Sequoia Fund Shareholders' Meeting[1]

May 13, 2005 – New York, NY

Bob Goldfarb:

I want to welcome all of you to Sequoia's 35th annual meeting and thank you for taking the time to attend.

Exactly two months ago today, on March 13, Hank Greenberg's reign as CEO of AIG, the huge, international insurance company that he built over four decades, came to an abrupt and unceremonious end. The company was mired in a very serious accounting scandal that directly implicated Greenberg. The board convened in New York on a Sunday to deal with the latest untoward developments. As the *Wall Street Journal* reported, the company's directors discussed the future of the firm without its legendary CEO at the helm, while Greenberg, calling from his yacht in Florida, berated them over the speaker phone, telling them that they couldn't — and I quote — "even spell the word insurance." Within hours, the board formally stripped Greenberg of his chief executive's role and later forced him out of the company entirely. The fall of Hank Greenberg will surely make a fascinating book someday — Roger Lowenstein, are you busy? Today let it serve as my point of departure.

I would like to talk about the limits of corporate boards as well as two steps that I believe boards should take to improve business practices. I agree that we have the worst system of corporate governance in the world, but I would add the qualifier: except for all the other systems. So the steps that I propose are non-invasive surgery. Indeed, I think a significant re-working of our system would probably be a mistake.

Hank Greenberg is an exceptionally capable businessman with a tremendous understanding of the many intricacies of AIG's businesses. He is also, obviously, a man with some serious and ultimately fatal flaws. So he may seem like an unlikely ally in the quest to improve what goes on in board rooms. However, the more I thought about the topic for today, the more I found myself sympathizing not with what he said exactly, but with what I think he meant.

I am sure that Greenberg was not questioning the spelling ability of the accomplished people on his board, but I strongly doubt that any of the independent board members had a deep understanding of the myriad of businesses in which the company was engaged or the ability to assess how management was performing.

What Greenberg was pointing out was a fundamental limitation that applies to nearly every outsider who serves on the board of a public company in the United States: Directors almost inevitably know less and understand less about the business than the CEO does and therefore function at a severe disadvantage when tasked with evaluating issues such as business strategies.

It is hard to imagine, for example, a better candidate for director of a public company than Robert Rubin. Yet in his book, *In an Uncertain World,* he is quite modest about his role as a director at Ford Motor: "The difficulties at Ford," Rubin wrote, "brought home for me how little you can know as an outside board member of a company, even if you are very conscientious about your duties…. An outside board member has an obligation to learn as much as possible about the issues facing the company. But in truth, it's very hard to know enough to disagree confidently with management about a problem until matters have reached a relatively serious state."[2] Such modesty may seem surprising at first coming from a person who has enjoyed the success in both business and public service that Robert Rubin has. In an ideal world, directors would function as smoke detectors. In the world as we find it, boards are much more likely to function as fire extinguishers.

Here is Rubin again reporting his real-world experience: "At Ford board meetings, the issues that ultimately led to Nasser's departure were often raised. My immediate reaction to hearing them would be: My God, we really do have a problem here and we have to deal with it. Then Nasser would respond. He'd either say that some issue that sounded like a problem really wasn't for the following reasons. Or he'd say, 'Yes, there is a problem, but here's our plan for dealing with it.' That's a good answer, I'd think, listening to

[1] Remarks have been edited for clarity.

[2] P. 317.

him. There's really not a problem. Or: There's a problem here, but he really does have a plan for dealing with it."[3] As we know, the board finally decided that Nasser's plan wasn't working and Bill Ford took his place.

Rubin's candid report is strong evidence indeed that even the most conscientious and dutiful directors, who spend at most a few dozen hours every three months attending to their duties, simply will not know as much about the business as the CEO who is on the job full-time day in and day out. In short, Hank Greenberg had a point even if he made it with a blunt instrument.

Increasing the power of directors, as many proposals for reform would do, in and of itself does nothing to address the underlying issue of the asymmetry of information, knowledge and understanding of the business that exists between CEOs and their boards. For that reason, shifting power from the CEO to the board may do more harm than good.

Under the current system, design usually bows to common sense. Directors have authority over a variety of matters including voting on potential acquisitions and approving succession plans. In the real world, however, the amount of actual power that directors choose to exercise varies considerably from company to company, and I believe it should. It is my observation that when CEOs are successful the board will usually defer to them. That makes good sense. It is just not realistic, for example, to expect most directors to have a deeper understanding of the potential risks and rewards of an acquisition than the person whose hands are on the wheel. Likewise, chief executives with strong track records often anoint their successors, relying on the board only for approval. CEOs almost always have a better understanding of the capabilities of the various candidates relative to the demands and responsibilities of the job.

There are exceptions. For example, a member of the board may have worked with a person who is being considered as a successor to the CEO, or a director with a financial bent may be more insightful than the chief executive about the benefits of a share repurchase program. But the current system does not prevent board members who may be particularly knowledgeable in an area from asserting themselves. And of course, the situation is completely different when the CEO is mediocre or failing. Directors can and do flex their muscles under such circumstances, although of late, some boards have probably been slower to act that they should have been.

Activists are promoting a model of corporate governance similar to what is commonly found in the UK and Europe. A key component of this model is a board that would amount to a second layer of management.[4] Such a move would bring in its wake a raft of unintended consequences that could affect the operations of a business every day, not just when the company is in crisis. Let me refer one last time to Rubin: "The European system also has real drawbacks," he wrote, "the biggest being that what is in some measure management by committee leaves companies less agile and adaptable, less willing to experiment and take risks, and less decisive."[5]

As laudable as the spirit of reform may be, it also has a dangerous tendency to apply one-size-fits-all solutions. And I firmly believe we live in a bespoke world. Good governance requires a structure appropriate for the particular demands of the business and the individual talents of the people involved. For instance, governance watchdogs[6] propose that the roles of chairman and chief executive always be separated and that the chairman be an outsider. In many companies this would be the exactly wrong thing to do. In the case of

[3] Ibid.

[4] The so-called *Higgs Report* is a study of corporate governance practices in the UK. According to the report the board, among other things, "is collectively responsible for the promoting the success of the company by directing and supervising the company's affairs. The board's role is to provide entrepreneurial leadership of the company within a framework of prudent and effective controls which enable risk to be assessed and managed. The board should set the company's strategic aims, ensure that the necessary financial and human resources are in place for the company to meet its objectives, and review management performance." *Review of the role and effectiveness of non-executive directors,* Derek Higgs, The Department of Trade and Industry, London, 2003. (p.21)

[5] p. 318

[6] *The Conference Board Commission on Public Trust and Private Enterprise,* January 2003.

Berkshire Hathaway, I am certain that the absolutely right person serves as both chairman and CEO. Jeff Lorberbaum, Chairman and CEO of Mohawk, and Peter Rose, Chairman and CEO of Expeditors International, are two additional compelling exceptions to such a rule.

On the other hand, not only does one size not fit all, it does not fit all all of the time. Mr. Buffett has made it clear that his son will succeed him as non-executive chairman of Berkshire. The CEO will be a non-family member. Sequoia owns four other companies with a similar governance structure — a non-executive chairman representing the controlling family and a strong CEO with no family ties.

Only one company in Sequoia's portfolio has a policy of having an independent non-executive chairman — GTech, which operates lotteries. But events at this company over the past few years show that the neat separation of powers that such a structure creates does not survive the mess of reality all the time. Bruce Turner, the current chief executive of GTech, actually started out as a director at the company. He was a member of the board in 2000, when the company was rocked by a scandal and its CEO at the time left under a cloud. Turner stepped down from the board to serve as interim CEO until a replacement was found. Eight months later, a permanent CEO was brought on, and Turner returned to board duties, this time as the non-executive chairman. But 16 months later, Turner stepped back into the chief executive's shoes for good when the not-so-permanent CEO left the company. In this case, circumstances blurred the lines separating the board and the CEO, and I would add, rightly so.

In many situations, having the retired CEO and now Chairman looking over the shoulder of the current CEO would be a disaster. But not always. In fact, at three of our companies, Progressive, Fastenal, and TJX, former CEOs serve as non-executive chairmen. For these companies and the individuals involved the system works very well. Furthermore, the proposed reforms would disqualify all these chairmen — Peter Lewis of Progressive, Bob Kierlin of Fastenal, and Ben Cammarata of TJX — because they fail to meet the litmus test of independence. It would have been a grave mistake to disqualify these visionary men, who built their companies practically from scratch and who have deep understanding and knowledge of their businesses and industries.

Even when companies seem quite similar, one size does not fit all. In 1999, Progressive, in an effort to improve the performance of its investment portfolio, decided to emulate Geico's management structure. Geico employs co-CEOs. Tony Nicely runs operations; Lou Simpson manages investments. At Progressive, putting that structure in place turned out to be a mistake, and the company abandoned the effort less than a year later. The CEO of the insurance operations, Glenn Renwick, was and continues to be exceptional. But the investment side of the business, as Peter Lewis put it, "spent too much time coming to sub-optimal consensus decisions." The model that was terrific for Geico was disastrous for Progressive because it did not have anyone with the investment acumen of Lou Simpson.

Rather than the right forms of good governance as defined by the conventional wisdom, what is really important, in my experience, is that management have the right stuff. In selecting stocks for over 30 years, I can't recall a single instance in which the composition of the board or the governance structure was a factor in our investment decision. Rather the choice has always turned on the quality of and the prospects for the business, the price of the stock relative to its underlying business value, and the capabilities and integrity of the CEO and other members of top management.

We don't think that we should insist on perfection in our managers, however. It's most desirable, but all human beings are flawed. We will gladly settle for the 99 44/100th% purity standard of Ivory soap. We have made mistakes about CEOs and we will continue to make them, no matter how much due diligence we put into the selection. Consider: It's hard to imagine any choice of a CEO that is subject to more scrutiny from the press and the public than the election of a president of the United States. Yet we've made some huge mistakes as voters. If such a fine-toothed comb still fails to tease out some terrible presidents, why should we expect a far less intensive process to avoid all the clinkers?

After hearing all I have had to say about the limitations of the power of directors, it may seem as if there couldn't possibly be anything that directors can do to address the problems that have been roiling the business world. But there is. I have two suggestions for making boards more effective. First, they should vote to end earnings guidance. Business is inherently unpredictable. Supplying narrow earnings guidance, sometimes down to the penny per share, suggests a degree of control over the world that very few enterprises truly have for any extended period of time.

Red-faced CEOs are reminded of reality every quarter, of course, but the real danger is not executive embarrassment. It is that having made a specific — and unrealistic — commitment to shareholders and Wall Street, managers will inch closer to the slippery slope of earnings management. And earnings management leads executives to focus on near-term results often at the expense of maximizing the long-term economic value of the enterprise.

This brings me to my second suggestion for improving business practices: Directors should forbid earnings management and make it an impeachable offense. Further, the board should insist that the chief executive communicate this policy of straight-forward accounting and sole focus on building the maximum long-term value of the business to all of the company's constituencies.

The notion that a company can steam ahead through all kinds of economic weather steadily ratcheting up its income X% every three months flies in the face of experience and makes no common sense. More importantly, not only does earnings management lock a company's focus on the near-term, it significantly increases the risk that managers will engage in false, misleading, and even fraudulent accounting and reporting.

Boards should act promptly, while the trumpets for corporate reform are loud and clear. Not since the 1930s has there been a period of greater skepticism about the validity of corporate financial reporting. That very distrust is the music of change. This is an ideal time for directors to act.

Boards will surely hear a chorus of resistance to ending earnings guidance and earnings management, but the loudest among the nay-sayers will be voicing a misperception. There is a widespread feeling that companies that show steady, rapid earnings growth win higher valuations for their stock. A moment's reflection will no doubt bring examples to mind. But I can think of a plethora of outstanding companies that report earnings honestly and that have been and are accorded premium multiples despite reporting erratic, but strongly growing earnings. We happen to own a number of these companies. In the current environment of skepticism, it is highly probable that this type of company will be awarded the higher multiple by investors precisely because the uneven pattern of profit growth is more credible. Credible because it more accurately reflects the way our common sense tells us the world works.

Already, the practice of managing outcomes has spread into critical areas of society such as health care and higher education. There is no question, for example, that a number of surgeons and hospitals reject patients who need surgery but are poor candidates for success because failure would affect the hospitals' ratings and marketing efforts. Nor is there a shortage of universities that tinker with the application process and manipulate admissions and acceptance data as if the school's ratings in *US News & World Report* were the academic equivalent of quarterly earnings per share.

So, there is really no reason why we should be surprised to read two stories in a single edition of the *Wall Street Journal,* the paper devoted to profit-making businesses. One story told how a public utility was "tired of the natural-gas market's increasing volatility, which … can turn off analysts and investors keen on steady earnings." The utility will, the story goes, propose to state regulators that it be allowed to raise customers' bills during the warm weather and cut them during cold, a process the company refers to as "weather normalization."

Another article in that same issue reported how a well-regarded company with a long and reputable history reported a restructuring charge in the first quarter that just so happened to be exactly offset by the income from a court settlement. Such serendipity is rampant. Shortly after we established a small position in a company, its management reported earnings that included charges for three non-recurring items, which in aggregate amounted to the same sum as an extraordinary gain from a tax credit. Needless to say, this position will remain small or be eliminated.

Despite the games that companies play with earnings and regardless of whatever changes, if any, come about in the practices of the board room, what will not be eliminated or lessened in the slightest degree is our dedication to thorough research and analysis and investing for the long-term. When I look at the universe of companies that our research is dedicated to finding I do not expect to see orderly increases in earnings per share quarter after quarter or a consistent system of corporate governance. What I do expect to see are companies that have demonstrated sustainable competitive advantages and sell for reasonable prices given the companies' growth prospects, companies that are run by managers of extraordinary capability and integrity. And I firmly believe that we have constructed a portfolio of such companies run by such managers.

This concludes my formal remarks, and I'll turn the microphone over to Bill.

Bill Ruane:

Thank you, Bob. I would like to make a few comments. Not only is this the 35th year of the Sequoia Fund, but it also represents the seventh year that Bob Goldfarb took over as Chief Executive and Co-Manager of the Fund. Well, Ruane, Cunniff & Goldfarb are still sitting up here as we were seven years ago. I believe that Bob has enormously enhanced the strength and depth of our organization during that time, while sticking to the fundamental values of our approach of investing in fine companies that will enhance your capital over the long term.

On a sad note, I regret to tell you that our partner, Carley Cunniff, passed away a few months ago after a long battle with cancer. Her wonderful qualities endeared her to many of us in this room. She was a real pro and played a special role as a mentor to many of the key workers on our present team.

Before I turn things back over to Bob, I'd like to mention that I was out at the Berkshire annual meeting, at which time Warren Buffett suggested to the people in the audience that they buy a book that was available among the many other products — You could have bought a couple of trainloads of paint, some cowboy boots, See's Candy. But there was a book that he recommended: It is called *Poor Charlie's Almanack*. It's a wonderful, wonderful book, which will not be available in bookstores. It's a compilation of many of Charlie Munger's thoughts on investing and on life. And in many ways, it's also a tale of the investment thinking of both Warren and Charlie, and the history of their relationship. I heartily recommend it. And if you are interested in buying it, you might want to make a note of this: You can go on to www.poorcharliesalmanack.com. The cost of the book is $49. If you want it signed by Charlie, it's $99 — I don't know how he figured out his signature was worth $50. In any event, it is not a commercial book. All of the profits will be going to the Munger Research Center at the Huntington Library. It weighs about five pounds; so it's not something to tuck under your arm to read on the bus. However, I promise that if you read through it you will not only have a lot of fun, but you will come away with so many marvelous thoughts on investing from both Warren and Charlie.

Going beyond that, one of the characteristics of the firm that Bob has continued to enhance enormously reminds me of a phrase that caught my eye about ten years ago when we were looking at all the banks. I came across Fifth Third's annual report, and it said that they only work half a day, from seven a.m. to seven p.m. And that actually was true. It was one of our major holdings and it had a very special culture. And it was very good to us over the years.

We don't have that exact same culture. We certainly do not have a time clock to punch at Ruane, Cunniff & Goldfarb, but the amount of research that our professionals produce has an enormous amount of depth and hard work put into it. Some of the fellows are in there very early in the morning, like Bob, and do that seven to seven, or six to eight, more than half-a-day.

And I want to just make a note of one of our very, very special members of the team, who really has proven a great investor and is one of the nicest people I know. He's sitting two spots away from me — Greg Alexander. There's a true story that goes around about Greg. Before I met him, I heard that Greg had read annual reports all the way through Yale. But he was able to handle the other subjects on the side. We were fortunate to receive a letter from him many years ago. Greg, how long is it now?

Greg Alexander:

More than 20 years.

Bill Ruane:

An unspecified number more than 20. He wrote me a letter, and he said, "I'd like to come to work as a summer intern. And I know that if you meet me, you'll hire me." And he was absolutely right. He worked that summer, and then we asked him to join us permanently after that. And I can't tell you how happy I am that we did.

But I just want to give you this one illustration. When Greg's wife, Chiu, who's very lovely, was in labor at the hospital with their last child, of course Greg was there. At one point it became clear that it was time to head for the delivery room. So they went in, but Greg was on the phone ordering more annual reports. So this may be an extreme example of how diligent we are, but I know it will pay off for all of us long term. Greg, thank you very much for being here.

Bob Goldfarb:

Bill once remarked that you'll never have to work another day in your life if you like what you're doing. And I'd add to that, especially if you like all the people you're working with. So I guess I didn't put in a single day's work in the last year, because I'm introducing the same team as I did a year ago, with one additional member.

To my right, I think you've already been introduced to Joe Quinones and Greg Alexander. To my left are, of course, Bill Ruane, Rick Cunniff, Jonathan Brandt and David Poppe. In the audience are Girish Bhakoo, Arman Gokgol-Kline, Jonathan Gross, who's the new kid in town, John Harris, Jake Hennemuth, Terence Paré, whom I want to thank for helping me with today's speech, and Greg Steinmetz. Would you all stand up? Thank you. With that, I think we're ready for your questions.

Question:

As Berkshire is by far the largest holding in the Fund, my question is about it, and I apologize if it's a little long. My basic concern seems obvious: Are you concerned about Berkshire's inability to find suitable investments and as a result carrying ever larger sums of money on the balance sheet at minimal cash returns?

And there are really two different aspects to the question. I believe Berkshire's net worth has grown about 8% per year for the last five years, which is okay. It's certainly not stellar and doesn't compare remotely to the prior 30 years. But the question is this: Are you concerned about Berkshire's recent $20 billion bet against the U.S. dollar? I recall a very interesting commentary by Bill Miller recently in which he noted that structural economic problems have curious and unpredictable ways of resolving themselves, the implication being, I think, that a collapse of the dollar is now not necessarily the result of what will happen with the U.S. trade deficit.

And the second question really relates to Buffett's inability to find stocks to buy. I think I mentioned last year when I asked this question that he hasn't made a really sizeable investment for 11 years, which is a long time.

He seems to be waiting, from his commentary, for a major market collapse of some sort, which may, of course, occur and may not occur. In the meantime, I note that other major value funds such as Oakmark, Longleaf, Clipper and Legg Mason Value Trust, for example, a few years ago made very sizeable commitments to companies such as Comcast, McDonald's, Walt Disney, American Express, Vivendi Universal and Tyco — very major companies, which at the time were, or at least hindsight suggests, extremely cheap. I think that the group of six has doubled in the last three years, a compound return of 27% per annum.

Now I understand from Buffett's point of view that these may not be 10 or 20 year investments, which is his ideal, but at the same time, they were extremely undervalued securities, and substantial money was made by very successful value funds. It's almost as if Buffett has sort of cornered himself by developing an investment philosophy that will not allow him to buy a stock that he doesn't intend to hold for 10 or 20 years. And these other funds probably will not hold those investments for 10 or 20 years. But doubling your money in three years is something that anyone can be proud of.

Bob Goldfarb:

I'll just start with a brief response to your last point, and I'll turn the microphone over to Bill and Jon Brandt. Buffett has bought and sold some publicly traded stocks within a relatively short period of time. HCA comes to mind as one that he bought, and I think sold fairly recently. Jon, aren't there others?

Jon Brandt:

The leasing company in Chicago, GATX. He bought 15% of the company and subsequently sold it all. There are other ones. He bought and subsequently sold some of his H&R Block. He sold most of his Costco. He still owns a little, but he's in and out of some things.

Bob Goldfarb:

Yes, those are all examples of investments he made, which he didn't hold for a very long period of time. He also made big bets during the period that you're referring to on a number of junk bonds when distressed debt had yields to maturity in the twenties and thirties. And he made a lot of money on those. He acknowledged recently, although I don't think this was his exact analogy, that he probably should have used a shotgun rather than a rifle. That would have enabled him to put even more money to work than he did in distressed debt.

In addition, his activities in fixed income arbitrage, which we discussed last year, were relatively short-term. Given those examples in both common stocks and debt, I wouldn't agree with your conclusion that he's only interested in instruments that he can buy and hold for 20 years.

Bill Ruane:

Well, I might generalize about a number of the comments you made. Your remark that he hadn't really made any big investments in 11 years, that's true, I think, in terms of buying a part of a company. But he certainly made a huge investment in General Re in 1998. And in a period such as we've been in since the end of the tech bubble, he hasn't bought any very large chunks of equities. But I think if you saw the list of Berkshire's equity holdings, you'd be surprised at the number. Some of them were purchased by Geico, which Lou Simpson manages. That's about $2.5 billion. Lou is often buying stocks.

As to my concern about the $43 billion or $44 billion dollars he has in cash, I have none. I'm delighted that it is in the hands of somebody who has such marvelous patience. I think this current period is one where there really are very few significant bargains around. Three of the companies you've mentioned — Disney, American Express, and McDonalds — actually are stocks that we have owned over a period of time.

Bob Goldfarb:

And Warren owned those three. He has no Tyco common, but he has owned Disney, McDonalds and American Express. He's the largest shareholder of American Express.

Bill Ruane:

You know, I don't think you have to make an investment. That's one of the problems that we have today in the investment field. People think they have to be doing something when the prudent thing might be to not do anything. And there are times when things are ridiculously high, and there are times when things are ridiculously low. And there are times when you have distortions in particular industries. At this particular time, I find in most areas where you can invest a lot of money, the prices simply are unlikely to reward you in a significant way, whether it's real estate or the bond market or stocks. And Warren has stated that over the next 15 years, and I think it will probably turn out to be less than that, he'll probably have an opportunity to put that money to work at some fairly nice returns. But you just never know when the opportunities will develop.

I think about my ownership and your ownership of Berkshire Hathaway as having a reserve available, managed by the greatest investor of all time, of having $40 billion ready to go when there are some real bargains around. And I'm quite sure he can do things that we don't try to do. During the period we're talking about, as Bob mentioned, he loaded up on junk bonds in a major way. He put about $7 billion or $8 billion to work and he wished he had gone ahead and bought another $7 billion or $8 billion. They were yielding 30%, and he sold them when they were probably yielding about 6% or 7% a couple of years later. And he made billions. You know, that would get a lot of attention if it was a stock trade.

Another major action was in fixed income arbitrage. This got very little attention, but he made a couple of billion dollars on it. It was a fairly low risk investment, but not one that we are knowledgeable enough to handle. Now everybody is aware of the possibility of the depreciating dollar. But he saw that two and a half years ago, and, again, it led to a couple of billion dollars in gain while he has been gathering a war chest for a different climate.

He would put it all to work tomorrow if he could find something that he thought really had all the qualities that he looks for, whether it's a privately owned company, a publicly owned company, or some combination of both. But I'll tell you, I admire his patience. He has a $105 billion portfolio now. Some $39 billion are in stocks that he's held for quite a while; $44 billion is in cash; and $22 billion is in bonds.

I think one of the interesting things about evaluating Berkshire is just considering that you've got the smartest investor of all time, as far as I know — Keynes or somebody might give me an argument on that — but you have Warren carrying a portfolio of $105 billion that yields less than 3% after taxes. And here's a person who historically has averaged a total return of about 21% after taxes. When we tell you Sequoia's total return is 16%, that's before taxes. Warren will not make a 21% return in the future. But if you ask me, is he capable and healthy enough, etcetera, to make a return of 10% or 12% over the next ten years — and I think the insurance tables might lead you to think that he could live that long — well, I am making a bet that he will. And then you take the difference between the 3% and the 10%, and you come up with a fairly large number that is potential earning power just sitting there waiting for the right opportunity.

It's not calling the market. It's just waiting for something that hits you in the gut. We've owned many hundreds of stocks over the life of Sequoia, but we made most of our money in a couple dozen securities that we bought at the right price and stayed with. Today I think it's fair to say that we see very little that we really want to pound the table on. I'm only speaking personally, but I think that Bob feels pretty much the same way. Warren made a comment that he was buying something recently and that it was a sensible thing to do. But he also said that he was relatively indifferent to whether he bought it or not.

Let's go back to the late seventies. Gillette was selling at eight times earnings with a wonderful growth rate, an absolutely great brand, and 75% of the razor and blade market. If they simply just held their earning power at that level, you'd get the inverse, a 12% return. Now that's simplistic. And, of course, the return over the next 10 or 12 years was enormous. So there's nothing like patience. I don't have that much patience, but I think we've got some, and I'm a big fan of that $44 billion dollars. Bob, do you have any thoughts?

Bob Goldfarb:

Yes. Jon Brandt correct me if I'm wrong, but I think it was in the 2003 Annual Report that Warren Buffett acknowledged that, while his managers had done an outstanding job of running the businesses, he had not done a comparable job in investing the capital. So to some extent he acknowledges your concern and your criticism.

Secondly, I think it was a real sea change that two weeks ago in Omaha at the annual meeting, for the first time he said that if in a couple of years he found that he couldn't put much of the cash to work, he would consider paying a dividend. So I thought that was a very marked change in his posture toward the cash.

Jon Brandt:

I just want to add a couple of thoughts, acknowledging your point in general, and maybe giving you some facts on the specifics. I think most of the stocks you talked about that the other funds were buying were purchased probably in the 2002 era. Bill and Bob already mentioned that Buffett did buy $8 billion in junk bonds. One of those buys was of Tyco bonds. Some of the other firms you mentioned bought Tyco stock. Buffett bought nearly a billion dollars' worth of Tyco bonds. And he also bought them in Euros. So he got a double dip in dollars from the appreciation of the bonds and from the appreciation of the currency.

I don't have the Berkshire annual in front of me, but I'll give my best guess of other investments he made in 2002 that were neither currency nor arbitrage. In the apparel industry, he bought Garan and Fruit of the Loom for about $1 billion. Those two companies together are now earning almost $300 million pre-tax. When he buys entire businesses, they don't get marked to market; so you don't see unrealized appreciation as you would in a mutual fund. There's no privately quoted market value for Fruit of the Loom and Garan. He bought two pipelines in the summer of '02. Depending on whether you include the debt or not in the purchase price, he paid something between $1.4 billion and $2.4 billion. He bought the Pampered Chef for something over $1 billion. I can't remember whether Buffett bought the $300 million White Mountain convertible preferred in '01 or '02. The value of that security, which has been converted to common, has tripled. He bought the outstanding minority interest in Shaw in January of '02. Again, that's not marked to market, but Mohawk, which we own, is up 60% from that time. Then he bought the poster-framing company, Albecca. If you add all those purchases up, you've got $4 billion, $4.5 billion. Then you have the $8 billion in junk bonds. He didn't even have the $40 billion plus portfolio of cash back then, but he did put over $12 billion to work in approximately one calendar year.

It would have been nice if he had put $30 billion to work, but he's a by-the-piece kind of guy. And that's worked for him for a long time. I think it's in his nature to buy things one at a time and totally analyze them. But I think he's starting to adjust to the fact that he can't do things one at a time any more. I saw some notes of someone who was at the Wesco annual meeting. They were brief notes, but they seemed to suggest that Warren and Charlie are reducing their hurdle rate. Warren's been saying for the last couple of years that he doesn't want to put money to work at anything less than 12% or 13% pre-tax. But I think it's going to be hard for him to make that much on the Anheuser-Busch purchase. It's not a bad buy. But I think that's perhaps an indication, as well as what Bob said about maybe returning money to shareholders. So they're going to lower their hurdle rate a little bit. I don't think he's going to put all $40 billion to work at only a 9% pre-tax return, but we've had an environment that's just the enemy of the Buffett-style investor.

We've had really, really low interest rates and pretty uniformly highly priced assets, as opposed to these little pockets of distress, where he's been able to do something. And interestingly, he could be wrong about the currencies, but so far, he's made a couple of billion dollars on it, and, he says it's a long-term bet. It's a five year or ten year thing. But so far, it's working out. Greg might have something to say about that.

Greg Alexander:

I have just a few very quick comments. First of all, Warren often says that he has $40 billion of cash, but I don't personally think of it as cash to quite the same extent as you might if you have a $100 balance in your brokerage account and no debt, but $40 of it is sitting in cash. The reason is that almost all of the $40 billion is from the float on his insurance businesses. And so I think the urgency of deploying every penny of that is less. If that were all deployed, he would, to my way of thinking, be more than 100% invested — and perhaps safely so, because he has so much equity. But I wouldn't quite think of it as entirely $40 billion of excess cash.

Secondly, he really has five options. I mean, he has gotten so big. One option is to find some huge new holdings. And I'm talking really big, $5 billion, $10 billion at a time, and maybe several of those. Another option is a huge addition to those few of his holdings that he might want to make really huge additions to. Would it make sense to buy a huge portfolio of 20 different $1 billion positions, many of which he might end up selling in a few years? He is in the corporate form, so he would pay taxes on the gains. And then we might someday in our estates etc. It's sort of double taxation. I think that's one reason he's oriented towards long-term investments.

And then lastly, I would just state that I think it's fairly obvious that in the recent decade or so that Warren has a preference for owning entire companies and controlling their future capital allocation. And so, if the environment ever did change, one or two $10 billion acquisitions — if a bunch of hedge funds don't take the companies over first — might put it to work pretty quickly. And then the last option, of course, is to return capital at some point. I think that is pretty much the universe of opportunities.

On currency, I don't have any profound thoughts, but to my mind the current account deficit — if it is in fact correctly reported — is a near to insoluble problem. I think there's some doubt in my mind whether it's really quite as big as people say, because the United States is the preeminent service economy and maybe it is hard to measure exports of services. That said, if the numbers are anywhere near correct, I just don't know how they're going to be fixed. I mean, whatever we still buy from Europe — Italian shoes, French handbags, wine — most of the people who are buying those things with today's higher currency valuations, they just want them and they're not a major part of their life spending. And I really don't know that those habits are going to change, irrespective of where the currency goes.

Then you have all the countries where the wage rates are very low. So let's say the Chinese yuan goes up by 25%, and people who are currently making a $1 an hour make a $1.25 an hour. Is that going to suddenly bring industry back to the United States because it compares less favorably to our wages here? To me, it doesn't seem likely. The oil price has doubled in dollars, although it hasn't actually gone up nearly as much in Euros. Are we importing any less oil? We're just spending more money on oil. So I don't see how the problem solves itself. There you are.

Bob Goldfarb:

I'll just add one final comment. Warren remarked recently how quickly a glut of cash, which has really driven up the prices of almost every category of assets, can disappear within a very short period of time when circumstances and psychology change.

Question:

My question has to do with the investment in Fifth Third. I enjoyed reading the post-mortem comments that you made on it. And certainly a 17% return over time is nothing to be embarrassed about. But I'm wondering when you look at what I think you labeled a mistake in not selling earlier, do you think that you fell in love with the stock and that you may have lost some objectivity and ignored some early warning signals that otherwise might have caused you to sell earlier?

Bob Goldfarb:

I might start by saying that it's not always clear at the time whether you're seeing a temporary stumble or a sea change in a business. We clearly saw a number of stumbles. And we probably should have done a better job of connecting the dots, if you will, which would have led to the conclusion that it was more likely an inflection point as opposed to a temporary stumble.

Jon Brandt:

I'd agree with you, Bob. I think one of the issues was they were earning a lot less than they would have been earning in a higher interest rate environment. A lot of things were bothering us, but we kept asking ourselves how long can this period of extraordinarily low interest rates, which are depressing net interest income and earnings, persist? But as each little problem became evident, the market always seemed to adjust. And certainly I take the blame for not connecting the dots. A sequence of things that were not optimal were going on there, but the price always seemed to discount it. We liked the people, and while there were things that bothered us, the market was always kind of keeping pace with the disappointments. But certainly, I think we could plead somewhat guilty to the charge of falling in love with the culture.

We saw little things that we really didn't like such as what they did in early January of '04. They were trying to protect their earnings stream by entering into derivative contracts to protect their net interest income, even if rates went down further. It always bothered us a little bit that they were trying to keep a smoother progression in their earnings. But when that became public, the stock went down a couple of points. There were just a lot of things like that.

They had some problems with one of their subsidiaries. I met the man who ran it several times. And it turned out the fellow was a good manager except when things went bad. I'd like to think that I'm a good judge of people, but it's hard to tell how someone you don't know well will deal with stress. The CEO and the other people leading the company thought he was a good choice. And he turned out not to be a good choice. They made a mistake, and I made a mistake.

George Schaefer still probably has one of the most terrific records as a bank CEO in the country. But you know, there's that book, *Good to Great*. Fifth Third has probably gone from great to good. We were close to it. And we saw some erosion, but definitely made a mistake in not seeing it more clearly before the market, which is what you guys pay us to do.

Bob Goldfarb:

To go back to the phrase I used in my talk earlier, we should have smelled smoke and realized that when we were smelling smoke we were detecting a fire.

Question:

Can you comment on Tiffany as it relates to the weakness in Japan, and perhaps having an opportunity to add to your position? And which is worse, the currency risk now or the equity risk?

David Poppe:

Tiffany's weakness in Japan in some ways is less of a concern than the overall carelessness with capital that they've displayed over the last three or four years. I think Japan is a problem. I don't think they have a solution for making it better. But I think there are other opportunities around the world for them to grow and be a healthy business.

But what I worry about is the fact that in 2000, Tiffany earned a 23% return on equity. Last year it earned about 12% on equity. Sales throughout that period have basically been quite good, despite September 11th and the recession that we went through. It remains one of the great aspirational brands. They have plenty of growth opportunity. You saw this morning in the earnings report that the U.S. comp is 11%, which is terrific. It's partly inflated by the fact that it's very cheap for Europeans to come here and shop right now. Japan remains weak. But I think Japan is not a killer given that they have opportunities to grow in other places.

What everybody should be focused on is whether or not they have the self-discipline to reign in the spending if they are not getting the returns. So I would want to see results in that area before adding to the position.

Bob Goldfarb:

The board did finally acknowledge the problem that David is speaking of by making return on assets one of the factors that will determine the compensation of Tiffany's CEO, Mike Kowalski. So, again, it is another example of what I was talking about in my speech. Could the directors have done a better job? Could they have voted down some of the proposals for investing significant capital that didn't turn out to produce much of a return? But they are seeing some fire, which they hope to extinguish by trying to improve the return on assets.

Question:

Bill Miller has characterized the debate on the trade deficit as overly simplistic. One of your holdings is Wal-Mart, which alone drives a not insignificant part of the deficit. And the reason that is happening is that the free markets are working the way that they are supposed to. It seems to me that a lot of the deficit is being driven by things which are fundamentally economic forces working the way they are supposed to. So I would like you to respond to that. Are people missing something? Is it overly simplistic? Another question is about improving corporate governance. One idea is to make sure that directors are qualified to serve as advisors to CEOs. Do you think that people who serve on boards of directors should be required to have some kind of training or actually pass an exam?

Bob Goldfarb:

In response to the second question, I would say that when I was thinking about this subject as I prepared today's speech, Jon Brandt suggested that each director might hire an assistant who would do the same kind of research that we try to do before we buy the stock in a company. And that assistant might continue to work with that director on an on-going basis. So that is one suggestion.

In response to your first question on free trade, Wal-Mart's share of the trade deficit is often exaggerated. I personally happen to be in your camp of being a free trader. And I do believe in comparative advantage, that the world is better off buying from whatever source has the lowest cost of production. I think clearly we are pretty far along in the transition from being a manufacturing-based economy to becoming a knowledge- based economy. What you do with unfair trade is another issue. Warren Buffet with his proposal addressing the trade deficit has come down for managed trade. If you wanted to import goods, you would have to buy the right to do so from an exporter. It's a very simple rule that would eliminate the trade deficit automatically. It's not one that I'm necessarily in favor of, but I don't think anybody can ignore a recommendation that comes from such a thoughtful and knowledgeable source. Does anyone else have feelings about either the trade deficit or how boards can improve?

David Poppe:

On Wal-Mart specifically, I think what I would say is, they're an easy target to criticize, but the American consumer has shown for 40 years that he has no interest in "Buy American," has zero interest in paying more; we drive Japanese cars and we eat Mexican produce and buy Airbus airplanes. Wal-Mart is doing basically what the market demands it do, which is provide the lowest price to the consumer for the best quality of merchandise they can get. They're easy to demonize because of their size. But I think if you looked at it, probably Target sources a higher percentage of its total sales overseas than Wal-Mart does. But because Target is smaller, it's harder to demonize. Wal-Mart has some other issues that also make it easy fodder for *The New York Times*. But at bottom, it's a consumer's decision, and people go to Wal-Mart because the prices are lower, and if the prices were higher, they would stop going. And so, they're sort of doing what they want to do. I don't think there's any political reason for what they're doing, and I don't think there's necessarily an easy political fix either. The consumer speaks.

Question:

How to you calculate the intrinsic value of Walgreen?

Bob Goldfarb:

We would calculate the intrinsic value of Walgreen the same way we would calculate the intrinsic value of every other company whose stock we look at, which would be the stream of all free cash flows until kingdom come discounted back at an interest rate. There's nothing about Walgreen, to my mind, that would cause us to apply a different standard of measurement from that of any other company. David follows Walgreen.

David Poppe:

Implicit in that comment is that you have much further to go before you get to terminal value with Walgreen than you have for almost any other business that we follow. And we're either right about that or we're wrong about that. But we think the runway, if you will, is extremely long. The population is getting older, filling more prescriptions every year. Walgreen, we believe, is the low-cost filler of prescriptions — certainly in retail by far the low-cost producer, and I think, overall, compared to any other source, mail order, or anything you want to look at, has a very low cost to fill.

Also, layered over that, Walgreen is an extremely good retailer. And that also generates traffic, generates loyalty, and generates business for the pharmacy side of the store. You know, they talk about their plans for 7,000 stores in 2010, and 10,000 stores ultimately. At this point, there's no reason to believe that those aren't very realistic numbers. Their market share is about 14% right now. Retail pharmacy is filled with inefficient and poor competitors.

The opportunity to take market share and go from 14% to some much higher number is there. They're fortunate. They have some very good competitors — excellent competitors — but there are still 20,000 independent pharmacies in this country. So, why do we own Walgreen at this very high multiple? It's because we believe that the growth rate is not just for the next four or five or six years, but they could grow at a pretty rapid clip for a much longer time. Certainly there's some risk there because over ten or twelve or fifteen years, all sorts of crazy, unexpected things could happen. But implicit in our ownership is the fact that we think there's a good and a very long-term growth rate for them.

Bob Goldfarb:

In at least the previous couple of annual meetings, I've given you an update on the higher multiple stocks that we've bought — and those would include Walgreen, Expeditors, Fastenal, Patterson, which is a small position, unfortunately — and I'll just repeat what I said last year, which is — so far, so good. We realize we are paying a high price. So we need a lot of years of rapid earnings growth to prove that our investment has been a good one. And when we gather a year from now, I'll be glad to give you a further progress report on that same issue.

Question:

Looking back over the past 35 years, could you tell us about a couple of mistakes that you made as a team and what we can learn from them?

Bill Ruane:

At this meeting a couple of years ago, we calculated the ratio of the number of stocks on which we realized gains to the number of stocks on which we realized losses. And the ratio was something like 80:1. One of the things we try very hard to do is to buy a stock only when the company is right, the price is right, and we have real conviction about it. And the nice thing about not doing a lot of things, but having a real conviction when you do is that when it goes down, you can add to it and ultimately make money. We've certainly made mistakes, but using the standards we've had over the years, we've been fortunate to avoid any major ones.

Bob Goldfarb:

Yes, I would say that if you extend the question to a broader universe, whether you want to go back to Pearl Harbor or 9/11, when mistakes are made, it's usually not something that's terribly complex in retrospect. It's usually some kind of simple human error such as our failure to connect the dots with regard to Fifth Third. I think that's a broader view than perhaps what you're searching for, but the answer I'd give is to look at the mistakes that have been made in all areas of human endeavor and see if you can find some common threads.

Bill Ruane:

Again, I go back to Warren Buffet, as I do so often. He has two rules of investment: Rule #1, Don't lose money. Rule #2, Don't forget Rule #1. We try hard not to forget those two rules.

Bob Goldfarb:

I would add that while we have been pretty good at avoiding mistakes of commission, we have made significant errors of omission. I think that if I had to point to one big mistake we made, it was putting undue emphasis on possible macro economic problems and overreacting to some that seemed overwhelming at the time but were dealt with reasonably well. {Editor's note: An even greater opportunity cost was incurred by our shareholders during much of the 1980s as RC&G kept large cash positions — as much as 61% of the Fund's assets — waiting for a return of the "golden era" of the late 1970s when a plethora of outstanding companies would again be selling for single digit multiples.}

Another thing I'd add is that it's extremely important in my mind to be and stay humble. There may be a clerk working in a drugstore somewhere who has knowledge about Walgreen which is superior to that of most of the directors of Walgreen, going back to my speech. There could be a clerk in a Walgreen store, or a Wal-Mart store, for that matter, who knows more than most of the directors, as well as the investors. So that leads me to two conclusions: One is stay humble, and the other is something we've referred to in the past — abide by Phil Fisher's scuttlebutt theory. Do an intense job of research and talk to as many people as you can who are likely to have knowledge that's of value in analyzing the situation. Don't just do a top-down "the numbers have been great" extrapolation.

Question:

I'd be curious as to your thoughts on the competitive advantage of Ethan Allen — what those are today, and have they eroded, or has the business been changed by the importation from furniture from Asia?

David Poppe:

I think that the competitive advantage has eroded more than we probably expected. But they're still performing well versus their peer group. It's a very, very difficult industry. I think a good comparable for Ethan Allen is actually Berkshire Hathaway's furniture group because they're strong retailers run by pretty good entrepreneurs. And if you read the 10-Q that came out the other day, the retail furniture comp was probably somewhere in the minus four, minus five range. Ethan Allen's comps in the recent quarter were right around that level, and they've probably been — not necessarily better than Buffett's group — but better than the peer group throughout the last four or five years.

But deflation has been much more harmful than I think we realized it would be, or anticipated. I think Ethan Allen continues to be a very well-run company. They're doing better than virtually everyone else in their group. You could argue that at times they can be penny-wise and pound-foolish and not do everything that they could possibly do to strengthen the brand and the brand image, primarily in terms of things like advertising and just being consistently in front of consumers with the brand name. But by and large, I think Ethan Allen's a case where the industry just got extremely difficult extremely fast. And, as Bob said, sometimes things come at you and surprise you. Unfortunately, I've got to say that happened to me a little bit. It happened a little bit faster and was a little bit more intense than I anticipated. I think going forward, I don't know: can everyone have negative comps forever? Can the Chinese continue to make cheaper and cheaper furniture when the price of energy and the price of freight and the price of wood continue to go up? Labor is not a huge component in the cost of furniture; so whether one of the guys makes a buck or a buck twenty-five is not the driver. I think the freight to get it back and forth is more than the labor. But right now the Chinese have made a decision that this is an industry that employs a lot of people, and they want to be really large. And so deflation continues. At some point, perhaps it stops, and the industry will get better. I think Ethan Allen is well-positioned if things get better. But I don't have a good handle on when that might happen.

Bob Goldfarb:

I would just add this in response to the two previous questions, one on free trade and the other on sources of mistakes. In my own experience Adam Smith's "Supply & Demand" explains a lot. If you just think about supply and demand, and you're constantly making estimates of both, that's going to be predictive of the success or failure of a lot of industries and companies. And we were clearly aware of the increase in manufacturing from China. I remember — I don't know how many years ago it was — I talked about "The China Syndrome." Farooq Kathwari, who's the Chairman and CEO of Ethan, has also been open about discussing the threat from China. But we should have listened to ourselves a little more closely, and taken Farooq's words a little more to heart than we did and realized that there was a sea change, and that this was a business whose fundamentals were deteriorating very dramatically in a relatively short period of time. And, again, if you detect smoke, you should probably leave the room.

David Poppe:

Right. I would say in that regard, Ethan still makes a lot of its product in the U.S., and still makes excellent margins on that U.S. product, even having to price it and compete against Chinese-made goods. So you know that labor's not a huge component of the cost basis of the product. I think what we missed was that Chinese-made product wouldn't be cheaper because the labor was so much less. It would be cheaper because they wanted the market share, and they wanted to control this market. We just didn't foresee the deflation being so extreme because the labor component of the product was not that extreme. But if you have a competitor who doesn't need to make a return on capital for some period of years, that can make your life pretty difficult, and that's what happened.

Bob Goldfarb:

David, do you have any idea of what percentage of furniture sold in the United States was made in China, say, five years ago versus today?

David Poppe:

It has grown tremendously over the last five years. Wood furniture — it's probably over 50%. Upholstery — a lot of it's still made here, but that's moving overseas too.

Bob Goldfarb:

Now, when you see that kind of a change in that short a period of time, that's far more than enough to alter the fundamentals of any industry significantly.

Question:

I would like to ask about three companies. The first one is GTech, the second one Danaher, and the third one is AutoZone. It's my understanding that GTech lost a couple of contracts to a Greek company. With Danaher, how long do you think their wonderful corporate culture and their wonderful business model of buying industrial market leaders and greatly increasing their profitability can continue? Finally, you bought and sold AutoZone rather quickly. What made you do so?

David Poppe:

GTech has an enormously dominant position in the lottery business, both in the U.S. and worldwide. I think they control about 70% of lottery contracts worldwide and a similar number in the U.S. Intralot is a Greek company. The only business they have in the US that I'm aware of offhand is Nebraska. Is that what you're taking about? Intralot won the Nebraska contract about a year ago, but honestly, it's almost an inconsequential contract in size. Intralot wanted to be in the U.S. market, and they bid it to lose a large amount of money over seven or eight years. GTech was willing to walk away from Nebraska.

What I would say about GTech is I'm not sure they can be underbid if they want a contract. They are the low-cost provider of lottery services to states. If they want the contract, they can bid the lowest. Scientific Games is a very good competitor and a very good company, but not as large as GTech and not as efficient as GTech. And you could argue about which one is better, which one runs a better lottery, which one does more for the state. But, you know, state contracts tend to be low-bid-oriented. And if you're the low bidder, and you're the most efficient player, you're going to win your share over time. I would say — Bob mentioned Bruce Turner in his speech — we have a good degree of confidence in Bruce and his team, and their ethics and standards going forward. And if you have confidence in that, boy, it's a very, very powerful market position that they have. I will turn it over to Terence on Danaher.

Terence Paré:

On Danaher, we've been asked this question before. Basically, Danaher is an industrial conglomerate in some very slow-growth businesses. And it expands by virtue of acquisition. They take their excess capital and go out and buy other companies and apply the Danaher Business System, which, essentially, de-capitalizes these manufacturing concerns and increases the amount of free cash they throw off.

I wish we owned more of it because each year, somebody asks this question, or a variation of it. But it's hard to get comfortable with a business that always seems to be selling at a relatively high multiple versus other manufacturing companies, and that has to go out into the marketplace and buy companies to get any kind of excess return. It's very risky, and it gets riskier the bigger the company gets. It gets more and more difficult to find acquisitions that are of size that they can apply the Danaher Business System to. It's not unlike the difficulties that Warren Buffett faces at Berkshire Hathaway. He has excess cash, and he's supposed to go out and buy stocks or buy companies. He has the advantage in that he generally leaves those companies alone. He will pay a lower price than Danaher will because he's not figuring to do anything dramatic to the business. He buys Shaw Industries and leaves it alone. He buys Flight Safety and basically leaves it alone because the returns that it will generate over time are just fine. Danaher can't do that. They have to pay up, and they've got to effect a transformation of the businesses they get into.

They've been very good at it; I've seen no diminution in the strength of the culture. It's just inherently a more risky way to go about running your business. And so, it's difficult to get comfortable with a larger position. If it got really, really cheap for some reason, maybe we could own more of it. But at this price, given their business model, as much as we admire their track record and as much as we admire their culture, it's hard to buy more, and there you are. John?

John Harris:

AutoZone, for those who don't know, is the leading retailer of auto parts and accessories for people who fix their cars themselves. We looked at it for a long time last year, and I think it's probably a good example of a challenge that we have faced, and will always face, which is that when we see what looks like a good price, which, as a few people have said earlier, is increasingly rare in today's environment, the question is, when in our research process do we act? Our preference is always to do all of our research first, and then make a decision with complete information.

Unfortunately, good prices don't last forever, and so, we probably hurried on — well, we didn't "probably" hurry — we did hurry on AutoZone. We bought the stock before we had finished our research, and that was partially my fault. We learned as we proceeded with our research that the company has a number of advantages and earns an extraordinary return on capital for a retail business, and the price at the time we bought it — I think we probably paid about ten times earnings for our holdings — was incredibly attractive for a business with those characteristics. But as we did more research, we learned two things that concerned us. The first was that they had clearly benefited from weak competition during the late '90s and the early part of this decade.

And that situation was changing, and it continues to change today. And it was clear to us that they weren't making investments in the business necessary to deal with the increased competitive threat. And, as a result, it was uncertain to us that they'd be able to earn the same returns on their capital in the future as they had in the past.

The other thing that concerned us was that as we did more research, we found that our view of reality differed somewhat from management's. From different perspectives reasonable people will often see the same thing in different ways, and I think we just felt that, as a result of those two things, we weren't really comfortable owning the business for five or ten years. And I think our general rule of thumb is that if we're not comfortable owning it for a long, long time, then we're not comfortable owning it for a very, very short period of time. And so we sold.

Bob Goldfarb:

And I'd say with regard to AutoZone that whenever you see a business that has already been milked so much, you're probably better off just getting out of the way because at some point, it's not sustainable

Question:

Would you please comment on the differences in the cultures you see between Wal-Mart and Costco?

David Poppe:

Wal-Mart ultimately is more focused on the owner. They are both great. They both have admirable management cultures. They are very aggressive at what they do, excellent at what they do. Costco deservedly has a reputation for being a very, I say this in the best sense of the word, paternalistic employer and a good place to work. Wal-Mart does not have such a good reputation. But they both really do have unique and, I think, driven cultures.

The difference to me, and this is a point we argue about a lot, is that Wal-Mart is really owner-focused. That is they want to make a return at the end of the day. I think their return on assets and their return on invested capital are significantly higher than Costco's even though Costco has the most productive stores in American retail. It is hard to criticize people like Jim Sinegal and Richard Galanti and the Costco management team when they are so good at what they do. But I think if faced with a problem or a crisis Jim's first response would always be to give something back to the consumer, and secondly to make sure the employees don't feel it. And thirdly, the owners will get what they get. And that is okay. But it has resulted in a company that is absolutely world class at what it does, but does not generate world class returns. Wal-Mart, on the other hand, I think is world class at what it does, and generates world class returns. And I think it is arguable whether they do things that we would all prefer they didn't do to get them. But you know, it is not a sweatshop. They don't chain anybody to the desk, and they don't buy apparel or other imported goods that aren't widely available to every retailer in the world. And every other retailer in the world, in fact, buys all of those goods in China; they just are not as big as Wal-Mart. And that, to me, is the major difference. I love Costco, by the way. I hate to say anything that is not totally flattering to Costco. But, it is what it is.

Question:

A question for Rick and for Bill, are you more optimistic or pessimistic about the future than you were, say, in the last 35 years?

Bill Ruane:

Well I am basically an optimist. But over the last 55 years since we came in the business, the United States was just so dominant, and that will change over decades with the enormous growth of China, India and the rest of the world. And I think productivity, you know, crosses borders now. Eventually, the rapid growth of the Asian superpowers will result in the loss of American economic dominance and maybe military hegemony. But it will take a long time.

I think that we have a wonderful country, and I think that we have a great system of government and enormous resources and fundamentally really honest people managing the government. So I am confident that the US will remain dominant for several decades certainly. I think the odds over the next ten years are that we will see some bumps. Rick and I have seen a number of them over the last 50 years. And there will be some more. But I am very optimistic that we will do just fine for a long, long time. And I hope the two of us stick around to see whether I am right.

As for our business, well a lot has changed. We came into it at probably the perfect time. In my particular class at the Harvard Business School, we had 645 graduates. And only eight came to Wall Street, which is an indication of some sort. We were a manufacturing-dominant country. And the interest in finance was about zero. We happened to really enjoy it, and that is why we went into the business with low expectations. But I am an optimist. I think that we can come up with scenarios that will lead to some bumps. But, I think our country will do just fine. And I think that if you continue to think about your investments on a five year basis, rather than over any short term period of time, and maintain a reserve for your needs over the next five years that isn't connected with the ups and downs of the stock market. I think five years from now and ten years from now, we will all be better off. Rick?

Rick Cunniff:

I think that the biggest change that we have seen is in the level of competition. It is just unbelievable. As Bill said, there were eight people in his class who went to Wall Street. I was one year later, and we had ten. There was no interest in investments, in Wall Street. The government bond rate was about 2 5/8%. And the Dow Jones Industrials yielded 6% and was selling at eight times earnings. This was 1950. You can see what a tremendous change has occurred in all aspects of the business and in the valuation of stocks. So it's very hard to say it is going to be as good as it was with the tail wind that we had. But ours is a marvelous, competitive country. We will keep our fingers crossed.

Bill Ruane:

I thought you might be interested, when I came down to Wall Street looking for a job; I sent some letters out and got some responses. And I went to one investment firm, a great investment firm. They interviewed me. And at the end of the interview I met a number of people in the firm. They said that they would like to offer me a job. And I met with the senior partner and he said, "Now for college graduates, we pay $35 a week. However, since you went to the Harvard Business School, we will make it

$37.50." And there you have the value of a Harvard Business School degree in 1949. Things have changed.

Bob Goldfarb:

One last question.

Question:

Setting Fifth Third aside, Sequoia used to own several bank stocks, and now owns very few. Why is that?

Jon Brandt:

I would just say it's company specific. I don't think we have an industry view. We used to own six bank stocks, but we sold for reasons that were more company specific than industry specific. We used to own Bank of Hawaii. We sold that for one reason. We used to own Banc One. We sold that for another reason. Bob, would you connect the dots more than I am doing?

Bob Goldfarb:

Well I would say with regard to the large money center banks, we have avoided them because of the risk inherent in their activities, and those risks have only increased in recent years with the explosive growth in derivatives. That would preclude our interest in that subset of the banking industry. You know, it is interesting a number of years ago Warren Buffett said that he was surprised at the profitability of the banking business. It inherently struck him as more of a commodity business, which shouldn't lend itself to a very high return on investment. Right now we are seeing compressed margins on both the deposit side and the lending side. We have seen those situations before, and they have been temporary. And I think the very valid question which you raise is, 'Could it be more than temporary?'

And with that we will adjourn. Thank you very much. We look forward to meeting with you again next year.