Important Disclosure about this Client Letter:

Semper Augustus Investments Group, LLC is an independent SEC registered investment advisor. The firm claims compliance with the Global Investment Performance Standards (GIPS) and prepares a Semper Augustus Total Return Composite of its institutional and individual client portfolios. At the time of this letter, Semper Augustus had not claimed compliance. Any references to performance in this letter is as it was presented at the time of publication. Do not rely on performance or performance language contained herein. The firm maintains a complete list and description of composites, which is available upon request. Policies for valuing portfolios, calculating performance and preparing compliant presentations are available upon request. A copy of Semper Augustus Investments Group LLC's Total Return Composite can be obtained by contacting Semper Augustus at (303) 893-1214 or at csc@semperaugustus.com. The Total Return Composite can also be found at www.semperaugustus.com.

SEMPER AUGUSTUS
Investments Group LLC

2004 Year End Client Letter

In This Letter:

- Headwinds p. 2
- Advantages vs. the S&P 500 p. 4
- Active Management p. 4
- Size and Concentration p. 5
- Valuation p. 7
- Growth p. 9
- Profitability p.10
- Dividend Income p.11
- Quality of Earnings p.12
- Leverage p.14
- Turnover p.15
- Management Compensation p.17
- Expected Returns p.18
- Mutual Fund Marketing p.19
- Conclusion p.20

Clients and Friends:

It has come to our attention that past annual letters may have typecast us as market strategists or economists. Contorting the words of the inimitable Charlie Munger, we would rather throw a viper down our shirtfronts than be labeled as such. The preponderance of our investment effort centers on the analysis and appraisal of businesses. We are investors – stock pickers and allocators of capital. We use an understanding of the macroeconomic climate to illustrate our process for selecting individual investments and to frame the environment in which we deploy capital. In essence, we invest in the micro but worry in the macro.

In past client letters, we ritualistically updated our ten-year projection for the S&P 500 based on growth rates, normalization of P/E multiples and after-tax profit margins, and in elaborate detail presented the accounting adjustments we make for the index. We discussed our dual margin of safety, Graham and Dodd approach to investing and in general terms have highlighted our advantages versus the index and against the aggregate investor. This year, we are shifting gears. **In this letter we break down our equity portfolio and lay out a series of ten detailed advantages, both quantifiable and qualitative, against the S&P 500.** Clients retain us to grow capital and to preserve capital. For too many investors, the charge to grow it and to protect it is incongruous. For us, growth and preservation of capital is at the bedrock of our investing principles. Conventionally, risk is assumed with the hope -- often dashed -- of earning high returns. We believe high returns are attainable at low levels of risk.

Semper Augustus' Investment Performance vs. the S&P 500
Annual Percentage Change

Year	SAI Equity Securities Only (1)	SAI Full Portfolio Composite (2)	S&P 500 Total Return (3)	Relative Results (1)-(3)	Relative Results (2)-(3)
1999	24.9%	9.7%	21.0%	3.9%	(11.3) %
2000	33.6	21.6	(9.0)	42.6	30.6
2001	23.6	15.8	(11.8)	35.4	27.6
2002	(21.0)	(9.1)	(22.1)	1.1	13.0
2003	38.7	13.5	28.7	10.0	(15.2)
2004	14.4	6.9	10.9	3.5	(4.0)
Average Annual Gain (1999-2004)	17.2%	9.3%	1.3%	15.9%	8.0%
Overall Gain (1999-2004)	158.5%	70.2%	7.8%	150.7%	62.4%

Notes: SAI results are gross of management fees and taxes, but inclusive of trading costs and commissions paid. SAI published fee of 1.25% would reduce the annual return by 1.25% per year (average annual and overall gain for the full portfolio would have been 8.0% and 58.8%, respectively, for the six-year period presented). SAI has clients that pay less than the standard fee and certain performance accounts may pay more than the standard fee.

The S&P 500 returns are gross of any fees required to replicate the index and are also pretax. The index is theoretically passive (unmanaged) but in reality, replication requires trading costs and some management fees.

Please refer to the entire disclaimer located at the end of our letter.

The table on page one updates our composite performance (average client returns) for each of the past six years. The bottom portion of the table presents our cumulative results, reflected as both average annual gain and cumulative overall gain. The results for our equity securities only and for our average full portfolio are compared to the results of the total return from the S&P 500.

For the sixth straight year our stocks outperformed the S&P 500. Our stocks outpaced the index in every year since founding Semper Augustus. We do not count on beating the index every year, however, nor can the results generated by our stocks alone indicate aggregate results earned by all of our clients. While our equity returns have been gratifying, in three of these six years our inability to be fully invested in stocks and our allocation to cash and short term fixed income kept full portfolio results under the index. Last year proved no exception. Further, new clients over the last couple years are really underinvested, as building new portfolios of stocks in a generally overvalued climate has proven difficult.

Our annual composite gain in our stock portfolios last year was 14.4%. The S&P 500 increased 10.9% on a total return basis. For the second straight year, our equity outperformance was not enough to overcome our allocation away from stocks. Our typical client, for most of whom we manage all of or the vast majority of their financial assets, earned 6.9%. Many of our clients do not fit a profile warranting full or high long-term commitments to stocks. Clients with higher allocations to our equities have earned higher returns over the past six years (except for 2002, when our stocks declined and our cash and bonds helped results). Recognize that in a year when our stocks significantly outperform our cash and bonds, the majority of our clients with more conservative allocation profiles will necessarily drag down our fully invested composite performance. Regardless, all of our clients remain underallocated to equities relative to where we would like to be. We simply can't find enough terrific companies trading at reasonable prices.

Our stocks held during the year generally increased in price faster than the underlying businesses gained in value. The appreciation in stock prices warranted reducing and even eliminating a handful of positions. We sold our entire positions in Stein Mart and in Watts Water Technologies during the year, both at sizable gains. The combination of appreciation plus the fact that we added to some holdings and initiated a substantial position in a special situation saw our allocation to stocks rise over the course of the year.

Despite the increase in our allocation to equities during the year, we won't apologize for remaining not fully invested. If we can't find sufficient or adequate homes for capital, we won't deploy it. We won't risk capital if the downside risk equals or exceeds the upside reward, on a probability adjusted basis. Annualized returns would have been closer to our equity only returns of 17.2% as opposed to our full composite gains of 9.3% if our allocations for ALL of our clients had been higher over the past six years, though we are content with our present posture. The current climate is without a question the most difficult in our near decade and a half investing capital. Given our more than cursory study of the history of the capital markets, we can't imagine a much more difficult environment than the present. Perhaps Japan in the late 1980's, though debt offered an attractive alternative to stocks. Perhaps the U.S. equity market in 1929 or commodity markets at various peaks, like gold in the early 1980's. Most stocks and securities we evaluate today are at a minimum fully valued.

In addition, the ownership of cash equivalents and fixed income securities at levels higher than we prefer has not been all bad. Only next to our exceptional equity results has our allocation hurt. Indeed, over the past six years, fixed income and cash have both left the S&P 500 in the dust. Over six years, U.S. Treasury Bills (a proxy for cash equivalents) have earned 3.0% per year and 19.1% cumulative, while the S&P 500 is barely positive, at 1.3% per year and 7.8% cumulative. Fixed income returns have been even higher than T-Bills.

HEADWINDS

We devote the majority of this year's letter to an analysis of our stock portfolio and advantages we believe we enjoy versus the broad market, which we find quite expensive and at risk. Before we begin with our analysis, though, we first can't let a year pass without addressing some of the headwinds blowing cold against the markets. We suppose the next couple years could get pretty nasty. Consider:

- Profit margins are at peak levels by any measure. If Wall Street targets for operating profits bear out for 2005, we will see the second highest level of after-tax profit margins ever recorded at 8.6%. Only 1929's 9.0% margins were recorded higher.

- P/E multiples are at the high end of historic levels. The average stock is probably more overvalued than at any time. The median P/E multiple on the Value Line has risen from 13.0 at the "market peak" in March 2000 to 20.5 at year-end 2004. Multiple expansion alone accounted for gains of nearly 60% for the "value" managers from 2000 to 2004, present company included.

- A combination of peak margins and high P/E's has proven unsustainable throughout history. Subsequent declines in margins and multiples have destroyed vast wealth.

- As Chairman Greenspan has telegraphed, interest rates are on the rise, though at a "measured pace." Having provided the punchbowl in the first place, the Fed intends to slowly detoxify this cycles' carry traders. Evidently, unwinding the tech bubble, Orange County, LTCM and the Asian contagion would have been less painful had these recent excesses been slowly bled to death. Whether the central bank runs or walks will not deaden the pain as too-leveraged households and financial institutions learn about the dangers of floating rate debt.

- Fiscal policy is no longer incrementally accommodative. Successfully reelected and comfortable at both ends of Pennsylvania Avenue, the White House and Congress, neither known for tightness with the purse strings, must deal with outsized budget deficits. The first two years of a President's term often coincide with weak and volatile stock markets. Washington's take of GDP is at decades lows and poised to grow. As taxes eventually consume more output, margins and consumer spending surely must slow.

- Household debt cannot grow faster than the economy forever. In the wake of the Fed's response to the fallout from having pricked the stock market bubble, low rates caused housing prices and leverage to grow considerably faster than personal incomes over the past four years. In fact, household leverage has outpaced personal income for over two decades. The global economy is hitched to the propensity of U.S. households to increase consumption. If the consumer slows, well...let's not think about that.

- Nearly half of residential mortgages initiated in the past four years are variable in some fashion. The standard margin on the typical adjustable rate mortgage is 2.75% above a benchmark rate, such as one-year Treasury bills or one-year LIBOR. When the interest rate adjusts and begins floating, many homeowners will see their mortgage payments rise by one-third to one-half or more.

- Despite prices up 9% annually, homeowners' equity has failed to increase above 55%. Low down payments and cash out refinancing have kept homeowners' equity at an all time low. A decline in national prices may pinch household net worth, particularly for recent buyers who bought too much house and financed their purchases on a floating basis.

- Margin debt on stocks has returned to the fore, representing 1.4% of aggregate stock market capitalization. Leverage in the bond market carry trade is much more troublesome, dwarfing that directly tied to stocks.

- The much covered and little understood trade and current account imbalances merit concern. Secular downward pressure on the U.S. currency, susceptible to capital repatriation, is a real risk. (Though with Europeans and Asians holiday shopping in New York and buying our real estate, the dollar may strengthen for a spell – after all, mightn't consumers be better arbiters of purchasing power parity than currency speculators?) The level of foreign ownership of total U.S. debt boggles the mind.

- Total credit market debt marches upward, now at 320% of GDP. Each dollar gain in GDP requires an increasing multiple of debt. We mention this relationship every year and contemplate how badly it will end.

- Liquidity in stock funds and pension funds has been spent down to levels seen at the market peak in 2000 – except for the few like-minded value managers allowed to store dry powder, ammo for the next battle, who lament their inability to spend money!

ADVANTAGES VERSUS THE S&P 500

Below, we contrast a series of portfolio characteristics, broken down into ten advantages, of our composite equity portfolio against the S&P 500. The index captures over two thirds of the market capitalization of the entire U.S. stock market and is most representative of the overall market. In each of our last two letters we restated Warren Buffett's sentiment toward gauging investment success. We again mirror his regard,

> *Whether we do a good job or a poor job is to be measured against the general experience in securities. We initially used the Dow Jones Industrials as our benchmark but shifted to the S&P 500 when that index became more widely used. Some people disagree with our focus on relative figures arguing that 'you can't eat relative performance.' But if you expect--as Charlie Munger, Berkshire's Vice Chairman, and I do--that owning the S&P 500 will produce reasonably satisfactory results over time, it follows that, for long-term investors, gaining small advantages annually over that index must prove rewarding. Just as you can eat well throughout the year if you own a profitable, but highly seasonal, business such as See's (which loses considerable money during summer months) so, too, can you regularly feast on investment returns that beat the averages, however variable the absolute numbers may be.*

If we can't demonstrate sustainable advantages versus the index, a viable alternative to our active management would be investment in lower cost passive index vehicles. Given that the vast majority of active managers lag the index over time, especially when fees and transaction costs are considered, are we delusional in our confidence? Read on and decide.

ADVANTAGE 1: ACTIVE MANAGEMENT

A running debate persists in investment circles as to whether active money management is superior to passive or index investing. For the vast majority of investors who attempt the active route, they would probably be better off in a low cost, passive environment. For a handful of investors wired with a Graham and Dodd orientation, a skeptical and contrary disposition, more than a modicum patience and an appreciation of the costly effects of investment costs and taxes, the active approach has proved rewarding over the years. We believe we possess those tools required to outperform the passive broad index over many years. We believe our advantages are sufficiently wide to justify the higher management fees associated with an active approach. We invest our own money alongside yours.

If we thought passive investing held superior prospects, then we would change our approach. We vehemently disagree with the Modern Portfolio Theorists, who maintain markets are so efficient as to eliminate the likelihood of long-term outperformance. These academics only attribute consistent long-term superior performance to a fluky aberration.

A disciplined value oriented approach to deploying capital yields not only higher expected returns but also comes with lower risk – risk defined not as volatility but as permanent loss of capital. We don't measure beta, alpha, or the covariance of our stock holdings against some irrelevant matter. We pay no heed to the day-to-day volatility of our portfolio, and actually prefer the prices of our stocks drop and drop until our portfolios are full up.

We chuckle that the CFA Institute (CFAI), formerly known as the Association for Investment Management and Research, presented its highest honor, the Award for Professional Excellence to its first three recipients: Sir John Templeton, Warren Buffett and John Neff, three of the best "active" investors of all time and all non-subscribers to the academic approach. The CFAI still advocates the Efficient Market Hypothesis and other such nonsense as its core body of knowledge. Further, the father of Security Analysis, Benjamin Graham, a name revered among value investors, is seldom taught (or even mentioned) at most business schools. Graham's two seminal works, *The Intelligent Investor* and *Security Analysis*, are undoubtedly the greatest investment books ever written.

ADVANTAGE 2: SIZE AND CONCENTRATION

We believe our relatively small size in terms of our assets under management and our concentration of investments in a manageable number of securities combine to give us a significant advantage versus the S&P 500 as well as against our competitors, perhaps even against those whom we admire.

We ended the year with 24 stocks in our core equity portfolio. Newer clients have fewer names. Compare that with the obvious 500 in the S&P 500. After nearly 15 years managing money, we have learned that great investment ideas don't come along very often. When they do, they need to be bought in enough size to have a material impact on a portfolio. What good does a great idea have if it represents a single name in a 500 stock portfolio? Even a 1% portfolio position cannot have much of an impact.

We generally expect most stocks in our portfolio to double in value over fewer than seven years, including reinvestment of dividends. If we were forced to own all of the stocks in the index, we would certainly not have that expectation for each of the stocks in the index.

The top ten names in our equity portfolio make up over 70% of the equity portfolio. Assuredly, our performance will be driven by these ten stocks much more so than the S&P 500 will be impacted by its top ten, representing a far lower 21.2% of the index. As the index is capitalization weighted, the top names do represent a disproportionate weighting. The top 50 names in the index, 26 more than in our entire portfolio, account for 50% of the index.

Of interest, the largest 50 companies in the index comprised a much larger 60% at the height of the bubble. In addition to the ridiculous tech, telecom and internet stocks, the largest index components held sway and were completely overvalued. The degree of excess paralleled that of the "Nifty Fifty" period in the early 1970's, a period marked by similar segregation between the haves and the have-nots – the exceptionally expensive and the exceedingly cheap. The earlier "Nifty Fifty" period ended badly, too.

Are the largest components in the index the most worthy of the next dollar of investment capital? As stocks outperform the index, their weightings necessarily increase, and they must therefore be bought in larger quantity. Often, this process mandates buying the most fundamentally expensive names at any given time. Microsoft achieved its highest weighting in the index at the end of 1999, when we wrote in our January 1, 2000 client letter that its shareholders would lose money for 15 years. At that time, Microsoft represented a gigantic 4.7% of the value of the index with its $620 billion market cap. The stock has since fallen over 50%, even including reinvestment of last year's special dividend. Its weighting has fallen to 2.5% of the index, which itself is still 20% below its March 2000 peak. At more than 60 times earnings and 11.5 times sales, The Coca-Cola Company nearly attained the number one spot in the index in 1998, some $120 billion and 55% percent ago.

While most are smaller than Microsoft (GE and Exxon Mobil are larger), the index components are still huge. The 450th largest component has a market cap of over $5 billion. By contrast, we own 14 companies (out of 24) with market caps below $5 billion. We own four with market values less than $1 billion. Our median market cap is $3.6 billion versus $10.6 billion for the index. Our largest holding by market cap (and fourth largest in the portfolio) is Berkshire Hathaway. Berkshire would not quite crack the top ten in the S&P 500 and comically has not even been awarded membership – probably better in keeping the passive money away anyway.

By the way, we have found more value recently with some big, big companies with jumbo-sized market caps. Many have been down in price for several years or have, at best, traded sideways while the underlying businesses have grown in value. In other words, the businesses are catching up with the stocks. Don't be surprised to see an 800-pound gorilla or two make an appearance in the portfolio.

At the core of our size advantage is our ability to buy much smaller companies and to buy them in size.

At the core of our size advantage is our ability to buy much smaller companies and to buy them in size. If we ballpark our targeted equity portfolio at a round $100 million, a 5% position equals $5 million. We can buy 5% of the outstanding shares of a company with a $100 million market cap. That level drills down to allow us access to the vast majority of publicly traded companies. Buying 5% of any company is never easy, but depending on the situation, can be manageable. Similarly, we can buy 0.5% of a company with a $1 billion market cap (about the 1,200th largest stock), or 0.05% of a $10 billion company – both immensely doable.

Compare our size advantage to a manager with $1 billion to invest in stocks. Still fairly small in size as far as managers go, the manager must either diversify more (own more stocks) or must move the minimum size threshold of companies buyable upwards. A 5% position equals $50 million, requiring the purchase of a controlling interest in a $100 million market cap company – nearly impossible. Even when buying a company with a $1 billion market cap the manager must buy 5% of the outstanding shares. Considering market impact (the degree to which buying or selling impacts the price) and the bid-ask spread, the larger the amount of money to deploy, the greater the impact.

The manager with less capital should enjoy some advantages, though may be handicapped in other areas. A manager with substantial assets under management will be paid more advisory fees. Higher fees may equate to a higher budget for research. A higher budget for research may add to idea generation or to quality of research, though we would have to be convinced of that.

While high fees are always nice, the larger asset base required for the higher fees can stifle performance. Forced to over-diversify or to limit the investable universe can handicap performance advantages. A smaller capital base keeps the universe of tradable names higher and may allow for optimal diversification. Less can be better.

We periodically review the holdings of various managers we admire. Regulations mandate transparency, requiring our mutual fund competitors and managers of assorted large pools of capital to disclose what they own and what they are buying and selling. Several managers similarly hold 20 to 40 names. Also, more than a few have closed their doors to new capital, an acknowledgment that too much capital may be unwieldy and a testament to the dearth of buyable names today.

Most of the funds we admire are run by managers with large amounts of capital to deploy. They all have wonderful records versus the market over most long-term periods. We wonder if they can continue to whip the market given their large asset bases. Success often becomes an anchor as new money comes rushing in. With larger bases, the new money becomes harder and harder to deploy.

Berkshire Hathaway, run by unequivocally the greatest investor ever, sits upon a mountain of capital to deploy. Mr. Buffett has overcome the need to over-diversify by buying entire businesses, both from private holders and outright purchases of public companies. To the extent he wants to buy shares in public companies, his universe is now severely limited. To invest 2% of Berkshire's equity now requires buying ALL of any company smaller than the 800th or so publicly traded domestic company. He would have to buy nearly 10% of the 300th largest company in the S&P 500, just to put 2% of Berkshire's increasingly liquid book value to work. Our expectations for Berkshire clearly decline as the capital base grows.

Whereas our investment in Berkshire has more than doubled since early 2000, our appraisal of the firm has nearly doubled as well. Even though we find the shares buyable today, Berkshire is not a stock to buy at any price (as with any investment). Our appraisal is considerably and conservatively higher than the current market price. The organic growth of the firm going forward is probably now no higher than high single digits. Accretion to fair value plus more modest business growth should produce a very good return going forward. If the shares were to trade at our estimate of fair value, our return expectations from that point would only be slightly better than average. We seek situations with high expected returns and modest risk. At a higher price, we would contemplate reducing or eliminating our investment in Berkshire. We like our holding in Berkshire. But we like our entire portfolio more, and our access to a huge universe containing the occasional great company at a reasonable price or the good company at a great price should yield rewards as we deploy capital.

Beyond the handful of investors we admire, how well can the behemoth fund complexes and monster institutional managers fare? We will never understand how a money management firm can invest, say, a half trillion dollars, and intelligently deploy it with an expectation of outperforming the market, in the aggregate. Charging very high fees on top of ridiculously high diversification and often high turnover cannot be a recipe for sustainable investment success. Simply, if we can't run circles around the mega managers, we will have done something wrong. In the investment world, bigger is not better.

Understand, it's uncomplicated for us to highlight our size advantage versus the index and even against our peers. We have never been burdened or saddled with too much money cascading in the front door! While we don't run around with sandwich boards emblazoned with advertising, we aren't entirely averse to working with a new client or two. At the point where we can't intelligently deploy the next dollar of capital, we'll be the first to let everyone know. While we appreciate the foresight, total forbearance may be a bit premature. Your author is not yet concerned that Reid the one-year old southpaw, with a veritable whip for an arm, might be throwing curveballs too early!

ADVANTAGE 3: VALUATION (PROBABLY OUR GREATEST ADVANTAGE)

They say the key to successful investing in real estate is location, location, location. We think the mantra for any type of successful investing must be price, price, price. Ben Graham wrote the following in his first edition of *Security Analysis* in 1934,

> *The price is an integral part of every complete judgment relating to securities. In the field of common stocks, the danger of paying the wrong price is almost as great as that of buying the wrong issue. The new-era theory of investment left price out of the reckoning, and this omission was productive of most disastrous consequences.*

Our portfolio of stocks trades at a discount to our conservative appraisal of fair value. Meanwhile, the S&P 500 trades at a sizable premium to our also conservative estimate of what the entire index should be worth. To quantify, our portfolio of stocks (excluding cash, fixed-income and options) trades at 84% of fair value. In other words, our stocks need to appreciate 19% (100/84) to reach our appraisal. Conversely, the index is valued at 165% of fair value. In price terms, the index needs to fall from its year end level of 1211 to our appraisal of 735, or 39.4%.

The requisite decline is not near as great as we projected at the market peak in March of 2000. Further, we do not presume the overvaluation must be rectified by a price decline. At nominal growth of 4% to 6% in GDP and corporate sales, it will take eight to twelve years for the fundamentals to catch up to the overvalued stocks. Reality probably falls somewhere between – a combination of falling stock prices and economic growth over a period of years. Below are our prior and current estimates of fair value since 1998 for the S&P 500:

	S&P 500	**SAI Fair Value**	**Requisite Decline**
2004	1211.92	735	(39.4%)
2003	1111.92	707	(36.4%)
2002	879.82	680	(22.7%)
2001	1148.08	655	(42.9%)
2000	1320.28	630	(52.3%)
1999	1469.25	606	(58.8%)
1998	1229.23	582	(52.7%)

Note the similar year-end index prices at 2004 and 1998. As our appraisal of fair value grows in line with economic growth, the requisite decline necessarily becomes smaller as time passes.

To arrive at our 735 estimate of the index's intrinsic worth, we continue to employ a 17 P/E multiple to a "normalized" after tax profit margin of 5%. A 1% inflation rate and nominal growth of 4% in GDP, sales, normalized profits and dividends results in the following over a 10-year stretch:

	Today	**2014**
GDP	$11.8 trillion	$17.5 trillion
S&P 500 sales	$8.0 trillion (865)	$11.8 trillion (1280)
S&P 500 profits (normalized)	$400.2 billion (43.25)	$592.4 billion (64.02)
S&P 500 dividends	$179.8 billion (19.43)	$266.1 billion (28.76)
S&P 500 fair value	$6.8 trillion (735)	$10.1 trillion (1088)
S&P 500 12/31/04 price	$11.2 trillion (1211.92)	

On a price basis, we now project the index needs to fall 1.1% annually to reach fair value ten years out. With a dividend yield of 1.6%, our estimate allows for a total return of positive 0.5% per year. And this just gets the market to a median valuation. By definition, to arrive at a median requires spending time on both sides.

At the March 2003 low, our calculation allowed for a 4.8% annual return. The market was closer to fair value than it had been it the prior eight years. If the market were at 735, our current appraisal of fair value, we would project annual index returns of 6.7% per year (4% price and 2.7% dividend yield).

Ironically, our valuation advantage versus the index is much smaller today than at the market peak in 2000. We have previously discussed the tiered nature of the markets in the late 1990's and into 2000. Since then, the undervalued segments increased dramatically while the ridiculously overpriced have fallen. The S&P 500 and NASDAQ remain 20% and 60% below their 2000 peaks, respectively. Meanwhile, the average stock, which had been significantly marked down for myriad reasons, has risen dramatically. The median P/E in the Value Line universe of stocks has moved up from a low 13.0 in March 2000 to 20.5 at year end. Our stocks were valued at roughly 60% of our appraised value at the peak, needing to rise 67% to be fairly priced. The S&P needed to fall nearly 60%. Given the wonderful gains in our stock portfolios and our good fortune to replace sold positions with new, undervalued stocks, we still enjoy a discount but that discount is much smaller today.

Given the wonderful gains in our stock portfolios and our good fortune to replace sold positions with new, undervalued stocks, we still enjoy a discount, but that discount is much smaller today.

The broad landscape is more expensive than we have ever seen it. Still, consider some yardsticks by which we measure value:

- Our stocks trade at a trailing P/E of 17.0 times GAAP profits versus 20.8 times for the index. We use median for our companies due to distortion of a few with reported losses.
- Our stocks trade at 14.2 times our normalized estimates of profits versus 19.0 times fairly aggressive (in our opinion) Wall Street consensus GAAP profits for the index.
- Using fully accounting adjusted profits (more on this later), our stocks trade at 15.1 times earnings versus 24.0 times for the index.
- Using a mean reverted after-tax profit margin of 5.0% for the index ($43.26 earnings on $865 of sales), the market trades at 28.0 times earnings as compared to 15.1 times for our portfolio's fully scrubbed, normalized profits.
- Reducing the index's mean reverted profits by our further accounting adjustments, the market trades at an unbelievable 61.0 times earnings.
- Our stocks are valued at 2.2 times book value versus 3.0 times for the index.
- We enjoy a 4.0% dividend yield, with a 48.3% weighted average payout ratio, versus 1.6%, with a 43.9% payout ratio (using either mean reverted or accounting adjusted profits) for the index.
- We estimate our companies will grow organically at 7.5%, despite a slightly higher payout ratio. We estimate slower growth in nominal GDP and for the companies comprising the index in a range of 4% to 6%, with a deflationary bias toward the low end of the range.

In short, our companies have a lower valuation, higher expected growth and provide significantly higher current income. At 84 cents on the dollar of fair value versus 165 cents on the dollar for the index, we could be substantially off with our estimates and still enjoy a margin of safety in our valuation advantage versus the index. We are not being forced to pay a high premium for high expected growth.

ADVANTAGE 4: GROWTH

We mentioned our growth projection for our portfolio companies above at a weighted average 7.5%. We believe eight of our 24 portfolio companies can grow at 10% or higher for a fairly long period of time, five to seven years. We own two companies with a growth target of 15%, the highest projection we use for any company. Use of higher estimates only brings trouble. We also own eight companies with lower growth forecasts between 4% and 5%. In several of these cases, the companies grow modestly and distribute the bulk of their profits to shareholders as dividends. For the remainder of the slow growth companies, we simply believe the stock price is low enough to warrant ownership. We are aware that "growth is good." If we are wrong in our price appraisal but the company grows enough over the years, the investment may work out. If we are wrong on the price and the company does not grow much or at all, time can be our enemy as our capital is tied up. In other words, growth can bail out slight overpayment. For low or no growth holdings, we expect the stock price to move up to some appraisal above current levels. These types of holdings always seem to give us grief. Are we learning?

We believe eight of our 24 portfolio companies can grow at 10% or higher for a fairly long period of time, five to seven years. We own two companies with a growth target of 15%, the highest projection we use for any company.

Wall Street forecasts of sustainable double-digit profit growth border on the insane. Profits cannot grow faster than sales and broad economic growth forever. Extrapolation of recent trends off a depressed based is a dangerous science. Considering 5.9% growth in S&P 500 GAAP profits over 77 years slightly trails GDP growth, consensus and strategist forecasts are again the product of fantasy. Most believe perpetual growth in profits over 10% annually is possible. We attempt to normalize profits such that sales and earnings forecasts parallel each other going forward. In that vein, we must make projections as to whether current profits are above or below normal or sustainable levels.

Given that profit margins are approaching a level only exceeded once in the last 100 years, we think index profits are more likely to decline over the next few years than to grow in line with Wall Street Projections. How many strategists dare project *negative growth in profits* over, say, the next five years? We are yet to find one. Wall Street expected consensus operating profits are $74 for the S&P 500 for 2005. If a 5% after tax margin implies profits at $43.60, how many years would profits need to grow to reach current forecasts? To spare the batteries on your calculator, over 13 years at 4% and a "mere" 9.25 years at the long-term average of 5.9%.

Given that profit margins are approaching a level only exceeded once in the last 100 years, we think index profits are more likely to decline over the next few years than to grow in line with Wall Street Projections

ADVANTAGE 5: PROFITABILITY

Profits are not easy to measure. They are certainly extremely difficult to project. We estimate profit margins of our industrial or non-financial companies relative to sales (16 of our 24 companies) at an "impressive" yet misleading 11.0%, especially when compared to Wall Street expectations for S&P profits of $74, which translates to an after tax profit margin of 8.5%. For perspective, profit margins for the index have ranged between 3% and 7% a full 90% of the time since 1900. On only four occasions have profits exceeded 7.0%, the highest being 1929 at 9.0%, with 2000 in the runner up position at 7.4%.

Our companies earn higher profit margins than the average or aggregate business, and therefore should be valued at a higher multiple to sales. Indeed, our companies are currently priced at 2.1 times our projection of next year's sales compared to 1.4 times sales for the S&P 500. At our appraisal of fair value, our companies would trade closer to 2.5 times sales while the index would trade at its' historic norm of 90% of sales, implying a drop of 35%.

So how could our companies earn such high margins? Is our profitability comparable to the S&P 500's? Essentially, margin analysis of a concentrated portfolio can produce deceiving results. We don't look at high margins as indicative of value or business quality. We happen to own a number of companies with high profit margins. For example, our second largest holding is Merck. We normalize Merck's after tax margin at 24%, before accounting adjustments, versus the high 20% level over the past decade (excluding Medco). In fact, we have projected margin declines for the entire branded drug industry for the past seven years. With a couple other drug stocks in the portfolio, a position in Diamond Offshore, which we sold early in 2005, and small positions in three mining companies, a handful of our companies enjoy extraordinarily high profit margins, driving the average margin of our portfolio upward versus the broad economy or the index.

We exclude our financial stocks and our single biotech position from our calculation of after-tax margins. Profits relative to sales are not a meaningful measure for these types of companies.

With such a large representation of financials in the S&P 500, we wondered in last year's letter whether profits to sales or even price to sales are reliable measurement tools. To solve our dilemma, we also look at margins of the S&P Industrials as well as U.S. aggregate profits relative to GDP as proxies for profitability. These measures confirm the same degree of overvaluation as our methodology for the S&P 500 does.

The best test of profitability is to measure return on capital employed and return on equity. Here, we can reliably measure the profitability of all companies in our portfolios, not just our industrials. Importantly, these are much better profitability gauges for evaluation of financial companies, and between them capture varying degrees of asset leverage. Our companies earn 12.3% on capital and 14.9% on equity, the difference between the two reflecting the modest leverage of our portfolio companies as a whole. The companies comprising the S&P 500 earned 20.9% on equity last year and have averaged 19.4% on equity for the last 25 years (Ned Davis Research). Book value or equity of the index is probably understated due to share repurchases above book value and to ongoing write-offs and write-downs, thus overstating return on equity. If full and proper accounting adjustments are made to profits and to equity, then the profitability of the firms in the index is clearly overstated.

ADVANTAGE 6: DIVIDEND INCOME

A full third of our companies do not pay dividends to shareholders. Despite this, our portfolio weighted dividend yield is 4.0% versus 1.6% for the S&P 500. Of our 16 dividend paying companies, only six bear dividend yields above the yield on the index. Our two business development corporations, one purchased below tangible book (actually below net cash at the time), are required to distribute nearly all profits. Merck yields 4.7%, given its' depressed price (in our opinion). We think a worst-case annual profit for Merck over the next few years is roughly $4 billion, even factoring in potential legal liabilities related to Vioxx and a handful of large patent expirations. Merck's current dividend totals $3.4 billion and seems safe. Looking forward, we don't think $6 billion in annual profits four or five years out is out of reach. The current market cap is $71 billion, before considering $7.6 billion in net cash and securities.

A couple other financials each yield roughly 3%. Having more than doubled in price over the past five years, our yield on cost for these positions is now north of 6%. We see no reason why these companies won't continue to compound profits, dividends, and net worth. We don't mind having to upgrade our assessment of fair value!

On a weighted average basis our companies distribute 48.3% of profits to shareholders as dividends. Our business development companies, who distribute nearly all profits to shareholders, skew this relatively high payout. On an equal weighted basis (not how the portfolio is invested), the payout ratio falls to 22.6%, leaving large amounts of profits for our managers to redeploy at attractive rates of return on reinvested capital. Most have reinvestment opportunities at the low to mid-teen percent return on capital level.

Most publicly traded companies do not reinvest their profits well and are poor capital allocators. They overpay for acquisitions; they overpay when repurchasing shares – often to offset option exercises; they overpay or overbuild on physical plant; they overpay their union laborers; and they overpay themselves! We think most companies waste capital in prodigious amounts. We have a Ned Davis Research chart, which shows total returns for dividend paying companies in the S&P 500 at 10.2% per year over the past 25 years. The chart also shows total returns from non-dividend paying companies in the index up only 4.4% per year. Wow!

Looked at another way, non-dividend paying companies have not even seen their shares even keep pace with growth in aggregate profits or in nominal GDP. The results lay bare the degree to which too many companies are capital destroyers. If we have any special talent at all, we think we are pretty good at identifying companies who can earn cash profits in excess of their cost of capital on a sustainable basis. Our simple dividend yield advantage versus the index is huge. To the extent our companies grow faster and earn high returns on reinvested capital, our advantage grows even larger.

The payout ratio for the S&P 500 depends on which earnings number is used. Begin with dividends of $19.41 on a trailing basis. Relative to next year's consensus operating earnings of $74.00, the payout ratio is 26.2%. Based on expected GAAP profits of $64.00, the payout ratio is 30.3%. If we shave consensus operating earnings of $74.00 by our accounting adjustments of approximately $23.41, adjusted profits are $50.59 and the payout ratio is 38.4%. Based on a 5% after-tax margin (our definition of normalized profits) of $43.26, the payout ratio is 44.9%. For the most drastic (and perhaps unthinkable) adjustment to profits, we would shave the 5% after-tax normalized earnings of $43.26 by our $23.41 accounting adjustments to arrive at $19.85. The payout ratio here climbs to 97.8%.

If non-dividend paying companies have seen 4.4% total returns over 25 years, is it inconceivable profits are overstated and managers redeploy profits badly? We have heard tell payout ratios are low and investors can expect outsized price gains going forward because of attractive reinvestment opportunities. Investors better hope so. We are non-believers. We think the puny dividend yield can be coupled with puny expected market gains for the average investor and for the index. We further believe payout ratios are actually quite high. First, the low payout ratio reflects high stock prices. Second and more importantly, the quality of earnings is poor and if accounted for properly, payout ratios are much higher than believed, perhaps encompassing a huge majority of true cash earnings. CFO's likely know this.

ADVANTAGE 7: QUALITY OF EARNINGS

The quality of earnings among our portfolio companies is substantially higher than in the S&P 500. We only have to shave our companies operating profits by 6.7%. By comparison, we eliminate a whopping 31.6% from S&P 500 consensus operating earnings for 2005. We reduce index profits by $222.5 billion or approximately $23.41 as against $74.00 in expected operating profits. Earnings quality gives us a significant advantage versus the index. Not all index companies push the accounting envelope. But a passive index buyer is forced to own the good, the bad and the ugly. Even the majority of active investors fail to properly account for profits properly. An owner of the S&P 500, or a similarly constructed portfolio, owns a shallow stream of massively overstated profits.

Our primary accounting adjustments are in the areas of compensation in the form of stock options, normalization of pension and OPEB accounting, and write-offs and write-downs.

Compensation as Stock Options

The first broad area of our adjustment process to earnings is in the area of options. Despite the trend toward adoption of expensing methodology (soon to be compulsory, though still phased in over time), the general failure to account for stock options as compensation expense results in significant overstatement of corporate profits. We assume if the companies comprising the S&P 500 accounted for option compensation properly, their profits would be lower by roughly $35 billion or $3.68 per share in 2005. Further, when employees exercise non-qualified options, their employers can claim as a credit the difference between the strike price and the exercise price of the option. This benefit totals roughly $20 billion, or $2.10 per share. Companies receive the credit against expenses that are not even treated as expenses! As our option cost is after-tax, to normalize, we must exclude the credit. The combination of failure to expense option compensation and our adjustment for tax credits reduces operating earnings (GAAP excluding write-offs) for the index by $55 billion, $5.78 per share for 2005. Expressed as a percentage of Wall Street operating profit forecasts, profits need to be shaved by 7.8%.

Compared to the index, we try to own more shareholder friendly businesses. Our companies grant far fewer option shares as a percentage of shares outstanding. We project the companies in the index will annually grant nearly 2% of their shares to employees, down from 2.5% at the bubble peak in 2000. Our companies will grant only 0.9%. Our companies have an option overhang of only 4.5% of shares outstanding. Where we revise S&P profits down by 7.8% for options, we only shave our companies' profits by 3.9%. With Warren Buffett as the patron saint of well-reasoned compensation, Berkshire grants no option shares to its employees. Two other of our businesses emulate Berkshire, also granting no option shares. Further, two of our companies have already adopted FAS 123, which charges at least a portion of option compensation against income. The standard has been somewhat slow to catch on, especially in Silicon Valley. Besides Berkshire, our companies with judicious use of options are often those with managements with large stakes already in their companies, generally bought outright or representing founder positions. Such companies include Diamond Offshore, IPC Reinsurance, Mercury General, and Washington Federal Savings.

Pension Accounting

Pension accounting represents the second big area of accounting adjustments we make. We have written about the abject failure of FAS 87, the aggression of companies and their advisors with pension assumptions, and the complicity of Congress in postponing the day of reckoning with short-term accounting breaks. Using a more conservative set of assumptions than companies employ, primarily a more reasonable rate of return assumption and more accelerated funding requirements, we reduce S&P 500 company profits by $75 billion, or $7.89 per share, 10.5% of Wall Street estimated profits for 2005. Conversely, we only need to shave our companies' profits by less than one-tenth of our index adjustment. We shave our portfolio companies operating profits by 1.1%.

How can our portfolio pension adjustment be so much lower than the adjustment for the S&P 500? For starters, 347, or almost 70% of the index members have defined benefit and / or "healthcare" liabilities established for their employees and retirees. The index itself includes the biggest and often the oldest companies in the country. These old firms traditionally offered pensions and more recently healthcare benefits to their retired workforces. By contrast, only ten of our 24 companies maintain plans, one of which froze its small plan years ago. More importantly, our companies with defined benefit and OPEB plans have much smaller plan assets, liabilities and ongoing funding requirements relative to the size of their operating businesses than do the index companies.

On average, our portfolio companies, with and without plans, have plan assets equal to 6.7% of shareholder equity and 28.9% of net income. Companies in the index (also with and without plans) have plan assets equal to 27.3% of book value and 258.6% of "normalized" net income. Most plans are underfunded, especially OPEB plans which are seldom funded (they are generally pay as you go, similar to Social Security – plans among the S&P 500 index companies have plan assets equal to roughly 15% of liabilities). The pension benefit obligation (PBO – or the present value of future liabilities) relative to the operations of the company is larger than plan assets relative to the size of the company. Our companies have PBO's equal to 9.0% of book value and 39.8% of net income. The index components have PBO's, including OPEB liabilities, equal to 41.6% of equity and 393.0% of after-tax net income.

Pensions are an increasing burden on sponsor companies and potentially on the U.S. taxpayer. Only 20% of publicly traded companies sponsor plans, but over half of the assets and liabilities rest with the 347 companies in the S&P 500 with plans. As active investors, we have the latitude to simply pass on companies with onerous retirement and healthcare liabilities. Index investors are compelled to own them all.

Merck is the company most burdened by pension and OPEB liabilities among our stocks. Yet compared to the average company in the S&P 500 with defined benefit plans, the burden on Merck is lower. Merck has plan assets, including its' half-funded OPEB liabilities, of $5.2 billion and liabilities of $6.9 billion. Its' combined plan assets total 30.2% of book value and 99.2% of net income. It's PBO and OPEB liabilities total 39.9% of equity and 130.9% of net income. By assuming Merck's plans will earn 4% annually on its investments, instead of their assumed 8.5%, and assuming they fully close their under funding over five years, we shave $354 million, $0.16 per share, from Merck's annual reported profits.

Our adjustment is serious, perhaps even too harsh, yet is a mere fraction of the pension adjustment required for various companies in the index with huge under funded plans relative to the size of the business. We believe the issue is so enormous that when properly considered, the value of some companies' shares can only be zero in a restructuring. Index holders are compelled to own these companies. Even many employees must own their own employers shares in their retirement plans. We have the luxury of simply passing.

Write-Offs and Write-Downs

Write-offs are the third and final area where we make considerable adjustments to operating earnings. Adjustments in this area are often a catch all, capturing many elements of aggressive presentation of corporate profitability. Whether a company improperly recognizes revenues, under reserves for warranties or for loan losses, or exits a business line and writes-down a plant, the end result typically results in some fashion of a write-off. Managements would have Wall Street believe that because these charges are against discontinued operations, or are non-recurring in nature, they should not be counted against corporate profits. The charges may even reflect decisions made by a prior management.

We believe restructuring charges from current operations and write-downs of depreciable, depletable and amortizable assets should be included in assessing ongoing profitability, despite the asynchronous nature of the charges. In essence, we attempt to capture the degree to which profits have been overstated in past periods, and incorporate that analysis in our projection of future "normalized" profitability. The process is far from easy and is purely subjective and assumption driven. We prefer estimating subjectivity to sticking our heads in the sand.

From 1984 to 2004, reported GAAP profits for the S&P 500 were $826 billion lower than operating earnings. Companies in the index took write-offs totaling 13% of their operating profits each year, on average. In 2004 alone, operating profits of $67.68 per share were reduced by $86.7 billion, or $9.13 per share. GAAP profits were 13.3% below operating profits, with the write-off total slightly worse than Wall Street analysts had projected a year ago.

On an ongoing basis, we acknowledge portions of charges against profits are not reflective of diminished profitability. For our index appraisal, we simply exclude 25% of rolling six-year restructuring charges to arrive at our "normalized" charge going forward. For 2005, we reduce S&P 500 operating estimates by $92.5 billion, $9.74 per share. The reduction shaves Wall Street's $74.00 target by 13.2%, which incidentally equals the average charge since 1984 (recognizing charges since 1998 have become regularly higher by historic standards – typically charges are higher immediately after recessions).

For our portfolio, our estimates are more precise. We analyze every charge against profits over several years to arrive at our best guess for annual write-downs or restructuring charges. Our approach attempts to calculate how much CASH our managements throw away on an annualized basis over time. At some level, if past profitability has been overstated through one-off restructuring charges, then our projections for future "normalized" profits take into account this diminution in earning power. Some write-offs overstate not only past profitability but allow for future profit overstatement. Smoothing, or big bath charges, can distort reported profitability. Our job is to ascertain how much reported profitability correlates to cash earning power over several years.

With our approach, we shave our portfolio companies' profits for write-offs by a modest 0.8%. We only assume seven of our 24 companies take distortive charges over time. We just don't own "serial restructurers." In a couple cases, we own manufacturers who have outsourced or moved all of their manufacturing operations abroad. While charges incurred to write-down plant and equipment are legitimate, we still recognize past profitability was probably overstated and perhaps depreciation schedules were too long. Compared to the more than 13% annual restructuring charges taken by component members of the S&P 500, our companies stack up quite well.

ADVANTAGE 8: LEVERAGE

Too much debt can be fatal. At a time when total credit market debt exceeds nominal GDP by more than a factor of three, and corporate debt is roughly equal to equity for the average company, our current portfolio companies are more under leveraged as a group than at any time since we began investing money.

Of the 24 companies we own today, a full 19 have net cash on their balance sheets, meaning cash and marketable securities exceed total debt. Of the five with net debt as opposed to net cash, three are financial companies. Thus four of our seven financial companies actually have net cash. Financial companies are generally leveraged, some frighteningly so. Twelve of our companies have net cash in excess of one full year's after-tax profits. Six of those have net cash in excess of three year's profits. At nine of our companies, net cash exceeds ten percent of current market capitalization.

We are conservative when assigning debt as part of our analysis. We place the entire underfunded pension liability on the debt side of the balance sheet, usually with an offset to equity (FAS 87 allows in cases an addition to intangible assets instead of an offset to equity).

Further, many companies have increased their use of operating leases. We generally capitalize operating leases, using a fairly consistent methodology. In the third edition of Ben Graham's Security Analysis, published in 1951, he noted, "The question of liability under long-term leases received very little attention from the financial world until its significance was brought home rudely in 1931 and 1932, when the high level of rentals assumed in the preceding

boom years proved intolerably burdensome to many merchandising companies." We observe too many companies in recent years attempting to mask the degree of leverage in their businesses with use of varying types of operating leases. Too few analysts pay heed to the leverage. We may be too conservative, but so be it. We sleep well.

While we are in no way averse to companies using leverage in their capital structures, we insist leverage not be excessive. On occasion in the past, we have been behind bad balance sheets. Fooling ourselves that everything that needed to go right would go right, we usually wished we hadn't placed our capital in such a predicament. Some companies *can* bear higher amounts of leverage, and we assess the durability of margin structures and of the core business when getting comfortable with more than modest leverage.

ADVANTAGE 9: TURNOVER

Surprise! The S&P 500 and its correspondent index funds are actively managed (as are other indices and index funds). Investors in index funds generally believe they own passive funds, which simply buy and hold a static portfolio over a period approaching eternity. Reality couldn't be further from the truth.

When index companies are acquired, enter bankruptcy, spin-off a subsidiary or are removed from the index for lack or representation or because they are simply "not U.S. companies" (as was the case with the S&P 500 in 2002), a void is created in the index. The void can be fairly described as a chasm. Over the 13 years ended 2004, the very active committee in charge of index composition at Standard & Poor's has deleted and added no fewer than 356 component members from the S&P 500. In other words, a full 71.2 percent of companies have been replaced in 13 short years. Whoa! While a majority of deletions are created because index companies are acquired, the committee has fairly broad latitude in coming up with its new component companies. We believe (though have not verified) the committee members are human. As such, they are subject to the same emotional behavior evidenced in herds during manias and are even susceptible to more simple biases during more "normal" times, when mere greed and fear hold sway over investors. During the heyday of the bubble, the bipolar committee replaced 48 index companies in 1998, 42 the following year, and a record 58 in 2000. At a time when the median P/E multiple for the average stock fell to under 15 times, the committee was adding companies with P/E's over 100 times like they were going out of style. Most did, eventually, go out of style. Some went out of business.

Along with the need to replace companies in the index come the commissions and frictional costs index funds must bear to buy the new positions and to sell outgoing ones. Further, as new investor cash is added to the funds and dividends are paid, the cash must be invested, also necessitating commissions and trading costs. As managers meet distributions to redeeming shareholders (it can happen), commissions must again be incurred. In a nutshell, the funds aren't free. Management fees, though nominal, coupled with trading costs and the taxes associated with turnover, are real costs borne by the passive fund shareholders. A new buyer of a fund is purchasing someone else's tax liability, assuming the fund has unrealized gains. Given higher than perceived turnover, these costs are not immaterial.

We are less reserved in our buying and selling of stocks than the august committee holding sway over the fortunes of index fund managers and investors. Annual turnover in our stock portfolios averages 15 to 25 percent. While higher than the turnover for the S&P 500, relative to most fund managers we can be accused of watching paint dry. Sometimes we go months without buying or selling a single share of stock. The reality is, when buying stocks at a discount to our conservative appraisals, the businesses come with warts – often newspaper headline issues which must be overcome before enough investor interest can be generated to drive the price back up to a more reasonable level. We have no idea when (or if at all) an undervalued position will appreciate to fair value. The process seems to take four to five years, on average, and is consistent with the experience of many great investors.

We had the good fortune to find a 1985 interview Kate Welling did with Walter Schloss in Barron's and a transcript from a speech Mr. Schloss gave at Grant's Interest Rate Observer Fall Investment Conference in 1999. Schloss, a Columbia student of and eventual associate of Ben Graham's (as was Buffett) posted one of the best cumulative investment track records of all time. In fact, had Warren not terminated his partnership and gained control of Berkshire as his "investment vehicle" which gave him the benefit of owning entire companies, particularly in insurance, at the holding company level, Walter's track record may have been better than the master's. (To the detriment of our free time, Columbia University School of Business' Heilbrunn Center for Graham and Dodd Investing created a website with a terrific and comprehensive compilation of articles by and about Ben Graham and Walter Schloss: www1.gsb.columbia.edu/valueinvesting) Both pieces referenced above can be found on the site.

When asked about his equity turnover over the years, Schloss replied,

> *I guess 20 or 25 percent a year. About every four years we turn over. We want to get long-term capital gains and when you buy a depressed company it's not going to go up right after you buy it, believe me. It'll go down. And therefore you have to wait a while for that thing to go around and it seems about, four years seems to be about the amount of time it takes. Some take longer.*

In our opinion, turnover of 15 to 25 percent is probably a good thing. When considering the investment track records of the greatest investors over many years, we draw one paramount conclusion, which is likely overlooked by students of the investment game. **The greatest investors have not been "growth" investors. The best investors, in all likelihood, did not own companies growing as fast as the investors' long-term investment results over time. In other words, they did not simply buy companies with 20% organic growth and hold those companies forever. Those situations rarely, if ever, exist.** We believe it was the ability to identify businesses trading for less than fair value, to buy those companies at a sufficient discount and, exerting discipline and patience, to eventually sell the positions when prices moved up close to appraised value. To the extent the process was repeatable, meaning the replacement of sold positions with new businesses trading at less than fair value, long-term track records were achieved. The investors who could identify growing businesses trading at less than fair value have fared well in the last 30 years, as the classic deep value situations favored by Ben Graham and by Walter Schloss and Warren Buffett in their early days disappeared. Those investors with the requisite skill set, to buy low -- *and to sell high* -- have posted the track records envied by the majority of operators in the equity markets over time.

We began 1999 with positions in 33 stocks, on average. By adding 46 new positions over time, we have owned positions in 79 total stocks. Of our 24 year-end positions, only three were initially owned in client portfolios when we founded the firm (some of the companies were pretty junky). We thus eliminated 30 of our 33 initial positions and 25 of our 46 subsequent purchases. Two of our positions are repeat performers, meaning we sold and repurchased the stocks – Mylan Labs and Diamond Offshore. Of the total positions eliminated, only eight were sold at a loss while the rest were up on a total return basis, with eight earning more than 100%. Among our current positions, five have earned more than 100% (Diamond Offshore was sold early in 2005, which marked the second time we booked more than a double in the stock). There's a lot to be said for minimizing mistakes. Risk management is an extremely important component to long-term investment success. Permanent losses of capital never help the cause.

All of the companies we sold at a loss either paid no dividend or had eliminated their dividend. Are we learning? Of the eight non-dividend paying companies in the portfolio today, we worry about seven of them more than any of the 16 dividend payers – Berkshire being the lone exception – We are learning – And the time spent writing this tree killer each year may have just paid off!

As we "churn" the portfolio, we believe we are buying at a discount to fair value and selling close to fair value. While we never expect to get the low tick when buying or the high tick when selling, the process is proven to work. We work hard to uncover value. The fact that we don't trade maniacally doesn't indicate sloth. As Buffett says, "Sometimes we're better off golfing." To the extent positions approach fair value (or even trade above fair value) and are sold, the key is to continuously discover undervalued situations. By keeping the quality high and the price to value low, the process becomes repeatable. Quite simple really. As long as we can identify sustainable competitive advantage, judge the character of management, identify when fundamentals deteriorate, understand business cycles and industry cycles within business cycles, approximate the degree to which regulation won't strangle profitability,

gauge the relationship between management and labor, identify changing levels of competitive forces, measure scarcity of inputs like raw materials and labor, feel shifts in macro supply and demand, and thoroughly understand complex accounting conventions and the use of estimates to exaggerate or misrepresent profitability. And oh yes, boil it all down to appraise the intrinsic worth of a business. And then have the patience for the short-term and intermediate term inefficiencies the market exhibits to send share prices down to a level below appraised value. And note, the price rarely gets cheap unless the enterprise faces either very real and / or perceived challenges. Our job is to reason the problems are only temporary. Also, because companies with problems (be they perceived or fatal) find their way into the headlines, and because investors read the headlines, we must also reassure clients and occasionally talk them off the ledge. And because some of our companies have eventually gone to zero (even if after we sold the position), the clients on the ledge can never be sure if we are really good, really lucky, or just plain dumb. Ideally, our long-term results continue to excel and fewer of our clients inch toward the ledge. Ideally. Realistically, we are all humans, equipped with a primordial core, which fluctuates between fear and greed.

The good news is, not only our clients are equipped with this core. The vast majority of market participants make emotional decisions. Fear and greed cause irrational behavior, allowing prices in the short term to occasionally get out of whack. So much for the Efficient Market Hypothesis.

ADVANTAGE 10: ASSESSMENT OF MANAGEMENT – COMPENSATION

In the area of executive compensation, our disadvantages relative to the S&P 500 may be as great as our advantages. Lucy the three-year old recently had an unpleasant (and sad for a helpless Dad to experience) bout with rotavirus. During the first round of expelling what ailed her, I asked her what was wrong. To my dismay, she exclaimed, “Daddy, I was reading your proxy statement for Mylan Labs and I got to the part about how much they pay themselves and my tummy started hurting.” While that may not be precisely how our conversation transpired, the reaction is not uncommon to proxy readers.

We look to executive compensation as an intangible indicator of the integrity of management. The problem is we believe most top executives of public companies are overpaid. We are proud of and proud to own a handful of companies with extremely reasonable, yet fair, compensation schemes. Excluding Warren Buffett, whose token $100,000 annual pay package is more a statement than a remuneration scheme, we own seven other companies where the top executive earns less than $1 million. We have no arbitrary quantifiable standard and many of our managers earning well in excess of $1 million earn every penny. Some don’t. It so happens that those commanding over $1 million a year stoke the interest of casual observers.

The best of our bunch of 24 companies in terms of executive compensation are Washington Federal and Mercury General. Roy Whitehead oversees the $7.2 billion in assets Washington Federal Savings and Loan and commands a reasonable $800,000 in annual compensation. Washington Federal should close their fiscal year with close to $1.2 billion in equity. The company earns a “normalized” 15 percent on a fairly underleveraged equity base. Whitehead’s counterparts and their lieutenants at similarly sized financial institutions often make multiples of the pay packages of Wash Fed’s top brass. Similarly, George Joseph takes home $1.4 million annually at the helm of Mercury General, which should net over $250 million this year. Perhaps the best-run auto insurer in the country, Mercury has always exhibited among the most reasonable compensation programs for its managers. While Mr. Joseph, the company founder, owns nearly 35% of the company (none acquired with options), similarly situated CEO’s would balk if offered the pedestrian compensation paid to the founder of the Los Angeles based insurer.

On the other side of the ledger, we often must hold our noses at the comp schemes of some of our companies. As mentioned earlier, Mylan Labs pays their officers as though they were multiple Cy Young award winners. We now own Mylan for the fourth time since the early 1990’s and have seen the company grow organically from $200 million in annual sales to nearly $1.3 billion today. Despite terrific growth and profitability, compensation has never been reasonable at the company. Bob Coury, Mylan’s Vice Chairman and CEO nabbed roughly $16 million over the past year. By contrast, Ray Gilmartin, team captain at Merck, makes a little more than half of what Bob Coury demands yet runs a company approximately 20 times as large.

In another case of imbalance, Paul Pressler at Gap gets $26 million where Jim Sinegal at Costco makes less than $1.8 million. In Pressler's case, his comp amounted to nearly 20% of Gap's profits last year while Sinegal's works out to less than 2% of Costco's. Go figure. And we own them all, the good and the ugly. It's love and hate.

Relative to the S&P 500, our hazard is this: We own smaller companies, on average, than those comprising the index. The demands of running any public company are huge. For smaller firms, the costs of executive compensation are necessarily higher relative to the size of the business than for larger firms – though with complicit consultants, growth in executive compensation at the biggest firms never seems to slow down. For example, assume Bob Coury at Mylan Labs made half of what Ray Gilmartin earns, instead of nearly twice as much. Coury's compensation relative to the annual sales, equity, and net income of Mylan would still be far greater than in comparison to Gilmartin's pay at Merck. Amplify this example for smaller and smaller companies and compensation simply becomes an unavoidable and costly issue, even for those firms with reasonable pay structures. Hence, compensation eats into the profits of our firms more than it does for the large components making up the index. That said, beyond a few abusers we choose to own, our portfolio companies are typically run by honest and fair managers with pay packages that are reasonable and not out of control.

ADD UP THE ADVANTAGES: EXPECTED RETURNS

Our comparative analysis suggests material advantages versus the S&P 500, and by extension, versus the aggregate investor. Recognizing we cannot predict the future and acknowledging we assess the intrinsic valuation of the S&P 500 only as a reference point, the following is an attempt to quantify our advantages. We have no idea what the market or the stocks in our portfolio will do in the short term. If the market declines over a period, it is not unreasonable to assume our stocks may decline as well. The degree to which our stocks advanced during the three-year market decline from 2000 to 2002 was likely aberrant. We are generally happy to stay close to the market during periods when it is rising rapidly but to trounce it during more difficult times.

The magnitude of our stocks' undervaluation, coupled with good prospects for our portfolio companies' outlooks, combine to give us a reasonably high expected return.

The magnitude of our stocks' undervaluation, coupled with good prospects for our portfolio companies' outlooks, combine to give us a reasonably high expected return. If we are roughly right on our appraisal for the S&P 500, then our advantages are significant. At 14.2 times our measure of normalized profits, our stocks have an earnings yield of 7%. We expect a combination of multiple expansion and margin expansion for the group. If our stocks can close the discount gap over a reasonable period of time and the businesses can grow at roughly our projections of growth, then our expected return for our stocks is in the high single digit to low double-digit range. Given our ten-year forecast for the S&P 500 of roughly zero, we hope to beat the market by perhaps as much as 10% per year. If our process is repeatable and we have the opportunity to replace sold positions at fair value with new undervalued positions, then our advantage may have durability. A 10% annual advantage is probably too much to expect over the long haul versus the index. The current market overvaluation relative to our portfolio's discounted valuation makes possible a sizable advantage for the foreseeable future, however. Time will certainly tell.

From a different perspective, using the earnings yield of the market is a good and simple way to peg projected returns. The earnings yield is the inverse of the P/E multiple. It measures profits as a percentage of current stock price. Using a 5% after-tax profit margin for the index, 2005 earnings will be $43.60 (versus $74.00 as forecast by Wall Street). At 1211, the market P/E is 27.8. The earnings yield is thus 3.6%. Add a market expected inflation rate of 3% to arrive at an expected long-term return of 6.6%.

If we use Wall Street's estimate of $74.00 in profits, which works out to 16.4 times a peak profit margin of 8.55%, the earnings yield is 6.1%. The earnings rate plus inflation, say 3%, would combine to provide a total return of 9.1%. For this best case to transpire profit margins would need to at least average today's nosebleed levels and P/E's would also need to at least average 16.4.

For our expected return from our stocks, we begin with our 7.0% earnings yield. With 3% inflation we get to 10.0% annually. Further, we expect our stocks to accrete to our fair value appraisal. At 84 cents on the dollar, we expect 19% appreciation. If we close the gap in year one, hallelujah. We would earn our earnings yield of 7.0% plus 19% accretion to generate a return of 26%. If our fair value gap closes over a more realistic five years, our annual accretion works out to 3.6% annually. Adding the accretion to our earnings yield plus inflation gets us to 13.6%. To the extent we can continue to uncover good businesses trading at a discount to appraised value and the process is repeatable, then using our earnings yield approach over many years, we think our advantage is somewhere in the 4.5% to 7% annual range.

If our companies close the fair value gap over a longer than expected ten year period, then we still can add 1.75% to our beginning earnings yield and inflation. Under this scenario, we would expect to earn 11.75% per year. In an even less optimistic light, if we have not underpaid for our companies and there is no fair value gap to close, then we are stuck with our 7.0% earnings yield and inflation.

The upshot to our advantage is our higher earnings yield relative to the S&P's. At 6.6% versus 3.6%, on a fully accounting adjusted basis for both, we are beginning with a 3.0% annual advantage. Coupled with our higher growth projection for our companies and our belief that Ben Graham's Mr. Market will continue to present us with opportunities, our return advantage may be quite large. If we are right on the market overvaluation and if our process works only reasonably well over the next decade, then failure to beat the index by a wide margin will cause disappointment. Our money is in there next to yours with high relative expectations. Now if we can only get Mr. Market to give us a few more ideas or larger discounts, we can get our sizable cash reserves put to work.

MUTUAL FUND MARKETING

During the heady days of double-digit gains in stock prices throughout the 1990's, marketing mutual fund performance was pretty straightforward. Every year seemed to be up, so the large fund complexes would typically selectively choose from among their best performing funds and advertise one, three, five and ten-year performance. When a fund fell behind, the big fund families always had different "winner" to showcase, given many funds in the family. If a fund really fell behind, it could be merged with a better performing fund or closed, thus erasing the poor track record.

Then along came the three-year bear market, sending many stock funds down 40% to 70%. All of a sudden, the three-year performance numbers looked really bad in absolute terms. We noticed one of the big fund families conspicuously stopped advertising three-year performance. The industry followed suit and now presents only one, five, and ten-year numbers. We are looking at a full-page ad in Barron's for a single fund with market beating performance for one, five and ten years. What the ad fails to show are the numerous funds within the particular fund family with returns still down over 50% over the past five years. Many of the worst funds among this particular fund family over the past five years are the largest flagship funds in the family. Nice.

What do you think the marketing folks will do presently or going forward? Given strong overall stock market returns for 2003 and 2004, if 2005 winds up being merely reasonable, we predict a return of three-year returns in advertising campaigns. Even now, the three-year return for the S&P 500 is now positive, up 11.1%, or 3.6% annually. We may soon start seeing three-year returns back in ads and perhaps an elimination of five-year performance, especially since five-year returns are now negative for many funds.

We will also be interested to see what happens in another five years. Returns for the S&P 500 are still down 10.8% cumulative, negative 2.3% per year for the past five years. If the next five years wind up lower than 2.3% per year, ten-year results will be negative for the index and for many funds. So much for 10% or more as a long-term birthright. Will the big fund complexes stop marketing ten-year results? We wouldn't bet against it.

Selective marketing of certain outperforming funds or using selective time periods are pervasive in the industry. The practice is appalling. We see investment proposals for advisory business with the same selective garbage. For all of the standards mandated in performance calculations, selective touting is about as retched as it gets. Where is the SEC or the NASD or even the CFA Institute? For goodness sake, where is Elliott Spitzer? A fund family with multiple funds should have to provide aggregate performance of all funds in a certain asset class. For example, mutual fund families should provide aggregate results of all of their stock funds together; including closed or merged funds, for annual periods and from inception. Investors would then have a tool, and a real eye opener, as to the degree that funds underperform the broad market on an after fee basis over time.

It will be fun to see the advertising touts scramble over the next few years, especially if prices mean revert down to normal levels.

CONCLUSION

The majority of this client letter addressed our stocks' advantages versus the S&P 500, and by extension, versus the expected aggregate experience of investors in the stock market. Whether our stocks can continue to outperform the market remains to be seen. We stress, as we repeatedly have in the past, that our advantages should be gained during years or periods when the market is flat or is down. We only hope to keep up during rising markets, and during rapidly advancing periods certainly expect to lag behind. Thus, analysis of our performance is best done over long periods, and must certainly be scrutinized against periods incorporating poor overall market performance. We do not expect to outperform each year. Further, we expect to lose money over various time periods, especially over short spans. In no way do we believe we will, or even that we should make money during down markets. However, we would be thrilled with a 15% loss if the market fell by 40% (though we're not sure all of you would be as pleased as us). We would rather lose far less money during a big decline than to make 20% when the market was ahead by 20%.

We don't know when the discounts of our companies' stock prices relative to our appraisal of fair value will close, only that we believe they will. On the other hand, there are no guarantees the discounts will close. We may wind up no better than average. We could even wind up a sub par performer. We may be on a futile, lifelong wild goose chase trying to keep up with or to exceed the investment track records posted by the greatest investors. We will certainly make our share of mistakes. Our hope is to keep the mistakes to a minimum and to minimize permanent losses of capital. By extension, the more capital we are willing to commit to a single position should reflect our confidence in the safety of the position and the existence of an outsized expected return.

We are aware of the confidence each of you place in our abilities and in our approach. We do not take your expectations lightly and we work as hard as anybody to help you reach your financial goals. It goes without saying you value our integrity and honesty. As Buffett often says, "A reputation takes 20 years to develop and only five minutes to destroy." The intent of this letter is in no way to guarantee future results or to raise your expectations bar. We sought to illustrate our process, the way we appraise value and to lay out our own expectations. If over the years we fall short of our own expectations but still manage to outperform not only the market but the majority of our peers, we hope you would be pleased with the result. If we ever believe our advantages disappear or are diminished to the point that passive investing (or any other approach) makes more sense, then our obligation is you inform you as such and to reconsider our approach to investing capital. For now, we believe our stock picking advantages and our process allow us significant advantages versus the S&P 500 and against the aggregate experience of investors.

If you have any questions or don't understand anything we are doing, don't hesitate to call anytime. We look forward to spending time with each of you over the course of the year.

Christopher P. Bloomstran

Disclaimer: Information presented herein was obtained from sources believed to be reliable, but accuracy, completeness and opinions based on this information are not guaranteed. Under no circumstances is this an offer to sell or a solicitation to buy securities suggested herein. The reader may judge the possibility and existence of bias on our part. The information we believe was accurate as of the date of the writing. As of the date of the writing a position may have been held in stocks specifically identified in either client portfolios or investment manager accounts or both. Rule 204-3 under the Investment Advisers Act of 1940, commonly referred to as the "brochure rule," requires every SEC-registered investment adviser to offer to deliver a brochure to existing clients, on an annual basis, without charge. If you would like to receive a brochure please contact us at (303)893-1214 or send an email to csc@semperaugustus.com.

How to contact us:

Christopher P. Bloomstran, CFA
314.726.0430
fax: 314.862.1927
1034 S. Brentwood Blvd. Suite 850
St. Louis, MO 63117
CPB@semperaugustus.com

Additional Performance Calculation Information:

Past performance is no guarantee of future outcome. When calculating investment returns and composites, Semper Augustus Investments Group LLC uses time-weighted gross returns, including the reinvestment of income. Performance figures are calculated before Semper Augustus Investment Group LLC's management fee, custodial fees, and other miscellaneous expenses, but after deduction for brokerage and SEC fees. January 1, 1999 is the inception for performance returns and includes all terminated, taxable, tax-exempt and leveraged portfolios. Based on asset allocation, commencement of a client relationship, taxability, risk factors, and other factors; individual client returns may differ from the equity composite. Return calculations are not audited and are subject to adjustment at any time. Cash has been a significant investment for Semper Augustus Investments Group LLC since inception.

Recent Client Letters:

2003 Year-End Client Letter

Still Facing Headwinds

January 1, 2003 Letter

Headwinds & Tailwinds

January 4, 2002 Letter

Price Matters

November 20, 2000 Letter

Predictions for the Next 15 Years

January 1, 2000 Letter:

Predictions

Future Economics of Microsoft

Property Casualty Insurance

August 6, 1999 Letter:

Mercury General

Broad Market Profile

July 12, 1999 Letter

Energy/Energy Services

March 23, 1999 Letter:

Diamond Offshore

Schlumberger

Transocean Offshore

How to contact us:

Christopher P. Bloomstran, CFA
314.726.0430
fax: 314.862.1927
1034 S. Brentwood Blvd. Suite 850
St. Louis, MO 63117
CPB@semperaugustus.com

Chad S Christensen
303.893.1214
fax: 303.893.1207
3164 Rockbridge Drive
Highlands Ranch, CO 80129
CSC@semperaugustus.com