a troubled industry. There are traditionally two revenue sources for newspapers. There's circulation revenue and there's advertising

revenue. Classifieds have long been a primary source of the later. But many classified ads have gone to the Internet, where they're now much cheaper, more easily searchable and run for a longer period of time. So it's hard to make an argument that you don't get a better bang for your buck by putting your job ad or your car ad on the Internet. The news itself is also online where it's free in most cases. Younger populations tend to read that form more often than hard copy.

So you've got a situation of steadily falling circulation, which make newspapers less interesting as an ad platform, and alternative sources for news. It's a double-whammy. So I can see why Buffett makes a comment like, "I wouldn't buy it at any price." It's absolutely headed downhill. And on top of that, it might be worth less than zero because there are severance costs and other expenses to pay meanwhile.

David Poppe:

I worked at the *Miami Herald* in the 1990s and I'm not going to get the numbers exactly right but I'm going to be close. When I was there — this is not that much longer than a decade ago — I think when my wife started maybe in the late '80s, there were 400-450 people in the newsroom. It was a pretty darned good newspaper. When I was there, say in the mid '90s, there were about 375 people in the newsroom. We worked pretty hard to put out a newspaper every day. I think there are probably 175-200 people in the newsroom today.

That product is done. It's not a good product. It can't be a good product with 175 people working on it. If you de-content the product to a certain point, then it's not really a product anyone needs to buy anymore. I'm not blaming them for doing it because the economics — Jake is talking about the vicious circle downward — but the vicious circle has become a swirl. I don't see how you turn it around because I don't see how you run a daily newspaper seven days with a Sunday paper that people want to pick up and pay $3-$4 for, with 175 people in the newsroom when there used to be 450.

Bob Goldfarb:

I was looking at the *Washington Post* numbers a couple weeks ago. You couldn't have a better management than the *Post* has both at the corporate level with Don Graham and with Katharine Weymouth running the paper. The content is great; they have a lot of unique content. But people have been unwilling to pay for it on the Internet. I think there are a few exceptions. One would be the *Wall Street Journal*. People have been willing to pay somewhat for *Journal* content on the Internet. I know the *Times* tried an experiment with some of the op-ed pieces and tried to charge for content, but there was no traction, no receptivity. So that's the key. They're trying to charge for content with Kindle, and in different ways, but unless people are willing to pay for content it's very, very hard.

Question:

As a follow-up to this, I understand rationally why Warren has held on to the *Washington Post* and he's held on to *Buffalo News* but he's had Gannett in his portfolio for a very long time. Considering the comments that he's made about the newspaper industry, I find that really curious.

Bob Goldfarb:

I think he probably ... he'd be the first one to acknowledge that he missed it, that he should have sold it.

Question:

But he still has it. I mean, if he thinks the business is dead, why doesn't he sell Gannett?

Bob Goldfarb:

I have to assume that he's reassessing it and revaluing it at its present price.

Greg Alexander:

It's easy to look now and say, "Why didn't XYZ." I mean, look in your own heart for most of these things. He knew the industry and he's been saying for many years that the industry was going to diminish. We have no Gannett; so we have no stake in it. But Gannett doesn't have an outrageous amount of debt. I am guessing, but I think most rational observers would have thought that the next ten years of cash flow as the business slowly disappeared would be enough to take care of the debt and probably build up some cash. But it just so happens that because of this first financial panic in 80 years in the United States, that the next ten years all disappeared in six months. So in retrospect you say, "Gee, why didn't he sell it?"

Jon Brandt:

Greg, it's not exclusively a newspaper company, correct?

Bob Goldfarb:

It also owns some television stations.

Greg Alexander:

I know, but the newspaper earnings, the tail could have paid off.

Jon Brandt:

That's true. I think he's holding on to the *Buffalo News* because he made a commitment to not sell it or close it unless the losses were too much to bear. It may reach that point eventually with the *Buffalo News.*

Question:

As a follow-up to the newspaper industry, have you considered buying Google? What is the valuation?

Chase Sheridan:

I haven't looked at it that recently so my numbers will be stale. But Google has, as you all know, an amazing franchise. So I did take a look at it. One of the things that prevented us at the end from buying Google was the capital allocation that we saw both through acquisitions and internally. They bought DoubleClick, and they paid $3.2-$3.3 billion for DoubleClick. I think that most observers would say that was a very rich price.

Then internally, their CAPEX numbers are very, very high. They had a policy of pursuing every project that came down the pike. So that caused a couple of problems. First of all, it blows through cash. Their margins are incredibly high and it really doesn't take much for Google to keep its business at a steady level but to grow it 20 percent a year does not require that much capital investment either — far, far less than what you see being spent. When you pursue all these projects that don't necessarily have a viable business model, what you will eventually get are very smart, very motivated people who are very frustrated. I think it's caused some dissent within the ranks of Google in the past and that may be happening now because they've got brilliant engineers working on projects that may never turn into businesses.

It was the capital allocation at the end of the day that prevented us from really pounding the table on Google. It's an excellent, excellent business model. I don't have a long career in this compared to Bob and some of the other folks on the dais, but it's one of the best businesses I've ever seen.

Bob Goldfarb:

We have time for one more question because we have to vacate the room by one.

Question:

Can you talk about Cummins, including its exposure to Chrysler?

Greg Steinmetz:

Cummins does have exposure to Chrysler. They make diesel engines for the big Dodge Ram trucks, and they were hoping to make a lot more of those because they had won the bids to get on even more platforms. Last week they announced that they were closing the factory that was making these engines. It's just been a disaster for them. I think it was about five percent of their sales at the peak, and it was going to be a lot more. Cummins is in all sorts of areas; so Chrysler alone is not going to cause that much trouble for them.

Their other areas though are also under siege. I mentioned before that Paccar's sales are way down. Cummins makes half of the heavy duty truck engines in this country. So their domestic sales are down. Their China strategy isn't quite playing out as planned. We talked about the ability to make money on green investments — Cummins has the cleanest engines out there. In 2010, they are going to be even cleaner. China has said that they're going to try to clean up their environment by mandating engines that are as clean as what they are in the US and Europe.

The trouble is they're not enforcing it. So here is Cummins having built all these factories over there to make clean engines and then the government is not enforcing it. The Chinese truck makers are buying engines that are just as dirty as they ever were. So there are a lot of headwinds facing Cummins right now.

Bob Goldfarb:

We're going to have to wrap up, since we are approaching one o'clock. I want to thank you all for attending and I want to thank you for your questions. We look forward to seeing you next year.