
Sequoia Fund Shareholders' Meeting¹

May 9th 2003 – New York, NY

Bill Ruane:

Good morning and welcome to the ... I was going to say the thirty-third annual meeting, Rick, but the facts are it is probably only about the twenty-seventh or twenty-eighth time that anybody has come to one. So it reminds me of, I think it was Steve Allen, who was on TV one time with his wife and he said, "We've really been happily married for thirty-four years. However, we got married fifty years ago."

This morning, for reasons that involve a change in the law, we don't have to go through the usual business of electing directors and counting votes. It seems to me somewhat counter to everything we have been talking about with respect to changing rules on corporate governance. But let's move along then.

I would like to recognize the people on the dais. We have David Poppe, our newly elected Executive Vice President on my far left. Jonathan Brandt, Rick Cunniff, whom you all know. Then there is Greg Alexander, and Bob Goldfarb, our leader and our CEO. Finally, there is Joe Quinones, who basically runs everything but the research aspect of the management of the funds.

I also want to comment on the fact that there is one person missing who has been here right along and whom we all love and miss, Carley Cunniff. I talked to Carley yesterday just to say, "Hi." I know that many of you are good friends of Carley. And I am pleased to say that she is thoroughly enjoying retirement. She is busier than ever, from what I understand. As a measure of how she is feeling, she and Andy, her husband, ride their bicycles literally thirty to thirty-five miles a day up near their country home in Old Lyme. She sends her best to all of you.

Bob Goldfarb is going to comment in much more detail about last year in a moment. But briefly now, in 2002 we were down 2.6% versus the Dow being down 15.1%. The S&P was down 22.1%. I don't know that it is a pleasure to report those relative numbers simply because the minus two is minus two. It doesn't

put any money in your pocket. Bob will expand on that shortly.

Five years ago at this meeting, Bob was made the CEO of our firm and the top man at Sequoia. Since that time, April 1st 1998 roughly, the fund is up 22.5% and the S&P is down over 15%. The compound rate for Sequoia has been 7.9 percentage points better than the S&P during this period. I think that performance shows that he is doing a great job and has assembled a terrific team. All the people who have been hired since April 1998 have been completely his choice. I honestly believe that we have the best research staff in the business.

While we have not been highly active, for all the reasons you will hear, you just need a few good ideas every once in a while to make things go. And the ones in the last 2½ years or so have made a big difference. One is TJX, where Sequoia has made well over \$100 million. TJX is the world's largest off-price retailer. TJX, which was a wonderful idea — I wish we could have bought every share of that company at the time Bob first mentioned it to me — was completely Bob's idea. It was just dirt cheap. More recently we have taken a big position in Mohawk Industries, which makes floor coverings. The idea for Mohawk came out of teamwork.

I also would like to comment just a little bit on the securities industry. When we started the firm, we had the idea that we should do all of the research on every company that we bought for our clients and not rely on outside research. We also felt that the people who do the research should manage the money so nothing got lost between the two functions. Right from the beginning we have done our own work. Now the work with the group that we have is more intensive than ever, not only in studying new ideas but in constantly reviewing the holdings that we have.

So, I have got to say that I was really shocked when everything came out about the Spitzer settlement, and I heard that some of the major firms were actually paying other firms to do research on the companies that they were doing investment banking business for. It shows that Wall Street has a long way to go to be

¹ Remarks have been edited for clarity.

straightforward about what it is doing for the public and for its clients. We are very proud that we have stuck to our goal of doing all the work ourselves and making our own decisions.

I would also like to echo something that I heard the other evening from a fellow on TV because it really described in one brief phrase what I think makes my job and the job of all of us up here really special. He said that if you find a job you love you will never have to work another day in your life. And I thought, you know, that is really true. Once I got interested, I realized that this was a business that I got a kick out of. As time went on, I loved it more and more. The same is true for Rick and Bob. In other words, the three of us together have had about 134 years of fun in this business. And I can see that also applying to the rest of the team. It is a lot of fun doing this and we are going to keep having fun and try to do our best for you.

Finally, I would like to recognize someone in the back of the room whom I tried to persuade to take over a third of this meeting, Lou Simpson. Lou is one of the top men at Berkshire Hathaway. Can you stand up, Lou? Lou is one of the great investors of our time. Lou is the only person whom Warren has identified by name to take over managing the investing side of Berkshire once he can no longer do so. Of course, Warren has said he will manage investments for five years by séances after he passes away. So we don't know whether Lou will take over before or after those. But Lou will be the one *visible* person we are sure will be on the scene. I would just like to give Lou a hand. He is a terrific guy. With that, I would like to turn it over to Bob Goldfarb.

Bob Goldfarb:

I want to join Bill in welcoming you to the meeting this year. I also want to thank you for your patience during the last several years. In fact, investors who had a dollar in Sequoia Fund at the end of 1998 had exactly one hundred cents at the end of March of 2003, which was fifty-one months later. And that was despite our best efforts to build your capital.

I would also have to concede that if we had not had about 20% of your money in Treasuries, it would have been a little less. I think we calculated that Treasuries contributed

about 2.3% to our aggregate performance during that time. Again, through March 31st.

Only one previous dry spell, and by that I mean a period during which the value of an investment in Sequoia did not advance, has lasted longer than fifty-one months. That drought began when the Sequoia sapling was first planted in July of 1970. And it did not end until the very end of 1974.

Both of these difficult periods followed hard on the heels of huge speculative bubbles, which inevitably burst. I am hopeful that those days of the early 1970s will remain in the record books as the worst of times for our shareholders.

We take little solace in the fact that we held our own during the last fifty-one months while the majority of mutual funds lost significant amounts of money. Likewise, doing better than the S&P is cold comfort when one dollar invested in this index would have shrunk to seventy-three pennies over the same period of time.

We have always asked our investors to measure our long-term performance against the S&P 500 because we regard the S&P as the most appropriate benchmark. But as Bill suggested, you can't take an index to the bank — you take dollars. We strongly believe that our primary job is to increase the wealth of our shareholders significantly over a meaningful period of time. In my mind, fifty-one months certainly feels meaningful enough to give me pause about how and why we have fallen short of this very important goal.

The four years preceding this drought were happy days indeed. Between 1995 and '98 earnings for our companies were rising rapidly. At the same time, interest rates were falling making the future earnings of those corporations more valuable. During these four fat years, Sequoia compounded at an aberrational 35% which was 4.5 percentage points greater than the also aberrational compound of the S&P 500. In other words, one dollar invested in Sequoia at the beginning of 1995 grew to \$3.33 by December 31st 1998. The dollar put into the S&P at the beginning of 1995 finished 1998 at \$2.90.

In effect, shares of our companies were getting a double dip. Share prices were rising

generally because the businesses were making a lot more money and the market was pushing up the multiple that it was willing to pay for those profits. (As an aside, we now know that a lot of the reported earnings that investors were paying up for were not true economic earnings, unfortunately.) Too many good things happening at once can cause Mr. Market to get a little, and sometimes more than a little, carried away. In this case, he clearly got much too euphoric and wildly over optimistic.

By early 1997, we were concerned about the valuation of stocks in general and of ours as well. We said so then in our reports to you, and we said so later as equity prices continued to climb rapidly. So what did we do about it? Nothing. And you know what? If we had acted on our conviction in early 1997, we would have left an enormous amount of money on the table because we had two spectacular years in '97 and '98. Doing nothing turned out to be doing the right thing.

Let's examine why in a little more detail. When you make a decision to sell a stock because you believe that the valuation of the company is too high, your timing has to be pretty precise. There may be some people who are very good at that. Experience, however, has taught us that we are not good at timing sales prompted by concerns of temporary overvaluation.

We have had much more success identifying terrific businesses and monitoring their progress closely through extremely intensive research. As long as that research shows that these companies remain terrific we are willing to hold the shares unless they sell at insane prices.

Let's first look at the specific stocks we held at the end of 1998, which have since been sold. In 2000 we sold Freddie Mac, which accounted for more than 20% of our assets at prices lower than its closing price at the end of 1998. However, we also disposed of most of our Harley-Davidson at prices much higher than the '98 close. We subsequently sold our Household International, our US Bancorp and some smaller positions. The net effect of all of the above transactions was essentially a wash.

That leaves the three primary movers of our performance — Berkshire Hathaway,

Progressive, and Fifth Third — which represented two-thirds of Sequoia's total equity position at the end of 1998 and significantly more than that after the sales of Freddie Mac, Harley-Davidson, and the smaller positions that I just alluded to.

On an earnings basis, the Big Three have knocked the ball out of the park since then despite some foul tips along the way. By the end of this year we expect that the earnings of each of the three, Berkshire, Progressive and Fifth Third, will all more than have doubled during the five-year period, which would represent a compound annual growth of more than 15% during a period of extreme economic difficulty. Two of the three, Berkshire and Fifth Third are to varying degrees affected by the level of economic activity. Progressive is immune from the effects of economic activity and one could actually argue that it benefits slightly from a difficult economy because there are fewer miles driven and therefore fewer accidents.

Even though the earnings of these rapidly growing companies have been flowing into a world where interest rates have continued to drop, their share prices simply bounced around and ended up at March 31st more or less where they began in January of 1999. But things are different now. Now the valuations of these three companies make a lot more sense.

This retrospective analysis may lead you to wonder whether we should have acted differently than we did when the share prices for these companies were at their elevated levels in 1998. Should we have sold some or all of these positions?

We would concede that holding these three companies at valuations that were a lot higher than they were at the end of the 1998 would probably have been a mistake. I remember that in this very room in 1999 Steve Farley asked Bill if there were a price at which he would sell Berkshire. And Bill asked Steve for a bid. But my current feeling is that we will be better off in five years for our inaction. Ironically, I strongly believe that the one action that we did take will have had a significant negative effect on Sequoia's net asset value when you look at it five and ten years from now.

This brings me to Progressive. During 1999 and 2000, we sold roughly one-third of the fund's position in Progressive after selling a very small amount at the end of 1998. That sale, I believe, will hurt us quite a bit in the years to come. The Internal Revenue Service has restrictions against overly concentrated mutual fund portfolios. And those restrictions have effectively prevented us from repurchasing those shares in Progressive for the fund in 2002 and early 2003 when Progressive was a bargain trading below \$50. This concentration restriction of the IRS effectively works like a roach motel in reverse. It is relatively easy to check out of a position that represents more than five percent of assets, such as Progressive did. But it makes it very, very hard for us to check back in.

One could logically challenge my conclusion that retaining securities of outstanding companies with excellent growth prospects through periods of overvaluation will turn out to be the most profitable course to follow. One could argue that our investors would have been better off if we had sold Berkshire and Progressive at the end of 1998 and bought them back at much lower prices in subsequent years. However, one of the many lessons that I have learned about investing from Charlie Munger is that finding and buying a great company at a great, or even a good, price is hard enough to do once. Buying a great company at the right time, selling it subsequently at the right time, and then buying it back at the right time would be winning a trifecta of difficult investment decisions. The odds are overwhelmingly against you winning that trifecta.

If you look at the stock price performance of great companies over many decades — and I am not just referring to these three but pick any great company you want to — there is a very high probability that you will find a fairly long stretch of years when their stock prices just marked time or even declined. This may have occurred during bear markets, which will often beat down the price of great, good and bad companies alike. Sometimes the market will turn against a whole industry for a period of time, as it did against the drug stocks in the early to mid-'90s when the proposal for

universal health care was on the front burner. Maybe a great company will trip over its feet. An example of that is Costco, which we own a little of. Costco stumbled in the early '90s. Selling at that time would have been a mistake.

Living through that long dry spell is the price that long-term investors must willingly pay if they believe that they own truly outstanding companies with the legs to go the distance. The challenge is to differentiate those companies that are truly exceptional from the many pretenders and wanna-bees.

How we go about answering that challenge is the subject for another day, or possibly for today's Q&A. One question to ask now, however, is: "What can we do better?"

When we added a small position this past year, the purchase reinforced for me the importance of listening very carefully to intelligent people with great knowledge of a particular company or industry. Many years ago, a client of mine who was an ex-pharmacist told me about this wonderful company, Walgreen, which is now America's largest drugstore chain. Had I followed up then and acted, this terrific company would be a much bigger part of Sequoia and our fund's net asset value would be significantly higher today. Around the same time, an acquaintance told me of his great admiration and respect for a very unusual company called Cintas, which rented uniforms and entry mats to other businesses. Again, more than a decade later, we finally got around to making a modest commitment to this outstanding company. In each case Sequoia shareholders have to date earned a little money, but have paid a much greater opportunity cost for my not acting earlier. There is an old saw that goes, "It is no mistake that we were born with two ears and two eyes but only one mouth." The wisdom in that chestnut has never been more apparent to me.

Fortunately, my ear is not completely made of tin. About ten years ago, a highly intelligent friend who knew the insurance industry very well told me that if he could take only one stock to a desert island for ten years, it would be Progressive. This time I listened and it really paid off because we acted.

In 1994, we made Progressive a 9% position at an average cost of \$11.22. Less than

ten years later, the shares are up sixfold. The unrealized capital gains alone on Progressive account for 10% of Sequoia's net asset value. The really good news is that right now, even after the sixfold gain, we feel more strongly than ever about the company's long-term business prospects. Now, as we mentioned, there can be periods when stocks outperform companies and vice versa. But over time we feel very strongly that Progressive will do quite well. And we feel worse than ever about our misguided sales. I hope that these three, and a number of other situations like that have taught me to listen a lot better.

Our ears will always be open to ideas suggested by others, but as Bill mentioned, we are largely self-reliant and generate the vast majority of our ideas in house. Since the end of 1998, we have put a total of somewhat over a billion dollars into a number of new positions that have come from our research staff. Thus far, our shareholders have earned a cumulative total return of \$281 million on that investment, which is 27%. That 27% compares with the decline of 20% in the S&P 500 during that same period of time. We are proud of this out-performance, particularly because the lion's share of this capital was put to work in just the last two and a half years. In fact, about \$250 million of the total gain of \$280 million has come from investments made no earlier than August of 2000. The reason I cite this factor is that on a time-weighted basis, our new commitments have actually produced annualized returns well into the double digits.

The fund's fourth-largest position now is TJX, which we bought in August of 2000. For those of you who are not familiar with the company, it is the world's largest off-price retailer. Our fifth largest holding is Mohawk Industries, a floor coverings company that entered Sequoia in July of 2002. Mohawk is already up 24% in that very short period of time. The performance of not just TJX and Mohawk but of the overwhelming majority of the funds committed to equities since 1998 reinforces my confidence that our people and our intensive research process are as good as or better than they have ever been.

To review, then, the last eight plus years of Sequoia Fund: From 1995 through 1998, our

companies did very well but their share prices did much better thanks to Mr. Market's irrational exuberance. Since then, while the earnings of the companies we owned and kept have continued to steam ahead, their share prices, logically enough, have not made any headway.

Meanwhile the companies we added to Sequoia since 1998, which we purchased at much more reasonable valuations to begin with, have enjoyed growing earnings as well, which in turn has helped lift their share prices. Add it all together and what do you get? For the ninety-nine months that ended in March of this year, the wealth of shareholders in Sequoia has compounded at a 15.7% rate versus 9.5% for the S&P 500.

Looking at the market as a whole for moment, we have seen several managers with excellent records opine that the broad stock market before the recent rally was as cheap as it was in 1974. Bill, Rick and I were all around in 1974 and still have some battle scars. We do not spend a lot of time focusing on the overall level of the stock market. Rather, we focus on the price-to-value relationship of each individual security. But I can assure you that this market is nowhere close to as cheap as it was in 1974. If it were, we would have bought a raft of companies in addition to Walgreen and Mohawk, our other more significant purchase of last year.

The fact that we took Mohawk up to 4.99% of assets speaks volumes as to our enthusiasm about this company, its management and the price we paid for its shares. As for Walgreen, with all due respect to TJX, Tiffany and Costco, which we also own, I believe that the first three letters of the names of the two greatest retailers of size in the United States are W-A-L.

I don't know how many of you are familiar with Jim Collins' book, *Good to Great*, published in 2001. It has had a remarkable stay on the bestseller list. Personally, I don't know if this book is either good or great. For one thing, I'm not sure that some of the companies that he discusses were ever truly great in the first place. And some others have already proven to lack staying power. Walgreen, however, is one of the few truly good-to-great companies in that book

that have not reverted from good to great or even worse in just a few years' time. The size of the Walgreen position, about 1.6% of our assets, is tempered by the threat of drug price regulation, which Walgreen management has cited as its greatest concern.

In closing, I am reasonably confident that over the next fifty-one months Sequoia shareholders should see their investment dollars grow much more than they did during the dry spell that began in January of 1999. Like the end of economic recessions, the endpoints of investment performance droughts are known only many months or even years after the fact. It is possible that Sequoia's drought ended in March of this year.

We are up 7% in April, and we are hoping that April showers continue into May. In the first six trading days of this month, we gained an additional 1.4%. That said, it will be many months from now before we know for sure whether the dry spell ended on March 31st or whether our recent gains are likely to wither on the vine. We do know that both our large and small positions are selling at much more reasonable levels of valuation with two small exceptions. Moreover, all but one of our companies are very well run and have excellent growth prospects. Now it is time for the rain dance. I mean the Q&A.

Bill Ruane:

Before we get to that I just want to make a few more comments. Joe Quinones, our head of operations, said, "There is only one thing you have to say." Of course, Joe, I said everything but the one thing you wanted me to say. And that is that we do like to consider these sessions off the record as far as the press is concerned. We like to feel that we can be relaxed up here when we are commenting. So, we would appreciate it if there is press here, and I think there is, that they keep this off the record.

Bob mentioned that Steve Farley asked at a previous annual meeting whether we would ever sell Berkshire, and the answer is "Yes." But I asked him for a huge premium on that bid if he wanted to make one. I don't think that we would sell Berkshire except, as Bob said, at some insane price.

And one final thing. I told you that we constantly review our holdings and we constantly talk about whether we should be doing something. Bob mentioned the sale of Progressive back two or three years. We talked a lot about that. And I have to take the responsibility for that sale. If I look back even further when the stock was higher, when we sold some near its peak, when was it Bob? About 1998?

Bob Goldfarb:

It peaked in 1998. That's why I mentioned that there was a small sale in 1998. That small sale was in reaction to valuation because the company was still reporting strong numbers. It subsequently went through a more difficult period when it got into a really nasty cost-price squeeze. Those business difficulties had something to do with the much larger sales that were made after 1998.

Bill Ruane:

I just wanted to say that at the time that Progressive hit its very peak, Bob, even then, said, "I think this company has the management and competitive advantage to continue to generate outstanding growth. I don't think we should be selling it at all."

Bob Goldfarb:

I will counter that, Bill. I asked you when it was at \$170 — that's pre-split — I said, "Bill, Progressive is selling at 35 times earnings. Do you want to sell it?" And you said, "No." And that was the right answer.

Bill Ruane:

Oh, I think we could debate this for quite a while. But he's smarter than I am.

Bob Goldfarb:

No, I'm not. But I would like to introduce the other members of our firm that are here today. Unfortunately, the dais just is not large enough to accommodate all the research team. So sitting in this room are the other members of our research staff. In alphabetical order, they are Girish Bhakoo, Arman Klein, Stuart Mieber, and Terence Paré. Terence helped me so much in writing this talk. He should get all of the credit for writing the speech and none of the discredit for delivering it. You may have seen that there are terrific

reviews for *Long Day's Journey into Night*, which opened on Tuesday night for a four-month run. But I want to let you know that *Long Day's Journey Into Night* was also on for a much more limited run of two days and nights on Monday and Tuesday of this week. I owe a lot of thanks to Terence and Jon Brandt, who starred in that production. To continue through the alphabet, I would also like to introduce the rest of the research team: Paul Scarpetta, Greg Steinmetz and John Taylor.

Not only do I sometimes have a problem with my ear, I sometimes have problems with my eyes. I am extremely near-sighted. In the audience as well is Cynthia Crystal, who is our librarian.

Bill Ruane:

Cynthia is the reason I don't know anything about computers.

Bob Goldfarb:

And she and Todd Ruoff are the reasons I don't know anything about computers. In addition to Todd are Arlene Farrand-Borgerson, who's both Bill's assistant and my travel agent. There is Joanne Chiarelli, who is my assistant. She's terrific. And Bob Gedicks works with Arlene in handling Bill's portfolios and many of Bill's clients. Then Gina Pedrotti and Michael Valenti, who's the point man on Sequoia. When people have questions about Sequoia, or they want to purchase additional shares or redeem them, Michael's the person they speak with. I apologize if there are any other members of our staff here whose presence I am not aware of. With that, let's go to Q&A.

Question:

Just a couple of quick questions, Mr. Goldfarb. When Joe Brandon spoke here about a month ago, I asked him if the reserves of Gen Re for asbestos liability were adequate. His reply was that claims were coming in as expected. First question: Are you of the opinion that the reserves of Gen Re, which I think are about a billion dollars for asbestos liability, are adequate, given from everything I have read that the overall liability going forward will be in excess of \$200 billion? Second question, on Fifth Third Bancorp: Its trust department computers continue to lag behind the industry's. The company has been sued in class action suits

for failure to disclose the inadequacy of their internal controls. Do you think that the formal agreement that Fifth Third had to enter into with the Fed will slow its growth going forward?

Jon Brandt:

Those are excellent questions. Let me start with Fifth Third, and I'll address the easiest part first, which is about the class action suit. I think whenever a stock goes down or when there are headlines, the nature of the tort system today is such that the company gets sued. I have a friend who works for the plaintiff's bar in California. That's his job. They look at the headlines. They look to see which stocks are down, and they sue. I'm not saying it's wrong or it's right. That's just how the system works. The suit will get settled for what I imagine will be a relatively minor amount.

In these class action suits, it's the shareholders suing themselves effectively. When companies get sued what happens is that the settlement money comes out of the corporate coffers to pay the lawyers a third or half and then the shareholders get the other half or two-thirds. So, the shareholders arguably end up worse off, anyway. Typically the managements never pay a dime out of their pockets because they have officers' insurance.

As for the question of whether there was wrongdoing, I think it's very important to say that I don't think anything Fifth Third did was wrong in that sense. It had a problem with the reconciliation of its Treasury balances and its investments. This was an honest mistake. There was no corporate malfeasance here.

The announced charge was \$83 million pre-tax and about \$50 million after-tax on a balance sheet of about \$80 billion. Management has said that Fifth Third is going to realize a recovery for at least a portion of the original charge. If you compare the kind of losses that some of the banks of similar size have realized on bad loans they've made, the amount of money that Fifth Third lost just pales in comparison. I'm trying to put it in perspective. I'm not trying to minimize it.

Question:

So, you don't think that scrutiny of its acquisitions going forward will slow growth?

Jon Brandt:

No, I didn't say that. I think Fifth Third's growth could slow while the supervisory letter, the written agreement, is in effect. It's a complicated situation. Because of the disclosure of the reconciliation error, the bank received additional regulatory scrutiny to see why this happened, and management signed a written agreement with the Cleveland Fed to address the problems.

The Fed found some issues, and I think Fifth Third management would be the first to say that on several of the issues they could bear to tighten up their controls. I mean, the mistake was made because of inadequate controls. So, I think the tone of the letter was a little harsher than Fifth Third deserved, but I think the company made mistakes, and it deserved to be reprimanded. And management is going to address those issues. In fact, I think the lion's share of the issues has already been solved.

But the letter will last as long as it lasts according to the regulator, and during this period, Fifth Third will be able to make acquisitions only if the regulators deem them to be in compliance with all the terms of the written agreement. To the extent that its earnings per share growth over the next two years would have otherwise been aided by acquisitions, yes, you could argue that perhaps the company's growth could be temporarily slowed.

On the other hand, during this period Fifth Third's capital will build. If you assume these were going to be cash acquisitions, the capital would build to fund those acquisitions at a later date, and there really would not be a material opportunity cost. Or management could buy back stock.

Now it may be true that even when the agreement is lifted, this incident might cause some lasting impact on their P/E in the future, which would affect the terms under which the company could make an acquisition based on a share-for-share exchange. So, this situation could have anything from a very minor to a moderate effect on the growth rate for an indeterminate amount of time.

But I think the most important consideration is whether this is a great company. You know, getting back to Bob's

speech, I think Fifth Third is a great company. Not perfect, but still a great company. It has a history of growing both through acquisition and by internal expansion. I think you cannot dispute that acquisitions have helped its growth. But I think the kind of loan growth, the kind of deposit growth that Fifth Third has produced organically through the years, the tremendous fee growth, especially in its processing unit, where it has superior systems and superior cost structure relative to the competition, could deliver growth well into the double digits, perhaps even without acquisitions. And the company will be back making acquisitions, and I think management will do a better job integrating them for having gone through this period.

Your second question was about asbestos reserves at Gen Re. I was at that meeting where Joe Brandon spoke. It was a good presentation, I thought, that Joe gave, and it was a very good question you asked because as most of you know, asbestos liabilities have been ballooning. Again, I probably don't have to go into how the tort system in this country works. But a lot of people who are not sick are reaching settlements with companies. Obviously, a lot of people are also sick. But the thing has ballooned. Companies that maybe just distributed a product with asbestos or had asbestos in one of their factories forty years ago and never made it or whatever, they are going into bankruptcy. But the question that generally remains is: Are the insurance and reinsurance companies adequately reserved?

Well, the short answer in Gen Re's case is: I don't know. I don't have the level of knowledge that would be necessary to say otherwise. After the meeting, though, I did follow up on the question because I thought Joe Brandon's answer, while clear, was not really that explanatory.

So far, this is what I've understood. There has been a raft of settlements with claimants that amount to say \$10,000 or \$20,000 or even more per person. Let's say the company settling had a policy with a primary insurer to cover general liability or product liability or premises liability. In those cases, there would be a limit to how much the insurer would be willing to cover, and then the insurer

buys reinsurance to cover itself in case the claims go above a certain amount.

This is complicated. So, I'm going to try to wrap this up but still be clear at the same time. Gen Re tends to write reinsurance policies at the excess layers, which are very high. So, instead of covering the first \$10 million of claims or even the second \$10 million of claims, it might cover only claims over \$50 million dollars. So, if the company with the asbestos liabilities has, let's just say, \$10 million or \$15 million of asbestos claims per year over a thirty-year period, that could amount to \$300 million to \$450 million of claims over the entire period. But if Gen Re doesn't have to pay claims except to the extent that its client, the primary insurer, has annual claims above \$50 million, Gen Re's going to say that even if it covered the same insurer for each of those 30 years, and the primary insurer had \$10 million to \$15 million a year in claims, Gen Re is going to have no liability because it was at the \$50 million layer.

I believe there are some insurance companies that are trying to pierce the limits of their reinsurers either by aggregating losses from several years to force them into one year, or by bundling diverse types of losses into one category and then saying to the reinsurers, "Your limit is \$50 million, but we're paying \$450 million in claims, or \$300 million in claims, and you have to pay the difference." Although these types of disputes between insurers and reinsurers have gone on since time immemorial, I understand that there was at least one important recent court case which went against a primary insurer that was trying to bundle and aggregate its claims in this way against its reinsurer.

So, while Gen Re has been hurt by a lot of other things — in fact by almost every other liability line but asbestos — my impression is that if the excess layers are on a per-year basis, the losses from all of these settlements haven't accumulated enough to pierce their layers. I think that Gen Re is also helped by the fact that asbestos claims tend to come in under various types of policies that shield the reinsurer from accumulations of claims. The company also tends to have caps and aggregate limits on most, if not all, of their liability business.

The last thing I'd add is I believe that they might have a little excess in World Trade Center reserves. After 9/11 there was fear that a raft of liability suits would be filed against security guards and anyone who could conceivably be blamed for what happened. Reinsurers like Gen Re put up huge reserves for that. I think because there was so much federal and private largesse to the victims of 9/11, there have been fewer liability suits than were initially anticipated. I think this could be an industry-wide phenomenon, although I'm not sure the industry as a whole is overreserved for 9/11. But I think Gen Re has something like \$2 billion of World Trade Center reserves. So, I'd hate to say it is overreserved on anything because almost all the surprises in insurance are bad. But, even if it's short on asbestos, the company may have some cushion in other areas.

That's about the best I can do for an answer now. The meeting was just a couple of weeks ago. And I'm continuing my research.

Question:

Well, you made it very clear how conservative Gen Re is in its reserves and for other liabilities. But you didn't really get into asbestos.

Jon Brandt:

I'd love to believe Joe. You know, everyone's been wrong about asbestos up to now. So, I don't want to say that we're 100% sure that the company is not going to have to add to reserves, but the company has a conservative reserving mindset that comes from Warren. And Joe and Tad Montross, who's the president of Gen Re, also share that mindset. Sorry to be so long.

Bob Goldfarb:

I'll try to be short and just add one thing. Your question on Fifth Third and Jon's response reminds me of another example of a tin ear. One of our colleagues had a friend who was a consultant to Fifth Third, and he told our colleague that Fifth Third's controls were lax. This was several years ago. And again, we pride ourselves on the intensity of our research effort but we weren't as thorough as we should have been. We should have listened and drilled into the question about those controls when he first got that information. I don't believe it would

have led us to sell Fifth Third. But even if it's not going to cause us to act, we should still ask.

Question:

I am thinking of adding to my position in the fund. However, I'm concerned about taxes on distribution. So, I have two questions. What, if anything, have you sold this year that might affect my taxes? And second: Are you willing to tell us what you might be thinking of selling that might affect my taxes?

Bob Goldfarb:

I'll try to answer that one. We haven't sold anything this year. However, we can't tell you what's going to happen for the rest of the year because we don't know what's going to happen to our companies and to their share prices.

Joe Quinones:

As Bob said, we haven't realized any gains in 2003. But we do have a carryover from the last two months of 2002, which will be paid in June, a long-term capital gain of about fifty cents per share.

Question:

A multipart question. Going back to your original comment about how you actually found that some of the best ideas have come from listening to the scuttlebutt. The question is: First, how do you distinguish between a true, genuine insight about a tremendous company like a Walgreen from a lot of the noise that you might get from a number of other people who turn out to be wrong?

The second part is: It seems like a lot of the great companies, Progressive in particular, seem to have something or someone like a Peter Lewis and what the company does with its art. And it just kind of shows you that there's something different about that company. It even comes through in the annual report. And the third piece of the question is: If it's a great company, when do you start getting concerned about size? A big company can't grow the same way a small great company can.

Bob Goldfarb:

You know, in response to the first question, it's a good one. But I think, in my remarks, I've said that we listen when a highly intelligent person who has great knowledge

about a company or an industry speaks. So, that's one way of differentiating. If Joe Kennedy's proverbial shoeshine boy told me that I ought to buy or sell Progressive or if he gave me the name of a stock to buy, I don't think I'd pay much attention — unless it was a company that manufactured shoe polish. I'll answer the other two questions, and the others can join in.

In terms of the culture, I would say that culture does matter. And while Peter brought many great things to Progressive's culture, I'll cite just two. One is very important, and it's unusual for most companies. He made the culture one of enormous honesty. I'm not sure that total honesty would work in all cultures, in all organizations. And it probably has some downside at Progressive. But it's generally worked very well there.

That same honesty extends to management's reporting to shareholders. As some of you may know, Progressive has never managed earnings and has never guided earnings expectations. We like the fact that it hasn't. The company has always tried to report its earnings accurately. But because of the nature of insurance, you can't be sure that what you see is what you get. The executives at Progressive were honest when they were reporting their results in 1998 and 1999, but they were wrong. They found out later that they had underreserved.

Knowing enough about Gen Re and Berkshire and Joe Brandon, to go back to that topic for a second, I would give the benefit of the doubt that they are being honest in their assessment of asbestos. But they may be wrong.

For the second example, I will refer to an excellent point that was made in *Good to Great*. Collins has a chapter about what he calls "Level Five" leaders. These are leaders that care more about the organization than about themselves. I think that the CEO of Progressive, Glenn Renwick, is clearly a Level Five leader. He's much more interested in making Progressive this country's biggest and best auto insurer than he is in his own compensation. Will Oberton at Fastenal is clearly a Level Five leader. And there are a number of other Level Five Sequoia CEOs.

More to the point, I think that what Level Five leadership often entails or creates is a culture of restraint. And I think a number of the excesses that we've now seen, the Worldcoms, the Enrons, the Tycos, sprang from cultures of excess carried to extremes that we never thought we'd see in public companies of size.

In response to your question about the law of large numbers, we're always thinking about that because we're always thinking about the future growth rate of any company we own or are thinking of owning. If one company has a 90% share of the market, and it competes in only one market, and that market isn't growing, you'd better think about how good management is at allocating capital for acquisitions if you're counting on growth.

Berkshire Hathaway is an example of such a company. Most of the wholly owned businesses don't have high organic growth rates. Warren Buffett himself has said that he is not going to compound anywhere near his historic rate because of Berkshire's size. Therefore, you have to try to figure out how fast the company can grow organically and how well and when Warren Buffett can deploy the excess cash that's already there as well as the cash that future earnings and float will bring in.

As a counter-example, Walgreen is a large company that does not rely on acquisitions to grow. It did make a terrible one in the '80s, and it's one of the best things that ever happened to the company because since then almost all of its growth has been organic. Depending on acquisitions for growth screwed up most of Walgreen's competitors.

As I mentioned, Walgreen is the biggest pharmacy chain. It has a 12% share of the market for prescription pharmaceuticals sold through the retail channel. In this case, you have to think about two things. One is how fast is that channel going to grow? The second is what is Walgreen's share likely to be in ten or twenty years? If you thought that the market for pharmaceuticals sold through the retail channel were going to grow rapidly and that Walgreen's share were going to increase significantly, you would assign a higher multiple to its earnings. If you thought that the channel and Walgreen's share of it were both going to be flat, you would put a lower multiple on its profits. If you

thought that the channel weren't going to grow at all, but that Walgreen's share were going to grow significantly, you would assign a multiple somewhere in between.

Question:

What if any advice do you provide to your companies about proposals on the proxies regarding the granting of options?

Bill Ruane:

Jon Brandt is the terror of all chief financial officers when it comes to that question.

Jon Brandt:

I'm not sure anything we do is really that effective. We try to convey to management that we think of options as an expense, and we try to get a sense of how they think about options. If they don't think about them as an expense, we try to convince them options are an expense. But if it doesn't work the first time, it usually doesn't work at all. We may have had some success with Fifth Third and Progressive. But you never know whether people would have come to these decisions on their own. When we first started looking at this closely, Fifth Third was granting about 1.8% of its shares a year as options. Now it's about 1%.

It's not that we're against options *per se*. But we prefer that restricted stock and cash comprise a major portion of incentive compensation because you can't really argue about how much the expense is. I think Progressive has completely jettisoned its options program and gone to an all restricted stock and cash compensation program. Is that right, Bob?

Bob Goldfarb:

I believe so.

Jon Brandt:

We have been in conversations with management about this issue for the past few years. It's just very difficult to estimate how much impact we've had. Bob, correct me if I'm wrong. We don't usually state our position by voting for or against a program.

Bob Goldfarb:

That's correct.

Jon Brandt:

It's rather that we try to engage the management and figure out how they feel about options. There are companies in which we have chosen not to invest because the percentage of options the company grants is high. Companies that are granting 8% or 10% of their shares in options each year don't think about options as an expense. Or they know full well they are an expense but management doesn't care because the money's going into the managers' pockets. Where it's marginal, where they're giving 2% or 3%, we might talk to them and figure out why. In some instances, it may appear that companies are granting a lot when they have actually combined two years of awards in one. It's also possible, for example, that a company has made a large one-time grant as a signing bonus for a new CEO.

Bob Goldfarb:

My poor vision kept me from recognizing two of our directors, Roger Lowenstein and Vinnie Ahooja. Roger, did you want to comment on this topic?

Roger Lowenstein:

I can't comment on what you folks have said to companies. Obviously, I haven't been in the room. But I think options were a dream that went sour and maybe were misapplied or misunderstood all along for a few reasons. One was the nature of the fixed-price option where you get to invest for the next ten years, and even if you do a lousy job, you're going to make a lot of money. That's never really been understood, although Buffett wrote about that about 20 years ago, I think.

And the other thing that happened with options is: If you give a guy a big option grant, say, when he goes to work on day one, and you know that when he retires 20 years later, he's gotten incentives at that price, fine. But if you come back the next year and give him another grant, and you come back the year after and give him another grant, you get this sine wave effect, where the stock can just sort of go up and down. Just by the nature of things, he's going to catch the troughs. He's going to exercise the options that were given at the troughs when the stock hits the peak. And he's going to end up really reaping millions and now tens of millions

of dollars for riding a treadmill. Sandy Weill just got 1.5 million options after the stock had fallen 25%. So, he's going to get zillions of dollars for merely recouping his previous losses. It's a great deal for Sandy. I think it's a scandal.

Bob Goldfarb:

Roger, didn't Sandy Weill trumpet the fact that he wasn't getting a bonus last year?

Roger Lowenstein:

Yes. He didn't get his bonus last year. The donation box is in the rear.

Jon Brandt:

Let me add just one more thing. If you look at our biggest holdings, first you have Berkshire, which grants no options. Fifth Third, our second largest position, is down to 1%. Progressive, our third largest holding, awards no options. Mohawk, our fifth largest position, grants trivial amounts. Fastenal, which is our sixth biggest position, just set up a very modest program this year and is granting less than 1%. The company's old program, which this one replaces, was very unusual. Under the old plan, the chairman and founder, Bob Kierlin, *not* the company, granted employees options to purchase stock that he owned. Other shareholders suffered no dilution at all.

It's interesting. You see a lot of CEOs like Dick Kovacevich of Wells Fargo. He wrote in his letter to the shareholders this year that options have value, that they might be an expense but not an expense of the company. They're an expense of the shareholders. Well, you know, that's kind of Alice-in-Wonderland thinking as far as we're concerned. In fact, the only way you could legitimately say it is an expense to the outside shareholders but not to the company is when the shareholders are actually giving their shares to the employees. Then it's not an expense to the company.

Bob Goldfarb:

Fortunately, we own a great company, but unfortunately its CEO agrees with Dick Kovacevich on the options issue. The first time we ever asked management about options, the CEO immediately proceeded to leave our conference room and go to the men's room. He

has been asked about options subsequently, but not by us.

The acid test question that we've used in the past is, "If expensing options is mandated, will you reduce the rate of grant?"

Question:

Could you elaborate a bit more on how you distinguish between good companies and great companies that have long-term staying power?

Bob Goldfarb:

That's an excellent question. Before I answer that, I would say that the concept of buying a company that's going from good to great is fine. And you'll probably make more money if you can identify a good company that's on its way to becoming a great company. You're likely to get a double dip because its multiple and stock price are probably reflecting an assessment that it's just a good company. So, catching companies at an inflection point in theory is terrific. However, Warren Buffett has said that when you look at a company whose track record hasn't been great, the onus is on the management to tell you why its future should be better.

But you know an unregulated monopoly is terrific. If it's not a natural monopoly, then you want a company with an unusual competitive advantage. If I could think about only one thing, I'd think about competitive advantage, the moat that Warren Buffett is always talking about. The challenge is to identify companies that have that competitive advantage, that moat, and then think about the probability that they can sustain or possibly expand it.

Another way to think about that is to ask the question that Warren Buffett has said he always asks: "If somebody had a billion dollars, could he significantly affect the fortunes of the company that I'm looking at?" If the answer is "No," then you can be reasonably sure that you have a company with a very significant competitive advantage.

Of course, some barriers to entry can be overcome with brilliant execution. An example of this process is Progressive's successful entry into the direct channel. It is extremely expensive to write first year direct auto

insurance because of the cost of advertising, the call centers, and adverse selection. Nevertheless, Progressive has successfully overcome these barriers.

Lou, five or ten years ago, did you think that Progressive could go direct and grow very rapidly and very profitably?

Lou Simpson:

Probably not. But we also thought that Progressive was the smartest competition around and if we had to pick one company that we thought was really going to be a tough competitor going forward, it was Progressive.

Bob Goldfarb:

Thank you. Yes. I would really emphasize execution and people. You know, Progressive was tiny when Peter Lewis took the helm in 1965, but State Farm was already a very formidable company. Charlie Munger has commented at several of the Berkshire annual meetings that State Farm is one of the great business stories of the twentieth century. In recent years, State Farm has been hemorrhaging capital from terrible underwriting decisions as well as from terrible investment decisions and the fact that they had huge over-exposure in equities. The story of State Farm in the twenty-first century is going to be an interesting follow-up.

Now State Farm had this enormous advantage. It had this huge moat, but execution trumped the moat. Execution can trump a moat, and that's something else you ought to be thinking about. Does the competitor have the human resources, the brainpower and the inspiration and perspiration to narrow or even overcome the competitive advantage that the dominant company starts with?

Question:

I'm a long-time shareholder of Sequoia, since the '70s. I want to thank you all for what you've done and also Lou Simpson and his group. We've been Berkshire shareholders since the '70s. So, I'm a very happy shareholder of both companies. I'd like to hear what you'd say about the intrinsic business value of Berkshire Hathaway. I think Alice Schroeder came out in the last couple of weeks and pegged the market value as approaching the \$105,000 to \$108,000 area. But as far as intrinsic business value goes,

would Jonathan or somebody like to take a crack at that. Thank you.

Bill Ruane:

Well, I'd like to make one comment about the intrinsic value first, which Warren referred to at his annual meeting. You don't put it down in decimal points. It's within a range.

I think that you can start off with a base of about \$42,000. As Warren pointed out recently, that was the low for Berkshire. It happened on the same day that the NASDAQ hit the high. That's just a little coincidence.

It was clear that they were prepared to buy the stock in; so you can start with that \$42,000 as a level where Warren and Charlie thought that there was a significant — that's my word — significant discount from intrinsic value. You can use your own number as to the size of the discount, but you can assume that they've got an idea that Berkshire is worth a fair amount more intrinsically than the price they were thinking of paying. Since then there's just been an enormous growth in the assets that are available to be put to work, and they've been putting them to work.

Almost any way you look at Berkshire is not going to be accurate. There will be all sorts of asterisks after the method. But if you think about the company as in part a portfolio of securities, the last number I came up with pegged the portfolio of bonds and stocks as amounting to something in the neighborhood of \$50,000 a share. And that \$50,000 a share is a portfolio run by Warren Buffett and Lou Simpson.

So, here you have unquestionably a man of genius managing a portfolio that in the earlier stages of Berkshire and for many years was the main source of growth — the management and the selection of securities. Growth came through selecting securities at undervalued levels and doing a remarkable job of that.

So if you buy Berkshire at \$73,000, about \$50,000 of that is being run by the world's greatest investment manager, and it's yielding 3%. Now of the \$50,000, some \$30,000 — my numbers are a little rough around the edges, but it's around there — are in fixed-income securities. Those fixed-income

securities can be redeployed into very attractive situations if and when they show up.

Warren likes to estimate his longevity in different ways such as how many haircuts he expects to get before he dies, and how many times he thinks he will fill his car with gas. What was the third one, Jonny?

Jon Brandt:

I think it was the number of calories he is going to consume.

Bill Ruane:

Anyway, we expect to see Warren around for quite a while, well into his eighties. Now those are just my guesses. In any event, he also said that he thought it was very likely that sometime during the period that he has left on this Earth that he would have an opportunity to put that money to work at very attractive levels. And his levels are not just two and three percentage points above the current bond rates or anything like that. His targets are much higher. There's no doubt in my mind that he will manage that \$50,000 part of your investment in Berkshire Hathaway and our investment in Berkshire extremely well.

Then you go over to the rest of the operations, which are expanding at a reasonable rate in terms of putting the money to work into wholly owned companies. But I think that you have — what is it, Lou? — another \$1,000 to \$1,200 a share and growing, in terms of earnings of companies that are wholly-owned.

Lou Simpson:

Depending on what time period you're talking about.

Bill Ruane:

That's right. He just picked up \$22 billion in sales. I'm thinking of Buffett's recent announcement that Berkshire is buying McLane. I don't know how much McLane earned. It's a low margin business but the profits are very significant. I think that if you consider the quality of the companies he's bought in terms of return on assets and cash throw-off, you wouldn't have much trouble coming close to \$15,000 or \$20,000 a share.

Now, my wife, who is sitting in the back there, is warning me not to diverge too much from the subject. But I think that in this

past year, Warren has shown his brilliance, his absolute brilliance in ways that may have gone unnoticed.

He is famous for picking stocks, and every time he makes a major purchase, everybody notices. But last year, there were three areas in which he just excelled. Number one, which was fairly well-noted, was in buying companies at very reasonable prices and putting 3% money to work at levels that I would guess, and this is just personal, will turn out to be about 12% or something like that. We are talking between \$4 billion and \$5 billion put to work, including deals made by Mid-American.

He also did quite a bit of arbitrage in fixed-income securities, which was brilliant. I don't know the exact numbers because they're not in the annual. But if you look under the financial products area, where this arbitrage takes place, it's clear that area made \$1 billion in operating income and I would think that a good chunk of that came from the kind of arbitrage work that I wouldn't begin to think about doing myself. He's got a genius for doing something like that, and I don't think anybody can match him.

Then another area where, again, I can't quantify the exact returns, was in junk bonds. There Johnny can give us an estimate.

Jon Brandt:

He bought about \$6.5 billion of junk bonds last year, and we know enough about what he bought to estimate the gain, which I figure was at least 25%. So 25% of \$6.5 billion is around \$1.6 billion. He's already indicated that he has realized several hundred million dollars in capital gains in the first quarter, and we think a lot of it could have been from the junk bonds. Plus there would be significant unrealized gains. He bought the bonds between July and December. This was a really quick hit.

Bill Ruane:

We're talking about someone who in two areas made probably well over \$1 billion pre-tax. Now, I think that over a period of time there will be opportunities for him to redeploy the pieces of the \$50 billion that are earning maybe 3% or less — some of it's earning less than 1% because he's got cash, which is earning maybe 70 basis points.

Rick, Bob and I have been through the '74 market, which is the worst I've seen in my lifetime, and we've seen some others that offered unusual values. In other words, opportunities will occur. I don't know what will bring them about but they will occur. Warren has compounded at 22% after taxes, but if he just did 10% after taxes with this \$50 billion in time, you're talking about an incremental 7% on that \$50 billion portfolio. That's a lot of money per share. So, I really do think that the intrinsic value of Berkshire is not a lot below this level.

Bob Goldfarb:

Jon, what's your assessment?

Jon Brandt:

I agree with virtually everything Bill just said. It's a pretty masterful discussion of all the issues. You asked about Alice's valuation. It's interesting to see how many different ways smart people look at Berkshire. Here is how I look at it.

Alice makes at least one indisputable point. She says that the two key inputs for the present value of Berkshire are the cost of float and the rate at which Warren and his successors will be able to invest the float. One other important input is how fast Warren will be able to put the current liquid low-yielding assets to work. If Warren can get 12%, which I think is his rough hurdle on new investments, and he can generate float at a negative cost, that could be a thirteen-point spread. A friend of mine calls that financial alchemy. You've got a great thing going, if you can do it.

But what happens when you plug in these numbers and you change the inputs by 100 basis points one way or the other? You can spit out not just \$100,000 per share; you can spit out \$400,000. Of course, there's nothing automatic about the cost of the float being negative, or about the company getting a 12% return on its investments.

So if you thought that Gen Re were not going to get its act together, that it were going to continue to have a cost of float in excess of the Treasury rate, which I don't think is going to happen, you could say Berkshire is worth less than where it's trading.

The only place where I might part company with Bill a little bit is on the so-called

permanent holdings like Coke, Gillette, and the Washington Post. Berkshire has \$9 billion of Coke, \$3 billion of Gillette, and \$1 billion of the Post. It will get a decent return on those, but probably less than 15%. And these are permanent holdings of Berkshire. On that portion of the portfolio, I would have somewhat lower expectations than on the equities that I would consider theoretically in the available-for-sale category and the fixed-income. And I think I would agree with Bill that the intrinsic value is a lot closer to the stock price today than it was four years ago when it was at this price for the first time. From here, I think basically the stock price will compound in line with the growth of intrinsic value over the next 20 years.

Bob Goldfarb:

Earlier, I was talking about the barriers to entry in direct auto insurance and the competitive advantage it bestows on the incumbent because of the cost of the first year subsidy. I was also thinking about the similarity to the drug store industry and the cost of opening new drugstores. This is exemplified by Walgreen's strategy versus CVS's. David, I thought you might want to expand upon that.

David Poppe:

I can talk about that. But I guess if we're going to talk about Walgreen, I would say something else. Somebody asked about how you identify a great company and a great culture. We went and visited Walgreen about three years ago, and Dan Jorndt was the CEO at the time. We spent the morning talking with him and other people in management. Then we split off and went to lunch in the Walgreen company cafeteria. And down three tables over is Dan Jorndt having lunch with the rank and file in the company cafeteria. And at the time, Rite Aid was in its meltdown period, and we were laughing a little bit.

The CEO of Rite Aid was a guy named Martin Grass. He flew to work every day in a helicopter. Little funny things stick with you. But it occurs to you that Walgreen has a great culture. This is a place where the CEO, I think with total sincerity, sat down and talked to us about how on Sunday afternoon what he really liked to do is drive around and look at

drugstores. I mean, there's a premium that you pay for that, and it doesn't exist everywhere.

Then there's the CEO who lives in a 45,000 square foot house and flies to work in a helicopter. Those would be things that probably many of us would like to do. That culture is not going to be the same as one where the guy drives a ten-year-old Buick and visits drugstores on Sunday afternoons.

And it speaks to Bob's point about discipline. Where that manifests itself, I think, in the business of Walgreen is in a willingness to do the right thing for the long-term health of the business. And that includes opening up new drugstores at the expense of making an earnings number, and that's what Walgreen does every year. We paid a very high price for Walgreen, and I think Bob talked a year or two ago about us possibly stretching in the future to buy great franchises. This is one case where we did it.

But one of the things that you realize — when you just kind of peel back the layers of the onion — is that every day the company sacrifices today's earnings for tomorrow's. Management is willing to do things like open new markets, painstakingly, deliberately, and with great resolve in place after place. The managers at Walgreen know what they're doing, and it works. That's the kind of discipline that, I think, comes from a culture where the CEO is not too proud to eat lunch in the company cafeteria.

CVS is a very good franchise, and I hesitate to talk about any company that we don't own that's a good business, and they're good people. But I think they're mortal. Like most mortals, they don't like to sacrifice today's earnings for tomorrow's earnings, and so they haven't been as aggressive, I think, or as disciplined about opening new markets. That doesn't mean that it's not a very good business, because I think it is. But we thought Walgreen was a special business and worth the premium because the earnings that you see today are not just sustainable into the future. They're actually sacrificed every year. And that was impressive to us, and it continues to be impressive.

Bob Goldfarb:

What was interesting about the CVS-Walgreen comparison is that CVS had promised Wall Street that it would grow at 15% a year,

and there was no way it could meet that goal and still incur the upfront costs of opening a significant number of new stores in new markets. Walgreen chose to incur the cost of expansion first. And that willingness just gave Walgreen an enormous competitive advantage because it was building out the Sun Belt and now CVS is stuck east of the Mississippi. CVS was trying to achieve what *Fortune* writer Carol Loomis has called "the 15% earnings delusion." CVS is finally opening stores in the Sun Belt, but much more slowly than Walgreen, which already has a very large first mover advantage.

Question:

I currently hold my shares in a Schwab account. My understanding is that Schwab is changing its fee structure for fee-based mutual funds like Sequoia, and that there are some funds that Schwab currently sells for a fee that will be discontinuing sales this June. Do you have any information regarding that? I was concerned because I know that Longleaf Partners is discontinuing its sales from Schwab in June.

Bob Goldfarb:

Yes. I think the difference is that Longleaf Partners was paying Schwab a certain number of basis points to be included in the Schwab marketplace. We have never paid anybody anything. First of all, Sequoia's closed. Second, even when we were open we wouldn't have thought of imposing an expense on our shareholders in order to sell more shares. And Longleaf finally said, "Enough is enough. We don't need you guys." Our policy when we were open was: "Sorry, guys, we're not going to pay anything. If you want to offer it, that's up to you."

Joe Quinones:

So, what Schwab does with other mutual funds will not affect your investment in Sequoia in any way.

Question:

Last year, in passing, you mentioned the use of derivatives. To what extent are you currently using derivatives in your portfolio?

Jon Brandt:

We've never used derivatives.

Bob Goldfarb:

We wouldn't dream of using derivatives.

Bill Ruane:

If you find one in the portfolio, let us know.

Question:

Good afternoon, gentlemen. The question I have is with respect to Sequoia's investment in Tiffany. The question comes in a couple of different parts. I think at one time you were right at or at slightly more than a 5% position in Tiffany, and you subsequently sold off a few shares. I'd be interested in knowing when you developed an interest in Tiffany, the average price you bought it at, and why you have sold shares if you hang onto Charlie Munger's thoughts about not trying to time the market?

Bob Goldfarb:

We never had anywhere close to 5% in Tiffany. Now, the question about cost is a good one. We no longer publish the purchase price for the positions that we take. Many mutual funds don't. If we think that Tiffany is attractive at a certain price, I'm sure a number of our shareholders would like to know what that price is. But so would our competitors. We have to make the decision as to what best serves the long-term interest of our shareholders. Divulging the price that we paid for a stock is probably not in your best long-term interest. You should have enough other indicators for measuring how well we're doing. David, why don't you talk about Tiffany?

David Poppe:

Sure. I think Bob's being humble. I think Bob's been interested in Tiffany for many years, and we've spent many years pestering management and talking to them before we finally became shareholders. They are literally across the street from us. So, we had ample chance to ask them a lot of questions.

I think the interest is that it's a premier franchise. In the last month, I've spoken just offhand to two well-known jewelry industry CEOs. They both sort of volunteered that Tiffany is really the only brand of jewelry in the US, that there is a trend towards branding, and

that Tiffany is perfectly positioned to take advantage of that trend.

I think it has a lot of growth ahead both here and overseas. Tiffany is 166 years old. But there are only 49 stores in the United States. Japan is huge for Tiffany, but the rest of Asia and Asia Pacific are small. Tiffany is not very big in Europe.

We think it's a dominant franchise with very distinct and sustainable competitive advantages for the next ten, fifteen, twenty years. It's a rare company that you can look at and say, "We think that 100 years from now it will exist," and Tiffany is the one that 100 years from now probably will exist. Again, that's worth something. It's a premier franchise, and that's why we own it. We felt very comfortable with management and their values. We talked before about culture. We think it's a healthy culture and just feel good about its prospects going forward.

Bob Goldfarb:

I think it will be an interesting test of competitive advantage, again going back to a question that was asked earlier. De Beers has decided to enter a joint venture with LVMH in which they will open stores under the De Beers' name, which has a significant franchise value as well. David, hasn't the joint venture already opened its first store?

David Poppe:

Yes, the flagship store opened in London.

Bob Goldfarb:

I don't know how big the stores are and what percentage of merchandise is going to overlap that of Tiffany.

David Poppe:

De Beers is obviously going to be a diamond-centric store, and engagement will be a major part of what it does, and that's a major part of what Tiffany does. I'm sure De Beers/LVMH will be a terrific competitor. Nevertheless, I'm happy to own Tiffany.

Bob Goldfarb:

But there's a real life test of competitive advantage. Two large companies seem ready, willing and able to commit hundreds of millions of dollars to compete with what Tiffany would

say is probably its single most important or core business. We're betting that Tiffany will do just fine and will pass that test with flying colors.

Question:

I had a couple of questions on your investment process. When you find something that you're thinking of buying, do you have to agree unanimously? Do you take a vote, or does one person ultimately decide? Or does anyone have a veto? A second question is: Do you have a fairly long list of companies you would like to own but just cannot because of the price? And my last question is sometimes you make a significant commitment and sometimes, occasionally, a very modest commitment in terms of the percentage of assets allocated. I was just sort of curious why when you make a very small commitment, you just don't sometimes say to yourselves, "We don't feel strongly enough to make a large commitment. So, why make any commitment at all?"

Bob Goldfarb:

I'll answer a couple of them, and I'll turn the first one back to Bill. The reason why you see some small positions is that when we bid for a stock, we set a price ceiling. And at that given price, sometimes we're only able to buy a limited amount of stock.

In response to your second question: "Do we have a long list of companies?" I would point to the gentleman on my right, Greg Alexander. Once a month or so, he circulates a list of what he calls "The Sequoia Universe of Companies." It's a much longer list than the number of companies you see in Sequoia Fund. So, yes, there is a list.

What surprises me is that as good and as comprehensive as Greg's list is, we've established significant positions in companies that weren't on that list. So, yes, I think it's a good idea to have that long list and be thinking about the prices at which you would like to buy those stocks. Just don't be tied to that list. Keep trying to add to that list. Bill, why don't you answer the first question about how we make decisions?

Bill Ruane:

We are looking for certain things such as free cash flow, companies that have a franchise, companies that have good growth

opportunities. And when we find something new, we spend a lot of time studying it. In fact, we all dig into it. Some get out in the field and talk to customers and to competitors and so on.

However, all of this is subject to price, which can change quickly. Every once in a while a company will come out and say, "Well, we're going to miss the earnings consensus by a penny or two." And it's like somebody shouting, "Fire," in a crowded theater. These fellows try to get out, and stocks will go down 20% on the opening. And in two cases, Bob stepped in on his own. He didn't have to call me or Greg or David or anybody here. He put in a bid and bought hundreds of millions of dollars of stock. That's the way we run. Bob can make that decision and he has done a great job of doing it.

Greg Alexander:

So, there's a lot of committee type consideration. "Have you thought about this? Have you thought about that?" But in the end, it's not a vote or anything.

Question:

So, in theory, just looking at the people on the dais, if three of you, including Bob, thought that making a certain investment was the right thing to do, and three of you didn't, what you would do? In other words, when you do choose to make an investment, is there unanimous agreement?

Bob Goldfarb:

We don't vote on making investments. That's just the way we operate. And we intend to continue working that way.

Question:

I'm going to address a different subject. And I would direct my complaints to the Kansas City office. And I just want to know how you protect your shareholders' information because people who have nothing to do with my accounts were able to get information. And until I wrote a letter to Mr. Cunniff, I really got no positive answers. So, it's very disturbing to me, and I would just like to have a concise answer.

Joe Quinones:

I can't give you a concise answer. You must be Mrs. *****?

Questioner:

Yes. I am.

Joe Quinones:

And you live in *** *****?

Questioner:

Yes. I do.

Joe Quinones:

And I know the address. But I can't tell anybody. You're right. I know what happened in your situation. I have been here for 8½ years, and I believe a lot in privacy. I don't even tell my wife how much money I have in my account. I have discussed your issue with the fund's transfer agent. To be frank with you, we have processed many transactions in my years at Sequoia. And what happened to you is a rare thing that can happen anywhere. It could have happened with any transfer agent. I asked Mr. Cunniff to call you, and I was willing to call you and apologize to you on behalf of DST.

Unfortunately, it appears that somebody in your family requested the information, and they knew all the answers to the questions that we would normally ask. A representative from the transfer agent is here, and he'll be glad to talk with you afterwards.

Questioner:

Last year, I asked a question about Household International and your comfort level with the company. You responded that you were comfortable with management and that most of the criticism in the press was unwarranted. One writer was I think a former bank examiner and then there were short sellers. Subsequent to that, the company sort of came unraveled to the point where they sold themselves out to HSBC for what most people would consider a bargain-basement price. Did management mislead you? Or did you miss something in the mix when you were researching it?

Bob Goldfarb:

I'd have to go back and look at last year's transcript to see exactly what we said. If we said that we were comfortable with management, we weren't. And that is a really tough issue for us because if we own a company, and we're not totally comfortable with the management, we do not want that fact

to be circulated in *Outstanding Investor Digest* for the management to see.

At a pretty early stage, we were uncomfortable with Bill Aldinger. I can just say that we are not comfortable with any CEO who on every quarterly conference call says, "Well, we actually grew faster than we told you, but Wall Street won't pay for more than 15% earnings growth; so, we're not going to show it." You won't hear that from Progressive. You won't hear that from Walgreen. You won't hear that from Fastenal.

So, no, we were not comfortable with the management. And I think I made a general point that short sellers sometimes use the business press to advance their case. Some times, the shorts are right. Other times they are wrong. As an example, I used Harley-Davidson, where there had been a lot of short selling. It had entered the business press. And the issue was the law of large numbers: Just how many bikes could they sell? How fast could they keep growing production? And my answer then was that there will inevitably come a day when Harley-Davidson saturates its market. But you have to know when. You just can't write an article and say that eventually supply and demand are going to come into equilibrium.

That said, we're disappointed, we're extremely disappointed in Household. You can't help but be ashamed that you owned stock in a company that would have been charged with fraud unless it had been sold. So, we made a mistake. Without question.

The phrase "connecting the dots" became common parlance after 9/11. Now, almost all of our errors are human errors. We don't rely on computers much. And there were enough dots to connect. One dot was that Household had very liberal accounting policies on loan charge-offs. The magnitude of the restructuring charges when the company purchased Beneficial was suspect. And we knew that Aldinger was a tout. But in the end, we were wrong. I would have to go back to see precisely what we said last year, but I hope that's close enough to satisfy you.

Questioner:

That's close enough.

Bill Ruane:

We became uncomfortable a long time ago. We asked for certain facts, and we couldn't get them. And we sold half our stock at that time, and the debate continued from that time on as to whether or not we should sell the rest of it. We made an error in thinking that the earning power relative to the price of the stock warranted retaining the reduced position. So, we made a mistake.

Question:

You've reduced your holdings in Dover Corp. What are your feelings about the company going forward?

Terence Paré:

First, there were redemptions in kind that reduced the position. So, we haven't sold as many shares as it might appear if you just look at the number of shares in the fund.

That said, I think that when we look at the long-term prospects of the company, the technology business, which was a great driver of the growth in the late '90s, probably isn't going to be returning to its former glory for a number of years. And I think that the manufacturing recession that the rest of the company has been suffering through has been much more severe than management expected.

Now, we're not so sure that Dover's future acquisitions will yield the level of returns that they have in the past. That said, most of the businesses that the company owns now are pretty solid. I think that when the economy comes back, Dover will do okay, but I think it's going to be much harder for it to grow at its previous rates.

Bob Goldfarb:

I want to add that Terence is in no way responsible for our failure to sell Dover or more Dover at much higher prices. He is, in fact, responsible for the stock that we sold a little over a year ago at much higher prices. But the issue we have, especially with a company that has so many businesses is that if you're going to start from scratch and try to derive its normalized earning power and intrinsic value, it's going to take quite a while. An issue that we often face is that they don't suspend trading in the stock while you're doing your research to determine whether or not you should buy or add

to a position, or whether you should sell or reduce a position.

We could have decided to sell the stock because the evidence that was coming in suggested that it wasn't worth the price at which the stock was trading. I decided instead to sell some and let Terence do more work. If the stock had remained at the price at which we sold it initially, upon the conclusion or further along in Terence's work, we would have eliminated the entire position at that price and at that time.

Question:

I so much appreciated Carley's answer two years ago about investing in technology stocks, which was a masterful, devastating analysis of Lucent. Are you actively considering any technology stocks now that the bubble's burst?

Bob Goldfarb:

First of all, I would say, the bubble has not burst. Technology stocks have been quite strong this year. I know that is from depressed levels. But just because something's down 80% or 90% from its high doesn't mean that it's cheap if the high was insane. If you look at the S&P and you divide it into the technology component and the non-tech component, you'll see that the non-tech component is selling at a reasonable multiple of estimated 2003 "reported earnings." I'm not sure that the multiple is nearly as reasonable when you use true economic earnings.

If you're going to value any company, you've got to run out the free cash flows from now until forever and then discount them back. It's just the nature of technology that it changes so fast that you can't figure out what those future cash flows are likely to be. There may be some tech companies where you can do that. But with the great majority you can't.

Question:

I just wanted to know what attracted you to Mohawk to begin with and if there were any concerns regarding the accounting, considering that it's a roll-up.

Terence Paré:

We are not worried about Mohawk's accounting. One reason is that just about all of the company's earnings turn up as cash.

Another is that Jeff Lorberbaum is clearly a man of honesty and integrity. He never hesitates to deliver bad news, and generally lets the good news take care of itself. And the company's accounting practices are conservative.

What attracted us to the business, I think, overall is that it fit our parameters for a terrific company. It produces an enormous amount of free cash flow. It has a strong position in its industry. Berkshire Hathaway, by the way, owns the other big player in the carpet business, Shaw Industries.

Plus we have terrific management. Although there's not a whole lot of opportunity in the carpet business for a great run of growth, Jeff Lorberbaum makes intelligent use of the money that the company makes. And that is one of the hardest things about managing a mature business: What do you do with all the money you make? What do you do with all that cash? Jeff either buys back stock or he makes good acquisitions, acquisitions that make a lot of sense. For example, while the carpet business isn't growing terrifically, the tile business that Mohawk bought, Dal-Tile, is growing pretty well.

Management's attitude toward shareholders is just terrific. When Bill and I went down there to kick the tires in Georgia, we walked in and sat down at the table across from Jeff, who's about my age, and within fifteen minutes, he was asking us if we would sell our stock back to him. He just really values his company.

And, as I said, he does terrific things with the cash. He's making a very good move by investing some cash in merchandising programs for the retailers. That's smart because it will help keep the retailers healthy, which will in turn help keep the retail base very fragmented. And that's good for the manufacturer because a fragmented retail base provides protection from pricing pressures. Mohawk sells to the big boxes, of course, but they can't beat up Mohawk on pricing all the time because Depot and Lowe's are a relatively small percentage of Mohawk's business.

Now, we own Mohawk and Shaw Industries. I think we can be pretty sure that both of these CEOs — Bob Shaw's a terrific

guy, too — are very interested in making a lot of money.

Bob Goldfarb:

I would take exception to your characterization that Mohawk is a roll-up. It was historically. But as Terence suggested, the industry's been pretty well consolidated, although Mohawk will make acquisitions, as I believe Shaw will.

In fact, when we recently met with Jeff Lorberbaum we asked him if there was an agreement that he would run the combined company after his family sold its carpet company, Aladdin, to Mohawk. The deal made the Lorberbaums Mohawk's controlling shareholders. He responded that he and family were just running Aladdin the same way they had in the past. Mohawk then ran into difficulties, but they weren't in the Aladdin division. And management realized that the Aladdin division was much better than any of the others and that Jeff Lorberbaum should be running the company. The old Mohawk was a roll-up. But the Mohawk under Jeff Lorberbaum is not.

Question:

You've said that Progressive is the kind of company that you should never have sold, and Warren Buffett has said that he's sorry he didn't buy the drugs when Hillary was trashing the industry. Since we were into Johnson & Johnson and out of it, I wondered whether there was a group that is being trashed now that you might want to reconsider?

Bob Goldfarb:

I would never say we should not sell Progressive at any price. All I said is that it was a mistake to have sold it at the various prices that we did and at the times that we did.

As for the traditional pharmaceutical industry, it's a good question. And I think that when Warren Buffett was asked that question, he said his mistake had been in not buying a basket of drug stocks. If you'd bought such a basket a few years ago, it would have worked out very poorly to date. Now, that doesn't mean it won't work out going forward.

I suspect that when Warren Buffett made that comment, he probably thought it highly unlikely that, in the absence of drug

price regulation, the great majority of the American pharmaceutical industry would simultaneously experience the kinds of difficulties that they have. But if you are not uncomfortable with the threat of drug price regulation, and you think you that some traditional pharmaceutical makers, domiciled here or abroad, are great, this dry spell might provide you with the opportunity to buy some great companies at a fair price.

Alternatively, if you think it is a great industry, but you can't pick the winners, you could do what Warren Buffett regretted not having done in 1994. You could buy a basket of pharmaceutical stocks with the expectation that some may be triples or home runs, others singles or doubles, and some strike outs, but that the aggregate return will be very satisfactory.

Question:

I know you talked a lot about management, and I was just wondering if you could give me some of your insights into management succession. Specifically, I'm thinking about a company like Franklin Electric with a great CEO who just left, and the new CEO's going to have huge boots to fill.

Bob Goldfarb:

Franklin is not owned by Sequoia. I'll be glad to talk with you personally. But given the limited amount of time, I don't think it's a company that's of interest to most of the people in this room. Is there anybody with a brief question to whom I can give a brief answer before we have to vacate?

Question:

What are your feelings about currency hedging?

Bob Goldfarb:

Zero. I guess that was brief enough.