Ruane, Cunniff & Goldfarb Investor Day

May 19, 2006 – New York, New York

Bob Goldfarb:

Good morning. We want to welcome all of you to our first Ruane, Cunniff & Goldfarb Investor Day. This meeting actually had its genesis in 1970, when Sequoia Fund was just beginning and mutual funds were required to have annual meetings at which proxies were voted. For many years, our meetings drew so little interest that they were always held in Bill Ruane's office, which accommodated 20 people.

Since 2002, mutual funds haven't been required to have annual meetings at which shareholders vote by proxy, except for an occasional meeting such as we had earlier this year when shareholders had to vote on a change of control. However, we've grown fond of this gathering and so we've continued to hold a meeting every spring. There's no longer any formal business that has to be conducted or voted on. But we do think it's useful for you to hear what's on our mind and for us to hear what's on your minds.

Over time, we've noticed that many people who may have had a Sequoia account but also had an individually managed account would attend, and some who were not in Sequoia but invested with us through a separately managed portfolio were in attendance as well. We decided this year that we ought to invite them officially. It's an overdue invitation, but we appreciate everybody turning out in such large numbers, and we hope you will find the next few hours worthwhile.

While we're pleased to start a new tradition with our first Ruane, Cunniff and Goldfarb Investor Day, we have to note, unhappily, that this is our first meeting without our co-founder and Chairman, Bill Ruane, who passed away last October. In fact, one of the things we came to enjoy most about these meetings was the chance to spend time with Bill, and hear his thoughts and hear his stories. We cherished the occasions when he was with us. We think about him often, but he's especially on our minds today. We miss his wisdom, his warmth, and his sense of humor. And we know you do as well. We're delighted that Joy, Paige, and Lili Ruane are here today, and we'd ask you to give them a special welcome.

Unlike in previous years, I don't have a prepared speech, which leaves us a lot of time to take your questions. But before we start, I want to set some ground rules. First, we'll try to answer your questions until 12:30. Then we'll stay around for a brief time afterward, but we need to vacate the room by one o'clock. Second, if you look at our 13F filings with the Securities & Exchange Commission, which are required quarterly, you'd see that we own stock in about 225 companies. That means that there's a chance that any one person in this room might have a question about any one of those 225 securities or companies.

In order to keep this meeting focused on the stocks that comprise the greatest percentage of most of your portfolios, we intend today to answer only questions about the core stocks we hold, which are the stocks that are in Sequoia Fund. Because we know some clients with privately managed portfolios won't know which stocks are in Sequoia, we've provided everyone here today with the most recent quarterly report, which lists all of Sequoia's holdings as of March 31st. If a stock is not listed in that report, we won't comment on it today. We'd ask you to respect that ground rule.

Third, as always, if there are any journalists or Internet bloggers in attendance, we ask that this meeting be off the record. We do prepare a transcript of this meeting for our clients and shareholders, and we prefer that all shareholders and clients receive the transcript of our comments at the same time, and in full. We don't want to inhibit your questions, and we encourage you to ask about any non-stock-specific issues you feel are important, but we must repeat that we won't comment on any stocks that are not listed in the Sequoia report with the exception of stocks that have been sold out of Sequoia in the last year.

Before we start, I'd like to introduce our team. I'm proud of the people that we've assembled in research and feel they bring a remarkable amount of energy and intellect to the task of building strong portfolios for our clients and shareholders. Starting at my far left is Greg Steinmetz. Next to him is Jonathan Brandt. Between Jon and Rick Cunniff is

David Poppe, who is the co-manager of Sequoia. I think all of you who have been here before recognize Rick, who is our co-founder as well. On my right is Greg Alexander and to my far right is Joe Quinones, who runs the operations side of our firm as well as that of Sequoia. Seated in the first row is the rest of our team.

If you could stand when I call your name — first is John Harris. Next are Jake Hennemuth, then Arman Kline, Tom Mialkos, Scott O'Connell, and Terence Paré. Not with us today is Girish Bhakoo, who is traveling on research business. Finally, I would like to introduce Jon Gross, who is our Director of Client Services. Jon is our primary contact person for our Sequoia shareholders, as well as for many of our clients. With that, I'd like to open the floor for your questions.

Question:

I'd like to ask a question, if I may, about Berkshire. I think about eight years ago next month, the stock broke about $80,000 a share. Today, it's about $92,000. So I guess it's compounded at a rate of about 1% for eight years. I wonder if you could comment on three issues. One is the degree of over-valuation in the stock that might have existed in '98; the degree of under-valuation that may exist today; and your views on how you feel the intrinsic value of Berkshire has in reality compounded over the last eight years.

Jonathan Brandt:

It's a very good question. It's interesting, I think in 1998 when I think it hit $84,000 briefly, it was overvalued. I'm not going to state what I think the level of overvaluation was down to the decimal point. What's interesting, I think, is that the degree of overvaluation was not apparent at the time, at least not to me.

At that time, Coca-Cola and Gillette were a larger percentage of the value than is the case now. I had been dubious about their stock market value; so I was haircutting their valuations. They were both promising 15% to 20% earnings per share growth each year. That was clearly not in the cards, and they were selling at 35 times earnings — don't hold me to those exact figures. But I don't think I realized, or perhaps others may not have realized, that their operations were not even as strong as my haircut might have indicated.

So if they were selling at 35 times earnings, I might have thought they were worth 25 times earnings, and in retrospect they probably weren't. Now I believe that Coke's value has grown since 1998. Buffett said at the Berkshire annual meeting that the firm has never been more valuable than it is today, that it's grown from 16 billion unit cases to 21 billion cases since 1998. One way to value the firm intrinsically is by how much soda it sells. So that's gone up by about 30%. Gillette is worth a lot more than it was then. It's since sold out to P&G at a favorable exchange ratio.

So, in 1998, Berkshire stock reached $80,000 before the Gen Re deal, and then went up a little more when the Gen Re deal was announced. On the surface, the Gen Re deal looked like it was a great deal, but the underwriting culture was not as strong as Buffett thought or as the market thought. So I'm conceding your point that Berkshire's shares were overvalued in June of 1998, and we were aware of it, but if I thought Berkshire was X-percent overvalued then, it was a little more overvalued than I thought at the time, in large part because Coke and Gillette were more overvalued than I realized.

I believe that the stock now is somewhat undervalued, or somewhere between reasonably priced and somewhat undervalued. I believe that the compound from 1998 till now has been reasonable and decent, maybe not superlative but I think it's been fine. I can't give you a percentage per year off the top of my head, but it wouldn't surprise me if I went back to the numbers that it would be something like 10%, 11%, or 12% compounded growth in value from what it was probably worth in 1998. Given Berkshire's size, I'm pleased with that rate of growth and I think some of the gain in intrinsic value has come just in the last couple months with the deals that have been announced.

These last five years, Berkshire has been coiled, waiting to spring into action. There's been a lot of latent value in the cash, and there's always been a question of do you value it on the current earnings or do you value it on the potential earnings? Buffett has created a lot of float and a lot of liquidity over the last eight years. Not all of that is showing up in the earnings currently, but it potentially can show up. I think the Iscar deal, which was announced on the day of the annual meeting this year, creates a lot of value. So that potential to create value has always been there, and there's much more there today than there was in 1998. I think now with the catastrophe market hardening and the capital rules changing for primary insurers and for reinsurers, I think Berkshire is very well situated to deploy more capital into insurance. Buffett continues to make insurance acquisitions as well, and that creates even more liquidity. The MedPro deal I think is going to work out well; Applied Underwriters too. Every time he buys an insurance company, there's a potential double dip in that he gets a nice stream of profits but he also gets more float to invest as well, and that creates more potential to generate earnings.

Question:

To what degree do you think the stock market is still fixated on the investment portfolio of Berkshire Hathaway, which of course in '98 accounted for a far greater share of the value? It's almost as if the market ignores the enormous growth in the operating earnings, which were relatively minor back in '98.

Jonathan Brandt:

Berkshire is not covered extensively by Wall Street, and I don't know what other buy-side firms are thinking. But any analyst who read the annual report would see that the operating earnings are there. I think to the extent that people are not focusing on that, it's because they haven't done a spread sheet or even read the annual report.

I don't remember what magazine it was, but one of the better articles I read was actually in a popular financial publication about a year and a half ago. The author was talking about what the latent earnings were. I haven't read a whole lot of articles or reports where I think they were totally missing the boat on what the earnings coming from the actual businesses are. It's there in plain sight. I don't think you could miss it.

Question:

Please comment on the reasons you bought International Game Technology.

David Poppe:

International Game Technology, for those who don't know, is the leading manufacturer of slot machines in the United States, and I guess in the world. It has about a 65% market share of all the slot machines you see in a casino in the US, and probably a 30-something-percent market share of any slot machines or gaming machines you would see internationally. It really is, we think, a terrific company. It's a very, very strong franchise. It is very good at what it does. It is an interesting market in that it's very difficult to enter because you have to be licensed in every state where you want to sell slot machines. So it's very difficult for new people to enter the market. There are three or four pretty good competitors. They are all much smaller than IGT.

We followed it for a few years before we bought it and actually missed a very good run in the stock earlier in the decade. When the price came down, we came back to it. We felt it's not easy to get such a dominant franchise and this kind of market share in a protected market. It is a growing market. Whatever we think morally of casinos, people love to gamble and every new casino that opens up pretty much makes money and does well. We think outside the United States there will be over time significant growth in the number of slot machines in other jurisdictions. IGT probably won't command the kinds of shares outside the US that it gets in the United States, but it still has proven in Japan and other markets that it can take share.

Then I think if you really follow it very closely, there is a replacement cycle of the machines that is likely to happen in probably two to three years from now. Slot machines, to really simplify it, are likely to move from being self-contained boxes with their own computer power inside the boxes to being parts of computer networks. This will allow casinos to download more functions and switch games from servers and run them out to the machines. That holds the potential to really change the economics of the business for everybody, and we think in a good way for IGT. We think that IGT is going to be the technological leader in that. While I don't know the timing of when it will happen, I suspect that it will happen before the end of the decade, and it will generate a very healthy amount of earnings increase.

So we felt very comfortable with the management. We had followed it for some time. We felt it was a best of breed kind of company with very good strength in R&D and engineering. And it has this replacement cycle coming up. Today's earnings don't look great compared to the stock price. The P/E is high. But if you look at what the potential earnings are likely to be in three or four years compared to the price we bought it for, it seems reasonable.

Question:

Progressive has been very volatile this first quarter after a very strong performance in the fourth quarter last year. How do you see Progressive in the portfolio?

John Harris:

The stock has been volatile, I think, probably because people are trying to figure out where normal earnings will shake out in the end. The combined ratio is a sort of measure of operating margin for the insurance industry. For a period of a few years now, Progressive's combined ratios have been surprisingly low, as have the entire auto insurance industry's. I think that people who follow the stock are aware that over time whether as a result of competition or just as a result of inflation in claims costs, that combined ratio will move up to some more normal level.

When it does or as it does, there will be a head wind that the earnings will face, and there will be a few years that we are probably — well, we are in the middle of it right now — when the earnings are not going to grow nearly as fast as they have in the past, or may decline. I think that the market is probably struggling to figure out how the stock should be valued as that transition takes place. I suspect that as more information comes out about how the company is performing from an underwriting perspective, the stock will continue to bounce around a little bit. But eventually the earnings will get to some normal level, and I think it will become an easier company to value.

In the meantime, I don't think our view of the company's prospects has changed. We think they are bright. We are perfectly happy to wait a few years while the earnings are flattish or possibly decline so long as we think that management is doing what it needs to do to maximize the company's ability to earn money far into the future. I think that Glenn Renwick, who is just an outstanding CEO, and his team are doing just that. As long as they continue to do that, we're very happy to hold the stock.

Question:

Could you comment a little bit on the current valuation of Fastenal and your degree of comfort with it?

Greg Steinmetz:

I don't know if everyone knows about Fastenal, but it's kind of a hardware store for contractors and for people who run factories. Its market is very big, more than $100 billion. Fastenal has maybe 1% of that. So if you think of the things that we own that have a very long runway ahead of them, Fastenal probably is near the top. It's been growing very, very quickly. This year, it's been growing sales more than 20%, and that's entirely organic. Last year, we saw the same kind of performance, and the year before that. It's growing consistently fast and on an organic basis. Fastenal practically never makes an acquisition. You pay up for that.

It will be very interesting to see where Fastenal is five, ten years from now. It has a wonderful management team. It can still open up a lot of stores. It finished the year with about 1,800 stores. Management says it can pretty much double that and it says that's a conservative estimate. Given how Fastenal is doing right now, we don't have a lot of reason to doubt that it can keep growing.

Fastenal is cyclical. The good news is in the last downturn, it was able to increase its sales because of new product lines. You think of a store — if all it does is sell fasteners and then it adds new products, puts more things on the shelves, it can grow even if fastener sales fall. That's what happened here. So we see some cyclicality in the earnings, maybe more this time around than last time. People worry about the housing market, but Fastenal doesn't sell a lot to home builders. It sells to contractors mostly in the commercial area, and that's operating on a different cycle than housing. So we're hoping that it can continue to do well through this cycle. But again, the secular trends here are just wonderful.

Next year, I think Fastenal is going to earn — what's the latest — $1.64? The stock trades at $43; so it's a little bit higher than we would like as an entry price for the stock, but it's not at a price now where we're uncomfortable holding it.

Question:

Do you have any thoughts on the energy sector looking backwards, currently, and looking into the future? Other than the MidAmerican holding in Berkshire, I don't see any energy here.

Bob Goldfarb:

Traditionally we haven't held a lot of energy companies. We owned Exxon at one time. We owned a refinery, I think it was United Refining. That goes back to the '70s probably. Energy has always been very small for us. Warren Buffett made some comments at his annual meeting a couple weeks ago about oil prices, and I think it applies to some other commodities as well. In fact, in today's *Wall Street Journal*, there's an article about copper in the *Money & Investing* section. The article states that the natural price supply and demand would suggest should be the clearing price is significantly below the price, at least on the spot market, which you see in the paper every day, because of speculative activity. That's true of copper; that's true of gold; that's true of oil. People aren't buying oil and gas just to fill up their cars, heat their homes or whatever. At some point in time, as Warren Buffett remarked, people begin to buy whatever financial instrument it is because it's gone up. So there's certainly some element of that in today's price of oil. I think this works as well in the reverse. At some point, the price will go down, and you'll probably clear out those speculators pretty quickly, I would suspect.

That said, there are very well-managed oil companies such as Exxon that are not running their businesses based on $60 oil. Many companies are running their businesses based on oil, I think, somewhere in the $30s. If you can find stocks of energy companies that would still be cheap with oil at $35 a barrel, then you have a pretty good deal. So we're clearly aware of the factors, some of which are structural, on the demand side, that are going to boost demand for petroleum for a long time. But demand isn't totally inelastic, and you've seen some reduction in demand, albeit it's been a relatively small reduction, already.

There's also a lot of potential supply of energy in all kinds of forms that are out there. David and Arman visited some of the companies in Canada a couple years ago that are developing the tar sands, and I've seen someone recently who argued that there's not a shortage of oil; rather there's a shortage of technology to get at the oil and all the carbon fuels that are out there. But as to our view of where the clearing price of oil is going to be in two years, I wouldn't hazard a guess.

Question:

I came in the room wanting to ask how you keep a relatively young staff motivated, standing at the plate, when you swing so seldom. But I heard you say you have 200 stocks in your portfolios. How did the number of stocks get that large?

Bob Goldfarb:

There are all kinds of reasons why there are 200. One is we do have a number of managers who manage portfolios, and they have total discretion to invest in securities that might not be in Sequoia. Secondly, we have a lot of clients that come in with very low basis securities, and in many cases they ask us not to sell them. We classify them as special holdings and don't charge a fee, but they're there in our 13F. We may have low basis stocks, some very low basis stocks that we bought 25 years ago which we're still holding because the client has asked us to consider tax factors. So those are just three of many reasons that account for the number of holdings.

Question:

So if you separated the active from the inactive portfolio, it would be about the same number of names per dollar of value in the active portfolio, 16 names and $3.6 billion, as in Sequoia?

Bob Goldfarb:

That will vary by the individual portfolio managers. Some may be less concentrated than others, and consequently they might have 30 names or 40 names, and we don't have a problem with that.

Question:

Last year I asked a question about Walgreen, and I was wondering how the moat increased or decreased during the last 12 months. I was thinking of two types of competitors: the mail order business, and CVS now that it acquired some part of Eckerd.

David Poppe:

That's a good question. I think the moat is maybe a little more narrow than it was a year ago because CVS has done a terrific job, as far as we can tell, integrating Eckerd. Even Walgreen admits that. I think management is saying now that pre-CVS buying Eckerd ... I want to say all Walgreen's Florida districts were in the upper half of the company in terms of comp store sales, and now it's something like 50% of the districts ... or 70% of the districts are in the top 50%, something along those lines. So it's clearly slowed for Walgreen. It used to be that Florida overall was much better than the chain as a whole, and now maybe two-thirds of Florida is better than average. So CVS has done a good job there, and Florida is an important market to Walgreen; so that somewhat reduces the moat.

Mail order has slowed, actually, over the last year. If you look at the PBMs, the growth in their mail order business slowed dramatically in 2005, and I think Walgreen at this point — I think this was true throughout — but I think Walgreen is taking more share of the total prescriptions filled in the US than mail order at this point. I think Walgreen is growing the prescriptions 8% to 10% per year in terms of the number of prescriptions being filled. In mail order, I think Express Scripts is growing about 3%. That's the one I know off the top of my head, and I think the industry is growing about 3%. That doesn't mean mail won't have another round of growth going forward, but for now, mail order is not taking share away from Walgreen, at least. It may be taking share from some other drugstores.

The bigger picture is I feel pretty good about Walgreen for a variety of reasons. The Medicare Part D program should be good for it, as a lot of seniors obviously get better coverage than they had before. When people have better coverage, they tend to fill more prescriptions. Secondly, unlike a lot of private party plans where the PBMs have been very successful at requiring people to use mail order to get 90-day supplies of drugs, Part D allows seniors to get 90-day supplies of drugs at a retail store. Both Walgreen and CVS are able to fill those prescriptions. That should be good for them going forward because I think mail order is very good for some people, and it's what they should use. But there are a lot of people also who would prefer to get 90-day supplies of drugs at the store. They would like to talk to the pharmacist because maybe they take multiple prescriptions.

So that should be a growth area also, and should somewhat inhibit the incursion of mail order on the retail store. I think if you look forward, it is possible that the pharmacy market is going to consolidate dramatically at some point. Most people in retail are earning extremely low margins in the retail pharmacy, and you could have a scenario where, for example, Walgreen, CVS, and Wal-Mart end up controlling a much bigger portion of the market in the future than they do today. Market share is good, but the bad part about that is you have stronger competitors that you're fighting against. Right now, I think everybody benefits from the fact that there are a lot of independents left, and a lot of very weak chains left. So I think going forward, the competitive environment is not likely to get easier — put it that way — and it could get much tougher.

Bob Goldfarb:

I would add that I think besides the competitive environment, it's important to look at the regulatory environment. David, how would you assess the regulatory environment right now?

David Poppe:

Bob's a lot more pessimistic about the regulatory environment than I am. The regulatory environment could become really difficult for pharmacies because as the government controls more and more of the payment for prescriptions through Medicaid and Medicare Part D, I don't think it's going out on a limb to say the costs could likely to spiral out of control relatively quickly. The first baby boomers turn 65 in 2011, and at 65, people really start taking a lot more prescriptions, and the taxpayers are going to be paying for all those prescriptions. So the reimbursement that the drugstore earns is likely to come down over time.

This gets back to my other point about consolidation. If you look at some of the big publicly held drugstore retailers, they are probably earning — you can tease it out of the numbers — somewhere in the range of zero to one percent operating margin in pharmacy. They don't make much money filling prescriptions today. So the potential is there for the reimbursement to come down — the government has crippled businesses in the past including the hospital industry at one point, by just changing the reimbursement terms — but it would also lead to a very rapid falling out of a lot of other players. We think the really strong people in pharmacy are earning 5% operating margins. Nobody is making a ton of money in this business.

Walgreen has a very good business model at a 5% operating margin in pharmacy. But there's not that much to give. So the issue is if the government got draconian on the reimbursement in Medicare Part D and in what it pays the states for Medicaid, the drugstore business could become very difficult. But as Walgreen would put it — I'm stealing the company line — Walgreen would be the last man standing because it makes the highest margin in the business today.

Bob Goldfarb:

I think there was an article within the last month or so in the *Wall Street Journal* on generics. Some of the large buyers, namely the states, are starting to question the markup on generics, which is extraordinary in some cases. I'm not predicting that this will occur. I'm just hypothesizing that an environment of total transparency where the buyer knew what generics cost pharmacies would put a lot of pressure on the industry. If you had total transparency in fasteners, and Fastenal had to disclose how much it paid for fasteners, I don't think it would make a big difference.

If you have total transparency in generics, it could make a big difference. Whenever you're selling into a market that accounts for 15% or so of GDP, and it is growing by leaps and bounds, and the taxpayers are funding it … people may be looking at it already. And I think it's going to get a lot more attention at some point; I don't know when. But you can be sure it's going to get a lot more attention than the price of fasteners. How much money do pharmacies make on branded prescriptions, David?

David Poppe:

They essentially make nothing on brands, and they make a large profit on generics. The differential is intended to influence the drugstore to try to get consumers to switch to generics. But the result is what Bob said. The generic profitability sometimes looks pretty obscene if you look at it in relation to what they pay for the drugs. The offset is they don't make money on the branded drugs. So if you get a Lipitor prescription, Walgreen actually makes maybe $1 on a $130 prescription. But if you get a generic prescription, pharmacies might make $5, $6 or $7 on a $20 prescription. So the margins look very outsized. But Bob is right, there's going to be pressure on that system. The issue is can pharmacies raise the reimbursement that they get on branded drugs.

Question:

Thank you. I had a two-part question on inflation. The first part is what is your outlook on inflation? The second part is if we have a return of inflation, which is the current market fear, what types of companies would you like to invest in?

Bob Goldfarb:

We really don't have a view on inflation that's of any value to anybody because our view historically has been wrong. In response to your second question, I think if we were to enter a period of significantly higher inflation, the businesses we'd like to own are businesses that could take their earnings to the bank in the form of cash. For instance, there's been a significant inflation in carpet in the last year or so because of the rising price of oil, which is the source of their raw materials. Mohawk's earnings historically equaled its free cash, but because of inflation in raw material costs, that hasn't been true in the last year or so. So I think in an environment where there is a lot of inflation, a Mohawk would be worth somewhat less, and an Expeditors — which takes almost all of its earnings to the bank — would be worth quite a bit more. But again, the variances between a Mohawk and an Expeditors are going to depend on just how great that inflation rate is.

Question:

I know in the last couple of years you've commented on Wal-Mart even before you've owned the stock. I'm curious about your outlook for the company, your view of the valuation, and assuming that's positive, why you wouldn't commit more capital to that company as you have with companies like Progressive and Berkshire.

David Poppe:

I feel the same about Wal-Mart today that I felt a year ago, honestly, which is I think it's a very good business that is in a very, very difficult public relations position. You know the operating income was up 8% last year, and the EPS — earnings per share — were up about 12%. We think EPS will be up about the same this year. It continues to be just an amazingly efficient company.

I was on a trip with Morgan Stanley a month or so ago, and we walked through a Wal-Mart store in Florida. We walked through the back room, and then we walked through the back room, which is where inventory is kept, of some competitor stores. The efficiency of Wal-Mart is really amazing, given the size of the store. This store is probably doing $100 million a year of sales, and there is no inventory in the back, and there's no more inventory on the risers, which are the high shelves over your head. You go to a competitor's store, and it does half that volume, maybe, and there's inventory in the back, and there's inventory everywhere. Wal-Mart is an efficient company.

I think that Wal-Mart is making some progress on its merchandising initiatives, but I don't have any great optimism that that's going to change things dramatically. The core Wal-Mart customer is really hurt by gasoline prices, and that's been going on for awhile now. But the company still is growing earnings about 12% per year. We think that's sustainable, and we think from $45 to $47, it's probably fine. But I have to sit here and tell you a year ago it was $45 to $47, and I thought it was fine then too.

Bob Goldfarb:

It was.

David Poppe:

Also, I think I said this last year, but whatever your politics, Wal-Mart has become kind of a pincushion for a lot of complaints people have about our economic system, a lot of which are legitimate. But Wal-Mart is not running sweat shops. It's not really doing anything that its largest peer doesn't also do. Yet, Wal-Mart takes a heck of a beating. One thing I would worry about is on that same trip in Florida, there were real estate developers talking about developing shopping malls and how hard it is to develop a shopping mall if you want to have a Wal-Mart in your center. The towns and the mayors and city council people do not want Wal-Mart. They are very happy with the other big boxes, but they don't want Wal-Mart. Longer term, that's something that I am concerned about, and I think bears close watching. Whether or not Wal-Mart will be able to grow the stores the way it expects to over time I think partly will come down to whether cities will let the company in, in the future. It's possible they just won't.

The other thing about Wal-Mart is that it's had low comps for a couple years in a row, but if you look at the return on investment that the company is getting on the new supercenters, it is very good. To sound a little like Eddie Lampert for a second, comp store sales can be overrated. If you open a store and it opens with extremely high sales and extremely good return on capital but it doesn't comp at a great level, it can still be a good investment. If your neighbor opens a store that has lower sales and a lower return on capital, and better comps, it's not necessarily a better investment.

Bob Goldfarb:

I think along with what David just said, as long as Wal-Mart has an opportunity to build a lot of supercenters and the construction of supercenters is where the bulk of their free cash or capital is going, it will do fine. If you look at the return on investment domestically versus the return on investment internationally, there's a significant differential in favor of the domestic. One concern long term would be if the law of large numbers eventually catches up with the company, and the mix of its investment shifts more toward foreign and international and less toward the US. I suspect you'd see the ROI come down. But that's not imminent.

Question:

This primarily would be for Richard and Robert, but everyone else is welcome to chime in. Looking at 1973 and 1974, that was the beginning, I think, of interest rate rises and energy rises which were not yet great, yet the markets got walloped, as you both know. Are there any similarities today in your views? I was wondering if you could comment on that, and maybe even blend it into Berkshire.

Rick Cunniff:

Going back to the '70s, one big difference today is that there's so much more liquidity. It's just unbelievable how much liquidity there is out there. We had the shock in 1973 of the price of oil tripling, and it happened so fast that everything else had to happen fast. But that's not what's happening today. Everything is rising and there's capital all over the world. All the oil-producing countries are just awash in currency.

It's interesting that yesterday the market was down again for the third day. But the bond market picked up. So there's been no steady collapse in the bond prices. If you remember, the long bond now is at 5% and a tiny fraction. That would seem very cheap if you went back to the earlier days. So I think the big difference today is the amount of capital that's out there.

Bob Goldfarb:

I'd say, in addition, I think you have countervailing forces of deflation that probably weren't out there in 1974. We spoke about Wal-Mart as one of them, and it's not an accident that Wal-Mart sources a lot of its goods in China, which has been a major source of deflation. Wage pressure is very contained at the current time, which hasn't been true historically in periods of inflation. I know you didn't ask particularly about stocks with the exception of Berkshire. But even if we were to see a repeat of the rates of inflation that we experienced in ... actually I think '75 was the peak year of inflation, after the bubble had burst. But I don't think stocks would sell anywhere near the valuations that they did at the bottom in 1974. Our weighted average P/E must have been three or four toward the end of 1974, and with all the private equity that's around and all the liquidity that Rick was talking about, companies wouldn't get to three or four times earnings. They would be LBOed or they would be acquired, etc. Johnny?

Jonathan Brandt:

I certainly wasn't doing a whole lot of investing in '74 and '75. But my dad was, and he was working at Ruane Cunniff at the time. I remember we'd sit down at the family dinner and he would tell me, "Johnny, your purchasing power is being eroded really terribly. This is awful, and this is never going to end." That's what our family dinners were like.

In any case, I wouldn't say that Berkshire's value couldn't be hurt by inflation. I've heard Warren say that the utility business is uniquely vulnerable to inflation because you can't change your prices the way they do in supermarkets — you have to go to the regulators and get your rates approved, and that's usually a long process. A lot of utilities are trying a new process whereby the rate changes are more automatic, indexed to inflation. But I think that potential time lag is something he worries about.

But Berkshire, by the last count on March 31st, I think it had about $64 billion of cash and fixed income just in the insurance segment. It also has several billion dollars of cash in the financial segment. I struggle sometimes about how to treat the financial segment cash, but it could clearly be earning more. If interest rates go up … I was just doing some math here. Every 100 basis points of incremental yield on just the insurance cash and fixed-income portfolio, after taxes, works out to an extra $640 million or so. That's more than $400 per share for every 100 basis points of incremental after-tax yield. So if you had rates go up five percentage points, that's 500 basis points, after tax ... if I'm not doing my math wrong here, that would produce more than $2,000 a share of extra earnings.

Then he has the hedge against the dollar; he's getting more of his earnings from abroad. He's taking off the currency hedge per se, but he's buying more foreign earnings. Presumably, if we had inflation here, a lot of people think it would be in part because of the dollar's being devalued, and I think he's got a fair amount of hedges against that happening, and that hedge should be growing all the time in terms of foreign earnings, if not in terms of currency forwards.

Question:

Can I follow up on that? You see Walgreen or Wal-Mart, and you know those companies backwards and forwards. But there is no transparency in Berkshire. We really don't know how Nebraska Furniture Mart is doing, for instance. You have to have a lot of trust.

Jonathan Brandt:

That's fair. I'm not crazy about the lack of disclosure at Berkshire. It could be more transparent. Buffett has got about 15 businesses now in the other category. I might be exaggerating a little. It's frustrating, but when it comes down to it, these are mostly marginal issues in terms of the valuation of the whole. With a little work, you can back into the furniture earnings, and I even have an estimate for the earnings of the Nebraska Furniture Mart, although it could be wrong. In fact, I have an estimate for all the businesses. Now, I have to do some spreadsheet work. But there are a lot of clues.

He does put all the manufacturing and service companies together. But you can see that the return on tangible equity is well over 20% after tax. It's lower than that if you include the goodwill. So I don't think those companies are not being run efficiently. The compensation agreements with each of the heads of those businesses rely principally on how much capital they're using; so there's certainly the same incentive that you would have at a Walgreen to use inventory and other types of capital productively.

Sometimes one of the things we worry about more with the operating businesses at Berkshire is that there's not enough incentive for them to invest in their businesses. I think Warren, rather than have the companies invest in their businesses, feels more secure taking the cash and investing it himself. But Nebraska Furniture Mart did open a new store in Kansas City; it's doing well. The R.C. Willey chain has opened a number of stores, some of which were over his ... not necessarily objection … but lack of enthusiasm. NetJets has certainly done a lot of expanding, so far without profitable result. But I think there's reason to be somewhat hopeful about that. Geico has certainly expanded. So it's not a uniform story of them not expanding.

Yes, there's a lot of trust in Berkshire, but I think he does release most of the numbers that you need to have to estimate the value and the growth in the value.

Question:

Patterson Companies is one of the smallest holdings in our fund. What would have to happen before you would make Patterson a more meaningful position?

Greg Steinmetz:

A big issue we have right now with Patterson is who's going to run the company in the future. Pete Frechette, who built that company from nothing, retired last year. He's still the chairman, and in fact I saw him last week. He had a very smart young guy working for him, who was running the dental business and doing a good job. From the moment we started covering Patterson, we thought that this gentleman was going to become the CEO, and we were quite happy with him. But he abruptly quit a few months ago and caught Patterson completely by surprise. Now they are trying to find a successor. We want to own companies that we can own forever, and if you don't know who is going to be running the company six months from now, let alone five years from now, it makes it a hard decision.

The dental business is a wonderful business. It's growing anywhere from 5% to 7% a year, depending on what you're looking at. So Patterson is going to grow. Unfortunately, there have been some other changes in the industry that make Patterson less exciting than it used to be. It has I think a 35% share of the dental business. Henry Schein has about the same amount. When the two large players have close to 70% of the market, it's very hard to gain share the way they used to do it, which was by buying up smaller companies. There aren't that many left of any meaningful size. Patterson has two other growth platforms. It has a veterinary business, but the veterinary business on the distribution side is about a $2 billion industry. Dental is $4.5 billion, so vet is a small market.

Patterson is also trying something in the rehabilitative medical supply business, which is quite a big market. Unfortunately, it's always been served as a catalog business. That seems to be the most efficient way to do it. Patterson's trying to make some changes, but it hasn't proven yet that it can make it work. I think there's some internal skepticism about it. So when you think about the valuation, Patterson on a calendar '07 basis will maybe earn about $1.75. The stock's trading this morning at $35. It's not cheap, even though it's come down quite a bit. I think the stock got ahead of itself last year because of the huge growth it had in dental equipment.

Patterson sells a product called CEREC. I don't know how many of you have had crowns or fillings replaced, but CEREC allows you to go for just one visit and get it all taken care of instead of getting the goop in your mouth and having to go back a second time. Sales of CEREC grew 40% last year.

Bob Goldfarb:

Patterson is actually an interesting case study because it was an extraordinary business a number of years ago, when it had a fragmented customer base. The dentist is usually a sole practitioner or has a small group of partners. Patterson had a somewhat fragmented supply base and a fragmented competitor base. That's an ideal world. The customer base remains fragmented, but the competitive base, as Greg alluded to, is no longer fragmented. Schein, which had been a catalog house, bought Sullivan. Schein had some integration problems in the early years, but the company figured it out and now it is a formidable competitor.

Moreover, Danaher, which is another holding of ours, seems to be trying to consolidate the dental supply business in a very short time. In fact, we know of two products for which Danaher is now calling the shots and said to Patterson, "We're not going to sell them to you because you won't give them preferred status in terms of the compensation that you pay your salesmen."

And you can see the negative impacts of having a strong competitor in Schein because Schein wanted CEREC. Schein went to Europe where it bought some dental suppliers, and Patterson had no interest in going to Europe because it isn't a terribly profitable business over there. But by going to Europe, Schein became a major customer of Sirona, which is the manufacturer of CEREC. So there was a bidding war for the rights to CEREC this year, and Patterson had to pay $100 million to Sirona in order to have the distribution rights to CEREC over the next ten years.

That's very, very different from Fastenal. You don't see Fastenal having to pay any of its suppliers anything. In fact, it's the reverse in the case of Fastenal. A bunch of us attended their investor conference in April, and I'm pretty sure the suppliers were paying for the whole conference, if not more.

Question:

I was hoping you could comment on Idexx Labs, its competitive advantage, the outlook and the valuation.

Greg Steinmetz:

Idexx is the leading manufacturer of diagnostic equipment for veterinarians. Its market shares in its different product lines are 60%, 70%. The veterinary business is growing — I saw some figures yesterday — 7%, 8%. It grew like that last year; it's been doing that for a long time. People love their animals, particularly their dogs, and they will spend whatever it takes to keep that dog healthy. When they take the dog to the vet, odds are it's going to have tests run on an Idexx machine. It's going to get tested for heartworm with an Idexx product. You send a test out to a lab — in one in three cases, it's going to be an Idexx lab. So Idexx is everywhere when it comes to veterinary diagnostics. Its competitive position is just extraordinary.

Bob Goldfarb:

I'd say that Idexx is in the reverse situation of Patterson. In fact, Idexx is a large supplier to Patterson's veterinary business, but the Patterson vet distribution businesses are Idexx-only houses. In fact, Henry Schein just acquired ... what was it, a couple months ago, Greg?

Greg Steinmetz:

Schein bought a company called NLS down in Maryland. It's not a big veterinary distributor, but it is an Idexx distributor. Schein was already in the vet distribution business and distributed some Idexx competitors. Idexx doesn't like it if you sell both Idexx products and competing products; so now Henry Schein has a choice: What is it going to do? It's difficult to have a large veterinary business unless you are selling Idexx. So we think that Idexx is probably going to be the survivor there.

Bob Goldfarb:

You can see the power is with the supplier, and it's working against the distributors in those medical businesses.

Question:

I came here to ask this particular question. It's been bothering me, and I want your thoughts on it. Historically, Sequoia has 30% to 35% of its investment with Berkshire. So one could make the case that as Berkshire goes, so goes Sequoia. I happen to be from Omaha, Nebraska, by the way. Mr. Buffett certainly is a legend and seems like he'll go on forever, but sadly that's not the case — none of us do. What happens to Berkshire when something happens to Mr. Buffett?

Bob Goldfarb:

We consider Berkshire every day in terms of the price-value relationship. But that said, I don't think any of us would want to venture a guess on where Berkshire would open on the day after Warren was either incapacitated or no longer with us. Because of the decentralized nature of the operations of the wholly-owned businesses, or 80% owned in some cases, and the autonomy that the managers have, I don't think his death would have much impact upon the value of Iscar, the Nebraska Furniture Mart, or whatever. I think the greatest likely impact would certainly be on the capital allocation side and on the investment side. That's where he focuses his talents and energy, and that's where he shines, and where he's irreplaceable. The price would probably decline on that date, but I'm not sure that the value of the businesses that are owned at that time would. But I do think that in the absence of his genius, the present value of the future cash flows would decline from what it would otherwise be if he were to live into perpetuity. Jonathan, do you have any thoughts on that?

Jonathan Brandt:

My view on that is that there are thousands of companies that do not have Warren Buffett as the CEO and chairman, and they seem to sell reasonably close to their value. There may be an air pocket, if he were to die suddenly. At the annual meeting a lot of people asked him if Berkshire is trading at a discount, why isn't Berkshire buying in its stock? He said that even if he wanted to, he really couldn't. He showed us slides illustrating the turnover of Berkshire's shares compared to that of a lot of other so-called blue chip companies. The other ones were 80% a year, 200% a year, 60% a year. And only 14% of Berkshire's shares trade ever year; so even if he wanted to buy back stock now, he couldn't. But if, in this eventuality, Berkshire were to drop an untold amount suddenly, I think there's enough smarts on the Board to take action if there was a lot of volume.

But I worry about the things that Bob was talking about: whether Warren's successor ... where his talents would lie in terms of what he could do with the cash flows, the capital allocation function that Warren has done so well. But I think as I've said in other meetings, Warren has been really constrained by the type of markets we've had the last several years, where it seems that all assets are usually trading at very high prices.

There have been some pockets of opportunity with junk bonds. He likes to talk about how he got to buy the 29-year bond at 30 basis points richer yield than the 30-year bond. I guess he hedged it to make a nice safely levered return after Long Term Capital had its problems. In 2000, he bought some so-called old economy stocks. In 2002, he bought some pipelines. But generally speaking, it's been a difficult period for him. He's had his hands tied behind his back. So even if he is — kind of like David Blaine in the water at Lincoln Center a couple weeks ago — Houdini, he's had trouble operating because the situation has been difficult, and he likes to do things that, as he says, are the obvious things.

He's done a lot of great things, going back to the question before about the compound in value since 1998. There have been a lot of great companies and great assets he's bought since then. I think the successors on the list are very talented. Probably none of them would claim to be as broadly talented as Warren. But he really hasn't been able to do his thing as much as he would have in a different environment.

So I think it is easy to overstate the difference in the returns on the total value of the portfolio that someone else would be able to achieve compared to him. They are both going to be constrained. The size of the company is such that you are just not going to have 20% returns. But I think there's a decent chance, with Warren there, that you could get 10% or maybe above, and I think that a successor would also be hopefully in the same range, and not too far below.

I really think that there are enough investors out there who understand how to value it, and it's not that hard a company to analyze. I don't think you are going to see it trade at 50% below what it's worth. If it did, I think it would be for a brief period of time. That's my view. Bob, do you disagree with anything I said?

Bob Goldfarb:

No. I thought for some time that Standard & Poor's had a problem because until the Google guys came along, Berkshire just towered in terms of its market cap over any other stock that wasn't in the S&P. If there were to be a lot of volume in Berkshire, precipitated by the event you're talking about, and if Berkshire hasn't entered the S&P by then, I would think that would be an ideal time for it to do so. That may be one thing. I wouldn't swear to that, and I'm not saying that you should count on that.

Jonathan Brandt:

I wouldn't calculate your return from today to the day after he dies when the stock is presumably going to go down all this much. But I don't think it's going to be as huge an event as people say on the stock price. I think if it is, I think it is going to be short-lived. It may not sell ever again at a huge premium, but I think it will find its level, and that level will be something close to its value.

Question:

I wanted to pick up on Wal-Mart, and what you said before. It could gain market share and turn around its public image by significantly reducing the cost of prescription drugs. Any indication management is thinking in that direction?

David Poppe:

That's actually an interesting question and a good question. That's one of the things that when I first started thinking about Walgreen I worried about a lot. Wal-Mart could use pharmacy as a loss leader and price the prescriptions below cost and do extremely well. I think Wal-Mart, partly because it is such a target for so many people, but also because its managers are disciplined good business people, has made a commitment to never lose money in any business. The company would face I think immediate antitrust repercussions if it were pricing goods below cost and somebody could prove it.

In the pharmacy market, the branded drugs, everyone knows what they cost. The generic drug prices are a little squishier. People negotiate prices. But for the branded drugs, everybody knows what they cost. So if Lipitor, Zocor, Crestor or whatever is $110 to $130, and Wal-Mart starts pricing it to health plans at $80 to become the only supplier to that health plan's customers, it would face I think some legal problems. So I think that is one reason why Wal-Mart wouldn't do it. If you're talking about cash pay, where people come in and they pay cash, and they don't have coverage, even there the price a lot of times is set by the PBMs that negotiate the plans because your third party reimbursement, your insurance reimbursement, is based on a high cash pay.

To get appropriate third party reimbursement, you have to agree to a certain level that you'll keep the cash prices at. So I'm not sure Wal-Mart, practically speaking, could actually lower prices. The gentleman over here asked about Wal-Mart earlier, and asked why it's not a bigger percentage of the portfolio, and I neglected to answer his question but I didn't forget it. What I would say on that is in the seven years I've been here, we've really only had two stocks that we've bought and taken up to close to 5% in Sequoia, which is the concentration cap we have on the mutual fund. Those were TJX and Mohawk.

While I wouldn't necessarily say they turned out to be the greatest, the best securities we've bought in the seven years, they were both about 10 or 11 times earnings, and they were both — and hindsight is 20/20 — but to us, there didn't seem to be any downside. It seemed as if it would be hard to lose money. Wal-Mart — it's not so much that we think we could lose money — it can't grow forever, and I think we're trying to be a little bit more disciplined where we're paying a 14, 15, 16 P/E on how much we buy for you. The positions that get to 5% in Sequoia are typically going to be very low- priced relative to their earnings.

Question:

I have two questions on Wal-Mart. You talked about the price of gas affecting lower wage earners who shop at Wal-Mart. Have you factored in yet what $60 oil or $70 oil will do to Wal-Mart's own business plan, since so much of it is based on gasoline?

David Poppe:

We had $60 oil last year. We had $3 a gallon gasoline last summer as well, and Wal-Mart's comps have been in the 2% to 3% range with oil at that level. I think there's not really any terrible change. I think if oil went to $80 or $90 a barrel, then you would have another leg down, I guess, in terms of the overall health of the business. Wal-Mart is an extremely efficient company. I think it is working on ways to improve the fuel mileage of its fleet of trucks, which it runs pretty hard. I think Wal-Mart is working on ways to be more efficient on how many times per day it delivers goods to the stores. Wal-Mart is pretty good at all that stuff, better at doing it than I am at talking about it.

Then I think everybody is trying to pass on some of the cost. You do have some inflation that you have to pass on as fuel prices go up. But in terms of the effect on the consumer, we had oil roughly at this level a year ago, and Wal-Mart had weakish sales. I would expect the same thing this year, if oil stays at this price.

Question:

Can you comment on how your philosophy may have evolved over time regarding owning companies that are trading near their fair value or above their fair value.

Bob Goldfarb:

I think what we've said before is that with regard to outstanding companies with a lot of room to grow at rapid rates for a long period of time that we would sell them if the price became obscene. Unfortunately, despite what Supreme Court Justice Potter Stuart said, it's not as easy to know that a stock price is obscene when you see it as it is in other areas.

Question:

A number of years ago, Bob, at the time that Reg. FD had just been passed I asked what you thought about it. My recollection of what you said was that it was going to make your business harder, but that it was a good thing in general for the body politic. What do you think about FD now after living with it?

Bob Goldfarb:

I would say that it's affected us less adversely than most other professional investors because generally the disclosures that are no longer permitted are about short term outlooks. We've never bought or sold a company because of its short term outlook. So I think to that extent, Reg. D may be of some slight competitive advantage to us relative to other institutional investors, but it's not huge.

Question:

What are you thinking now about investing in foreign companies?

Bob Goldfarb:

We're always looking. The rules are different. In fact, Porsche is our only foreign stock in Sequoia, or company that's domiciled abroad — a fair percentage of its sales is in the United States. There's no Reg. FD in Germany; so that means that there can be selective disclosures. Porsche publishes financials twice a year rather than quarterly, etc. I think probably we would want a discount. If two comparable companies were available at the same price, and one was domiciled in France and one was domiciled in the United States, I think we'd pick the one that was domiciled in the United States. If the one in France were selling at 10% cheaper, then I think the equation and the decision would change.

Question:

I have two questions. The first is how quickly and completely has Mohawk been able to pass through the increased costs of its raw materials? The second question is would you please comment about the elimination of Harley-Davidson from the portfolio?

Terence Paré:

There are a couple of moving parts about Mohawk involving price increases. It makes it a little bit tricky if you're watching just the top line. Generally it takes about nine months to move the price increase from the manufacturer all the way through to the retailer. But when the price gets to the retailer, he's going to make adjustments in the products that he sells to his customers. Retailers like to hit certain price points, and so they tend to maybe sell a cheaper, lighter weight of carpet, so that they can hit the same price at retail. So the price increases, in other words, don't go through penny for penny at retail because the mix tends to shift to less expensive goods. But overall it takes about nine months or so.

David Poppe:

On Harley-Davidson, actually it used to be a much larger position a few years ago. We sold most of the position ... I want to say in 2001 or 2002. We had a little bit left, which we sold I guess in the last year. It is a great company, a tremendous brand. Harleys command significant premiums to other motorcycles in the market. Today, you could look at it and say the P/E is attractive. It's not expensive relative to its earnings or to its free cash flow. I think we got nervous early; so maybe we had foresight or maybe we were just nervous, but I think we did foresee some of the production issues that now people are more worried about.

The core issue with Harley is there is not a good replacement cycle for its motorcycles. What I mean by that is most people use them as toys. They get driven 3,000 or 4,000 miles per year, so they don't wear out. Harley needs to sell more bikes every year to make their profit goals, and it's very difficult to do that when you don't have older bikes coming out of the market at any kind of rapid rate at all. So we looked at it, and we were a little bit nervous that one day you might have a tipping point where everybody who needs or wants to own a Harley is going to have one, and the older bikes are not coming out of service. After ten years, your car is no good because you've driven it into the ground. So there's a natural replacement cycle. But a motorcycle ... we couldn't figure it out. We looked at it and thought a motorcycle could last 15, 20 or even more years if it was built well enough; so you wouldn't have a good replacement cycle over time. So I'm nervous today about Harley's ability to continue to raise production. But that said, it's a very good company, and they are very good brand managers. They may well figure it out.

Bob Goldfarb:

I think I saw something recently where dealers were offering incentives to consumers to purchase Harleys. This is peak season. Five years ago, at the same time of year, those dealers would have been charging premiums over MSRP. I think that says something about supply and demand at these levels of production.

Question:

I'm curious why you have so many big box stores and then Tiffany — how does it fit in?

David Poppe:

I like two kinds of companies. I like a commodity business where you have a demonstrably lower cost of doing business, and you're demonstrably more efficient than everybody else. I would put Costco and Wal-Mart in that category — they can deliver the product to you more efficiently than anybody else can, and essentially they are distribution companies with a lower cost of operation.

Then I like dominant franchises like Harley-Davidson, or Tiffany or IGT. They control the market, they in some cases are the market, and they can command a higher price from the consumer because people want to own that brand. I think Porsche would also fit there. Porsche, Tiffany, Harley-Davidson would all be of a piece, really. Tiffany certainly doesn't control the jewelry market, but at that high end, Tiffany really does dominate the market and it is able to command a higher price. We have friends in the jewelry business who lament that they can't get the same price for the same diamond that Tiffany can. That says something about the power of the brand.

Tiffany has its ups and downs, and I think last year I was a little bit critical of them, and I could still be critical of them on some little things around the edges. But the power of that brand is really amazing, and my guess is 40 years from now, people will still give their brides-to-be the Tiffany ring. That will still mean something to people, to own something that says Tiffany on it. It's a meaningful brand; people want to own it. They are willing to pay more for it. So we feel that it's a good business with terrifically sustainable earnings power.

Question:

Regarding Porsche, I would like to know how you view its buying 20%, roughly, of Volkswagen.

Greg Steinmetz:

We were surprised. There's no Reg. FD. Management could have told us, but didn't. It's always nice when you pick up the *Wall Street Journal* and you don't feel like eating breakfast anymore. But the truth is Porsche is run by just an extraordinary manager, Herr Dr. Wendelin Wiedeking. He has done just a marvelous job fixing Porsche. Now he and another Porsche executive, Herr Harter, are on the board of Volkswagen. Maybe they can work their magic over there. Porsche spent €3 billion so far. We were hoping to get that back in the form of repurchase. It didn't happen, but Porsche bought Volkswagen at around €50. Where is at now, Arman?

Arman Kline:

Porsche bought VW between €45 and €50 a share. It's over €50 now.

Greg Steinmetz:

So Porsche is making money on it for now. VW pays a dividend; it's going to be accretive to their earnings this year. Our concern is Porsche generates about a €1 billion a year in cash, and could keep buying stock in Volkswagen. Porsche still has an option to buy some more, although it's not going to be a big amount. But it doesn't seem necessary, now that Porsche has gotten its managers on the board. We have our fingers crossed. David?

David Poppe:

Volkswagen — we're not crazy about that investment, or we haven't been happy about it. However, Volkswagen is not like General Motors. I think a lot of people conflate them — they're not the same. Volkswagen makes a product that Europeans like to buy and like to own. Its market share is increasing in Europe, not decreasing in Europe. Volkswagen has some problems in North America, but all in all, the products are pretty good. The engineering is pretty good. VW has a lot of fat in the system, just like General Motors does, but it doesn't have nearly the same degree of financial distress. I don't believe that VW has the same level of long term commitments to the employees that GM does, although there are some similarities there. So Volkswagen is not as unhealthy as General Motors by a long stretch.

I do think Volkswagen probably stands to benefit from some of the ideas that the Porsche people have because the Porsche people are really that good. It is a better company than Volkswagen. So if you are Volkswagen, any time you can import somebody like Dr. Wiedeking to help you with engineering and manufacturing ideas, that's probably for the good.

On the Reg. FD issue, German accounting I would describe as very strange. It requires you to do a little bit more work. At the end of the day, I think we came away feeling pretty confident. The Porsche income statement may not be all that meaningful, but the Porsche cash flow statement is pretty meaningful. If you look at the Porsche cash flow statement, at the end of the day, there's a lot of cash. We feel management is very honest even though the accounting is less forthcoming than American accounting. So I think we are pretty comfortable with what we own. I think we know what we own, even though it's a little more difficult to know what you own in Germany.

Bob Goldfarb:

I think also there's some element of payback. Porsche had gotten a pretty free ride from Volkswagen on the Cayenne, which was a huge success for Porsche, whereas the comparable model that it was based on, the Touareg, was not a success for Volkswagen. So there was probably some payback due, and we probably should have anticipated that possibility when we bought the stock.

Question:

Questions about two companies — one, Idexx, would you comment on the valuation; and on TJX, would you comment on fundamentals as well as valuation?

Arman Kline:

For those who don't know, the stock price of Idexx has been rising pretty fast. I think the main reason is that it's been gaining more and more coverage on the Street. People are becoming more and more familiar with the company. When we first looked at it a couple years ago, there were maybe two analysts who followed it. It's selling for about 30 times earnings now, which is obviously very rich. But as we've talked before, when you find a company like Idexx — and one thing we didn't really talk about before was that the management team there is quite young, and it's quite impressive — when you find a company like that in a growing industry with the market shares it has, you should hold onto it. It's hard to value it on just 12 months future earnings. You kind of have to look at Idexx for the long run. We feel pretty comfortable with the valuation here.

Bob Goldfarb:

I think there's clearly been some element of categorical, if you will, over-enthusiasm about small or mid-cap companies with fast growth rates like Fastenal, Idexx, and Expeditors, although the latter has gotten to a point where it's no longer ... it may be a big cap, because of the enthusiasm. At the same time, you have seen a fair degree of pessimism about the large cap companies such as Wal-Mart, Berkshire, General Electric, whatever.

That raises the question, should we be contrarian and sell the ones where there's over-enthusiasm and put the proceeds in the ones where there is under-enthusiasm. It's a fair question that we think about all the time. I presented it categorically, but we don't think about it categorically. We think about it individually.

David Poppe:

You asked about TJX. I'm the primary analyst on TJX, and I made some mistakes that were pretty easy mistakes, in retrospect. I think I really underestimated the importance of a deep management team. When you're thin at the top, and you are trying to manage six different store concepts, which is what TJX has, you're going to have problems. I can just tell you, it was so clear to me that this was a possibility, and yet I didn't really allow for it. Of course, TJX did end up having problems. The company didn't have enough — to be blunt about it — enough talent at the top to manage all the different businesses it had

If you know TJX, it runs the Marshall's and TJ Maxx off-price stores in the US, but also Winners off-price stores in Canada. It has stores in Great Britain. It also has a lower-end newer concept called AJ Wright, which is like Marshall's, but for a clientele a rung or two down the ladder. Then it has a home fashion store called Home Goods. It bought another concept called Bob's. The company couldn't manage all these things, and the last couple of years have been very difficult, I think, as a result.

I guess the good news is the founder, Ben Cammarata, has come back in the last seven or eight months as CEO. And while the old CEO, Ted English, did a lot of good things, he was not open to the idea that the company needed to import some talent. It had gotten so large that it really needed to import some new people. It's a very — in a good way — an insular culture, where people get promoted up through the company. But the company just really wasn't willing to reexamine the need for some new blood and some new talent.

I think Ben has been very open with us and everybody else who visits with him. He needs to hire maybe a half a dozen senior level people over the next year, which really says something about how weak things had gotten at the top. Potentially the good news is that with Federated and May merging, there will be people looking for jobs; so there may be high level people out of the department store industry whom he will be able to hire. But it's a bad sign when you have to hire that many that quickly.

All that said, you think about selling TJX because you're unhappy with the management — it's not very expensive. Again, it's really quite dominant in its core business of buying the surplus merchandise from apparel vendors. Vendors really like having an outlet so that they can take gambles with their inventory and have enough supply in case they hit a big home run and have an outlet in case it doesn't work out as they expected.

TJX dominates that market. It is the buyer of choice for most of these large apparel vendors. The company still earns a pretty reasonable profit, and you have the possibility that if the company can import a half-dozen managers over time, it would be even stronger. But I would say fundamentally, TJX is performing reasonably well today. The next year will be important because I'm really curious to see what level of person TJX brings in.

Question:

What do you see in O'Reilly and AutoZone, and would you compare and contrast those two purchases?

John Harris:

I talked about AutoZone last year, I think. AutoZone was the first auto parts retailer that we bought, and we ended up selling it. Our concern was that ... I think what we found was that the auto parts retail business is a wonderful business for a lot of reasons. The stores are pretty spartan. The consumer is not expecting a fantastic store environment like you might find in a Tiffany or a Whole Foods.

Also, the consumer is largely unaware of the prices of the goods that he or she is buying. If I told you to go buy a box of cereal, you would have a pretty good idea of what to pay for it. If I told you to go buy an alternator for your car, you might not have a very good idea of what a good or bad deal is. So the retailer has unusual power over the consumer in that business. So for those two reasons and some others as well, it's an excellent business.

We were initially attracted to AutoZone because it is the dominant retailer in that business, and has been for awhile, and it was selling at a very, very low valuation. There was a management team there — still is, really, a chairman there, Eddie Lampert basically runs the company — and he was allocating capital in a very efficient way by buying the shares back, and it looked attractive.

I think our concern with AutoZone was just that the company was being managed for short term profit, potentially at the expense of its ability to generate profits over the next 5, 10, or 15 years. Since we like to hold for awhile, we don't like the idea of sacrificing the future for the present. So we bought it and then we sold it, and we did that in a very shrewd way so that we bought it I think at 85, sold it at 77, and then it went up to 90.

You can credit me for those skilled acrobatics. But along the way, we came across O'Reilly. Same business, excellent business. I think that we really liked the management team in O'Reilly. There was a real culture there. We are fond of businesses where there is a strong culture. It's probably the most — not just O'Reilly's but generally — under-appreciated source of competitive advantage, a strong culture, and O'Reilly has one. It is also in a unique position in that it sells half to commercial customers — these would be like body shops — and half to retail customers.

O'Reilly also sells to a certain kind of retail customer who tends to be less of a car novice and more of a car fanatic. He likes the particular kind of store environment you'll find in an O'Reilly, which is different from the environment that you might find at an AutoZone or at an Advance Auto Parts, which is the other big retailer. So O'Reilly has sort of carved out an interesting little niche for itself, and we've been very pleased with the way Greg Henslee, who is the new CEO there, but a long term manager of the company, has performed. I think Greg has really exceeded our expectations in his first year or so of running the company.

We bought it at a reasonable price. I was just saying to Bob the other day, I wish we had bought more. It has appreciated somewhat and it now sells for a higher P/E than it did when we purchased it, but probably not an unreasonable one, given its growth prospects. I think O'Reilly ... maybe it has 1,300 or 1,400 stores, and one of its competitors, NAPA, operates I think 6,000 stores. So there's potentially a long runway for O'Reilly, and we like the guys in charge and they are young. So I would imagine that if nothing material changes, we'll probably own it for a long time.

Question:

I would like to ask about Mohawk. I believe in the past year, the company bought a Belgian business that makes laminates. I'm curious about your opinion on that acquisition, and whether you think as a result Mohawk is overall a better business.

Terence Paré:

The quick answer is I think yes, overall we think Mohawk is a better business for having bought Unilin. Laminate flooring, for people who don't have to think about floors, is basically fiberboard that has a photograph of a surface attached to it. It can be made to look virtually like anything — wood, stone, ceramic — really whatever you can take a picture of. It is probably — in fact, it is — the fastest-growing kind of floor covering in the United States.

Unilin is also pretty interesting, because the product was invented by a Swedish company that never really thought to patent it. The Unilin company came along, and figured out a way to click the flooring pieces together. Under the previous technology, you glued laminate to the floor. As you can imagine, that was a messy thing to do, a pain in the neck, and could create all kinds of installation problems. But when the folks at Unilin figured out how to essentially turn laminate flooring into a giant jigsaw puzzle, the market for it took off. They did patent the technology for clicking the floors together. So the company was able to ride the surge in the purchase of laminate flooring in Europe, and it was collecting royalties from anybody who used their click system.

When Unilin came to the United States, it was very careful to carve out a niche in the high end of the market and it has essentially been riding the surge in laminate flooring in the US to the same extent. Mohawk did pay a pretty high price for the company, but it got proprietary technology, and a very fast growing business in the United States. It's probably mature in Europe, but in the US, last year I think it grew 15% in volume — that is, the laminate industry grew 15%. The floor covering business in general only grows about 3% a year; so that's pretty good.

The second thing about it that makes it attractive for Mohawk is that I think as most people have noticed over the years, less carpet is going into homes and more hard surfaces, one of those hard surfaces being laminate. The operating margins on carpet are significantly less than the operating margins on laminate. So for Mohawk, which has a very strong position in the carpet business, as the market shifts to laminate, their overall margin improves because while it may be selling less carpet — it's selling more laminate. The overall margin goes up.

The third thing about it that I think strengthens Mohawk overall is that it brings some very sophisticated research and technology into the company, which it hadn't had before. Obviously, there's the patent that I mentioned, but the guys at Unilin in Belgium have done a very good job of developing other products as well. That is going to help over the years both with the ceramic tile business, which Mohawk owns, but also with carpet. It gives them exposure to a whole other market in Europe for floor covering.

So overall, it was a little expensive, not as expensive as Dal-Tile, by the way, which has turned out to be very good. It's brought Mohawk good management; it's brought Mohawk a fine product and access to a growing market. And so I think overall, we're in better shape now than we were before Mohawk bought it.

Question:

Can you discuss why we don't own Ethan Allen anymore? It seems to me the management has done a very good job of responding to a difficult business environment.

David Poppe:

You're 100% correct. The management has done a terrific job responding to an extremely difficult business environment. We did sell it over the last year, and I think one could argue it was not a great sale. What I would say is we'd owned it for five years, and at that point the operating profit of Ethan Allen had gone down slightly over five years. I want to say from about $150 million to $140 million per year.

While the sales have subsequently turned, we did not see that, nor did any of our very good contacts in the field see that happening. The second thing that was really troubling to me about Ethan is that while the company's operating profit had gone down a little bit over five years, the independent dealers who own the stores and sell the product had seen their operating profit go down a lot. It's just part of the way the business worked. The retail margins they were able to command in the marketplace were not as good as they used to be. Ethan Allen had transferred some charges from the corporation to the dealers in some ways to make its own profitability, perhaps, look better than what it was.

So we saw a system — not just the company, but a system — that was significantly less profitable in 2005 than it had been in 2000. Also, we just felt furniture imports from China are not probably going to stop anytime soon. The deflation that a lot of companies are experiencing is not likely to get any better any time soon. Nevertheless, the stock had done really well because thankfully we had bought it for such a low price. We made a good return, or at least a reasonably good return on Ethan Allen despite the fact that the profit picture really wasn't very good.

The fact is, we're known as value people, but we want businesses that grow. I would say subsequently at Ethan Allen — because the management is very good and very disciplined and because it did have a lot of initiatives in place, which we knew about, but that started to take hold only relatively recently — the sales have gone up, and the earnings have gone up. I'm delighted for Ethan because I think it's a really great group of people. But I would also note that in 2006 the system-wide profitability will still be less than it was in 2000. It's a good company, but sometimes you have to make decisions that you're going to use your capital somewhere else.

Question:

I have two questions. The first question relates to Berkshire Hathaway. Obviously, Sequoia Fund has a very low basis in Berkshire Hathaway. What influence does this low basis have on the decision to hold Berkshire for so many years through thick and thin? My second question relates to Mohawk. I'm reading in the paper a lot about the expected changes in the housing market as a result of interest rates going up and having gone up. What effect do you anticipate that will have on the sales of Mohawk?

Bob Goldfarb:

I'll tackle the first question, and then let Terence address the second. We do have in-kind redemptions, as we've tried to make everybody very aware of. We have used Berkshire occasionally in those distributions, which are essentially tax-free and don't create tax liability for the taxable shareholders. If we were to receive additional in-kind redemptions, we have the option of distributing Berkshire and reducing our position in a tax-efficient manner. But tax efficiency isn't everything, and the decision on an in-kind redemption is always going to be a combination of valuation, which should be the dog, and tax efficiency, which should be the tail. Terence, you want to respond to Mohawk?

Terence Pare:

It's pretty clear that if housing starts go down, it's not good for Mohawk. But it's not terrible for Mohawk either. Only about 15% of sales from the company go into the new residential construction market. So even if it drops — now it is supposed to be under two million units this year, and that's a significant decline — it won't help, but it's not going to kill them.

I should have mentioned this before about Unilin, and that is that a significant portion of Unilin's sales are remodeling sales.

Remodeling sales can do okay, even if housing starts and existing home sales aren't doing well. So in a way, that's yet another advantage Mohawk got from buying the laminate company. Often, if people don't move, they decide, "I'm going to fix up the house that I'm living in. I'll either change the carpet or I'll redo the bathrooms," or in this case with laminate, "I think I will put in some laminate flooring." So the overall demand picture isn't as positive, given the weakness in the housing market, but Mohawk will do all right — just not as well as it would if we were going to do two million units of new housing.

Question:

Just to follow up on Mohawk — Bob, earlier you said that if the inflation environment gets worse, that on balance it would be negative for Mohawk. Is that because of the nine-month lag time in their prices catching up with their increased raw materials? Or is it that at some point Mohawk is going to run into some brick wall in terms of increasing its prices? Then secondly, how much of a runway is there for Mohawk? What is your longer-term thinking is on the company.

Bob Goldfarb:

Sure. All I was trying to suggest is that if oil went to $100, the incremental working capital that would be required would be even greater than what was required last year when oil went into the sixties.

Terence Paré:

It's kind of interesting that even though the carpet business has seen its costs rise over the past two years more frequently and at a faster rate than probably any time in its history, carpet still remains absolutely the most economical way to cover a floor. It's about $1.35 a square foot to have carpet installed, on average, compared to hardwood, for instance, which is about $7.35 a square foot, on average. So even with this dramatic increase in price, the carpet business still sells a very good economical product.

In terms of the secular trends and the long term runway, the flooring business isn't going to grow a heck of a lot faster than overall economies will. Mohawk already has a large share in carpet in the US, an absolutely dominant share in ceramic tile, and a growing share in laminate products in the US. So with the exceptions of this product and the mix shift into laminates and ceramic tile, Mohawk's overall growth in the US is limited by the growth of the market. However, Unilin does give the company access to and business in Europe. And the floor covering business there is kind of interesting. There are probably growth possibilities there for the company, although I don't think we'll see any acquisitions or dramatic actions taken by the company any time in the near future. The company took on a lot of debt to buy Unilin, and management will certainly work that down.

All that said, it's pretty clear that this is not a fast-growing industry. That is one of the reasons why it's important to have intelligent management with an ownership stake. We've seen over the years that it's one thing to make a lot of money in a business. The problem for an investor comes with what you do with the money you make. There's a tendency on the part of companies when they reach the end of the obvious road to go seeking after strange gods and try new businesses. Mohawk's management has shown good discipline in putting its excess capital to work, either by repurchasing shares or making intelligent acquisitions.

So although the runway isn't as long for Mohawk as I would say it is for maybe Fastenal, because Mohawk's management has shown such intelligence in what it does with its excess capital, I think we're pretty confident that on a per share basis the value of the company will do just fine.

Bob Goldfarb:

We only have time for one last question

Question:

Recently, a lot of value-oriented money managers have loaded up with large cap stocks that might be selling for slightly below market multiple. They seem very optimistic about their return over the next five years, yet you haven't load up. Can you discuss your reason for not doing that?

Bob Goldfarb:

I think I alluded to that earlier when I contrasted the valuations of the Expeditors, the Fastenals, and the Idexxes of the world with the

Wal-Marts, the General Electrics, etc. As I said, it's something we might do, and we've done some of that. I think Wal-Mart is an example, and we may do more of it. But again, as I said, we'll do it on an individual basis, rather than a group. We won't make a decision that we're going to allocate a third of Sequoia or whatever percentage of Sequoia to these large cap companies that have been successful. It's going to be stock by stock, company by company.

Question:

I think they are doing it stock by stock, company by company. But maybe besides Wal-Mart, you haven't really found anything or committed to anything. Besides Wal-Mart, you seem to not have committed to anything like a GE or McDonalds or Dell, or whatever else these guys are buying.

Bob Goldfarb:

Berkshire happens to be in that class; it's got a pretty large market cap. As was pointed out earlier, it's one of those companies. What Berkshire has in common with a lot of the companies you're discussing is that earnings have grown quite a bit, but the stock has not appreciated in tandem at all. So we have a fair amount of our money in these situations, but a lot of it happens to be in one, Berkshire Hathaway.

There are opportunities in the area, but we are 95.6% invested. I don't know if we've mentioned that today. But I don't remember sitting up here when the percentage invested was higher than that in many, many years. So we would probably also have to decide on what to sell before we make any changes.

I'd say we might be a little less sensitive to capitalizing on short term valuation differentials in companies or groups. If you have a very long term horizon, if you think in terms of ten years, that gap that you're talking about — it's going to help you, but it's not going to help you as much as it might over a shorter period of time. With that, we'll conclude the formal meeting.