SEMPER AUGUSTUS
INVESTMENTS GROUP LLC

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CLIENT LETTER **January 1, 2003**

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Clients and Friends:

Do you hear the bells ringing? Ding dong merrily on high! To complement our best wishes for the New Year, we have big news. For the first time in seven years, our 10-year projection for the S&P 500 is now positive! (before costs, taxes, and inflation, of course). Annual price gains of 1.36% and a beginning dividend yield of 1.80% add up to expected annual returns of 3.16%. Put another way, the market still needs to fall 22.7% to be fairly valued. But hey, this projection is a heckuva lot better than last year's 43% required decline to reach fair value.

As with any good news there is often bad. The glass may be less than half-empty. For two primary reasons, the risk to our forecast is unfortunately to the downside. Through the accounting adjustments we make to profits, cash earnings are presently well below the level required to achieve 3% annual returns and drastically below those levels currently reported by companies and forecast by Wall Street. Further, significant economic headwinds should restrain both absolute levels of after-tax profits and the requisite growth in those profits to achieve our forecast return. In short, profits are punk, will likely remain so, and the prices being paid for those punk profits remain dangerously high.

Semper Augustus completed the year with its first ever investment loss. Our equity securities declined by roughly 20%. Fortunately for our clients, for the first time our heavy weighting in cash equivalents and short duration fixed income obligations clearly helped our results; i.e. our cash beat our stocks. Our heavy cash and fixed allocation hurt our absolute performance for each of the prior three years. Note, however, cash hasn't been a bad place to be for the last four years. Three-month US Treasury Bills have returned 16.3% versus a 24.4% decline for the S&P 500. Who said cash is trash? We have remained very cash heavy, 40-70% for our typical client. Our four-year results look something like this:

Semper Augustus' Investment Performance vs. the S&P 500
<u>Annual Percentage Change</u>

Year	SAI Equity Securities Only (1)	SAI Full Portfolio (2) *	S&P 500 Total Return (3)	(1) - (3)	(2) - (3)
1999	25.8%	9.9%	21.0%	4.8%	(11.1)%
2000	33.6	21.2	(9.0)	42.6	30.2
2001	22.6	15.8	(11.8)	34.4	27.6
2002	(21.0)	(9.1)	(22.1)	1.1	13.0
Avg Annual Gain (1999-2002)	13.0%	8.8%	(6.7%)	19.7%	15.5%
Overall Gain (1999-2002)	62.8%	40.3%	(24.4%)	87.2%	64.7%

* Notes: SAI Full Portfolio Results are gross of management fees and taxes, but inclusive of trading costs and commissions paid.
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 disclosure on page 12 of this letter.

While we are extremely disappointed in our results for 2002, our apoplexy is driven by a different reason than most would assume. We don't mind negative investment returns over short periods. In fact, from time to time we expect them. We are actually quite pleased with our single digit negative result because in relative terms, we still "beat the market" by 13.0%.

In fact, our outlook regarding investment results parallels Warren Buffett's. We reference the Berkshire Hathaway 2001 annual report p. 3, which, as shareholders, we encourage everyone to read (www.berskhirehathaway.com).

> "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."

Our agitation regarding 2002 results stems from the fact that we owned two companies which turned into permanent losses of capital (PLOC's). Given our process, we never thought it would happen. We typically employ a dual margin of safety in our investment process, trying to only buy good businesses at good prices. In the case of our two PLOC's, we failed on the first count. No price is too low or reasonable to pay for a company destined for the dustbin of history. While in both cases we thought we had a margin of safety, we succumbed to what turned out to be two outright frauds. While fervently hoping for (and in one case working toward) members of management being barred from running public companies and spending time behind bars, we make no excuses. No excuse in the world can make up for a PLOC. Never own a balance sheet where success depends on everything going right. It rarely does. Our two PLOC's accounted for nearly half of our equity decline and absolute loss for the year.

Fortunately, even though the share prices of several of our other companies declined for the year, in most cases the businesses grew in value. In fact, we think the value of several of our businesses grew by over 15% during the year. As we measure our portfolio, we think we own a group of good companies trading at 13 times earnings (7.7% earnings yield), growing organically nearly twice as fast as nominal GDP, and presently valued at approximately 75 cents on the intrinsic value dollar. Contrast our portfolio with the S&P 500. At 22 times normalized earnings (33 times our measure of accounting adjusted earnings), growing only as fast as bloated GDP, and valued at 129 cents on the dollar, the index remains unattractive.

We are at the party and we have advantages. While our equities need to advance 33% to reach fair value, the index needs to fall by nearly 23%. Even if we get no accretion back to our estimate of fair value, we are starting with an earnings yield of 7.7% versus anywhere from 3.0% to 3.9% for the index depending on the index's earnings.
We believe:

- Our companies will continue to grow their core intrinsic worth faster than the average business.
- Our companies will continue to earn high returns on invested capital.
- The prices of our companies' share prices will ultimately accrete to fair value.
- We have the requisite skills to continue to find good businesses, run by intelligent and honest managers, whose share prices occasionally decline enough to make them attractive to us.

Our job remains to worry about each of the above beliefs. Best wishes for a safe, prosperous and healthy New Year.

Getting There. Maybe.

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FAIR VALUE/10-YEAR PROJECTION

The S&P 500 closed out 2002 at 879.82, down 23.4% for the year and marking its third consecutive annual decline. The index has now lost 43% of its value, $6 trillion, since its March 2000 peak. The last three-year decline ended in 1941. The last four-year decline occurred from 1929-1932 (yes, Virginia, there is a precedent), with an 89% drop, peak to trough.

We now peg the fair value of the S&P 500 at 680, up 4% from last year's target of 655. Fortunately for the sum total of investors, even as stock prices have fallen, fair value has grown. Recall our estimates of fair value relative to yearly closing prices since 1998:

	Yearly close	SAI fair value	Required decline
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)

Projecting declines of nearly 60% can cast one beyond the periphery of the perceived sane. At a "mere" 129 cents on the dollar, our current price-to-value analysis now simply hinders us from winning popularity contests.

To arrive at our estimate of intrinsic worth, we continue to employ a 17 price-to-earnings (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	2013
GDP	$10.5 trillion	$15.5 trillion
S&P 500 sales	$7.28 trillion	$10.78 trillion
S&P 500 profits (normalized)	$364 billion ($40.00/sh)	$539 billion ($59.20/sh)
S&P 500 dividends	$135 billion ($15.80/sh)	$200 billion ($23.39/sh)
S&P 500 fair value	$6.27 trillion ($680/sh)	$9.28 trillion ($1007/sh)
S&P 500 current price	$8.107 trillion ($879.82/sh)	

An advance from current levels to 1007 would yield a 14.5% cumulative price gain. Converted to ten year annualized gains results in a whopping 1.36% per year. With a dividend yield of 1.80% added in, the 10-year annual total return works out to 3.16% per year. Our projection last year was a 0.00% annualized 10-year result.

To arrive at a higher result, an investor must believe nominal growth will exceed 4% per year, normalized after-tax profit margins will average over 5% and/or profits in excess of 5% of sales should be capitalized at over 17 times earnings.

We feel the risks to growth, profits and P/E's are to the downside. Please refer to our 40 page January 4, 2002 client letter that addresses our views of these variables. We also assume the wizards who comprise the very ACTIVE committee at Standard and Poor's responsible for switching index components maintain their remarkable track record unblemished by success. Would you believe a staggering 115 (23%) index companies have been replaced since the beginning of 2000?

ACCOUNTING

We can not let an entire year pass without writing again about the lack of integrity in corporate accounting and the still poor quality of reported profits. On an annualized basis, we think aggregate profits for the companies making up the S&P 500 are overstated by $188 billion or $20.41 per share. Said differently, these companies are only actually earning half of what they report to shareholders as operating earnings. We make the following adjustments to S&P 500 operating earnings on a top-down basis. The process parallels the more specific adjustments we make on a company-by-company basis:

Semper Augustus Reduction in Profits
(from S&P 500 Operating Earnings)

Compensation as Employee Stock Options	$43 billion	$4.67/share
Option Tax Credits	$20 billion	$2.17/share
Pension Accounting Adjustments	$75 billion	$8.14/share
Write-Offs	$50 billion	$5.43/share
Total	$188 billion	$20.41/share

To put our adjustments in perspective, Wall Street expects $46.94 in operating earnings for 2002 and $55.39 for 2003, a 6.1% and 6.9% after-tax profit margin respectively, both extremely high by historical standards. Our $20.41 reduction would lower profits to $26.53 and $34.98, a 3.3% and 4.4% margin, low by historical standards. Based on our earnings reduction in profits, p/e's are a high 33 times 2002 Wall Street forecasts and 25 times 2003 estimates. We expect 2003 Wall Street profit expectations are at least $5.00 too high, without even considering our accounting adjustments. The Street is universally too rosy with preliminary projections.

PENSIONS

Declining equities and interest rates have begun to expose a veritable powder keg. The issue is widely misunderstood and underappreciated. Regardless of market conditions and valuation, pension accounting assumptions have been a tool for masking corporate financial health.

> As recently as two years ago, pensions were given little consideration regarding their impact on corporate America.

Various analysts and observers would rightly point out that pension "income" from overfunded plans artificially inflated reported profits at large companies like GE and IBM. Popular media now points to the fact that companies will have to, for the first time in many years, fund their defined benefit plans. Thus a P & L issue. Other more astute observers, with accounting or actuarial understanding, correctly demonstrate that the issue is not significantly material to the P & L. Due to smoothing, funding methods and other actuarial conventions and rules, actual cash expenses will not be significant.

Most have failed to step back and, from a macro perspective, grasp the magnitude of the developing black hole. The potential cost to shareholders is staggering. At the end of 2002, 347 of the 500 companies in the S&P 500 have defined benefit plans. At year-end 2002, we approximate plan assets, at roughly $1 trillion, fall short of liabilities by $650 billion. At the end of 2000, plan assets actually exceeded liabilities by $3 billion.

Pension accounting and actuarial math are complex. Cogently writing about pensions in a short client letter is impossible. We are thus only going to present our conclusions regarding the pension issue and some highlights:

- The 347 S&P 500 companies with defined benefit plans (pension and other post-employment health plans) will have liabilities in those plans of roughly $1.65 trillion at year end 2002.
- Those liabilities are largely not carried on the balance sheets of the companies with the plans. As plans drop below 80% and 90% funding levels over 1 and 3 year periods, more and more plan contributions will be required.
- The stated value of plan assets at year-end 2002 will be roughly $1 trillion. Thus, on the surface, plans will be underfunded (per FAS 87) by $650 billion.
- We think the fair value of plan assets (market value) is actually overstated by as much as $100 billion, 10% of plan assets. Half of plan sponsors employ smoothing techniques (moving averages) of up to 5 years when calculating returns. Given the 40% market decline over the past 3 years and a typical 60% allocation to stocks, plans have probably lost close to 25% of their value excluding cash flows in and out). Despite the losses, five-year smoothing would still result in a positive return calculation when fixed income returns are taken into account. We thus think plans are underfunded by closer to $750 billion.
- Contributions to plans were $21 billion in 2001, probably $25-30 billion in 2002 and will likely be closer to $30-35 billion this year. Contributions may take the form of any "prudent" asset, including the stock of the company making the contribution (up to a point).
- Benefit payments were $95 billion in 2001, probably $100 billion in 2002, and will likely be $105 billion or so in 2003.
- Cash flows are thus negative to the tune of $75 billion, 4.5% of liabilities but a whopping 8.3% of our estimate of plan assets.
- Liabilities grow by roughly 5% per year.
- Other post-employment benefit plans are typically health and welfare plans. These liabilities are "pay as you go" (like Social Security, meaning no invested assets) and represent roughly half of the $650 billion ($750 billion-our estimate adjusted for smoothed market values) of the liability. As plan assets have fallen below 125% of liabilities (under FAS 87), the pension plans will no longer be able to pay these health benefits. Companies will be on the hook.
- ERISA, not FAS 87, governs the calculation of funded status as it relates, not to the financial statements, but to mandatory company funding. ERISA regulations ignore estimated wage inflation and use the lower yielding 30-year US Treasury as the discount rate (versus the higher Moody's Aa Corporate yield under FAS 87). Plans are therefore less underfunded and require fewer contributions under ERISA.
- ERISA requires companies to carry a certain portion of liabilities on the balance sheet, at least equal to the unfunded Accumulated Benefit Obligation (remember calculated more liberally than under FAS 87). At a point, the unfunded portion may require a charge to shareholders equity.
- The book value of the S&P 500 equals $2 trillion. The largely off balance sheet liability (underfunded status) is thus nearly 38% of equity. Start thinking debt covenant violations. At our 680 estimate of fair value for the S&P 500, the market would be 23% below year-end closing levels. At a 60/40 asset mix, plans would see plan assets value fall from $900 billion to $800 billion, an 11.4% decline. With $25 billion in contributions and $100 billion in benefit payments, plan assets decline another $75 billion to $725 billion. Even assuming no wage inflation, plan assets would fall short of liabilities by nearly $1 trillion! Funded status falls to 44%. Enter the grim reaper.

The pension issue stands to be a nightmare for some companies and industries, not to mention for the PBGC. Years of irrational exuberance, overstating expected returns, increasing benefits (COLA's, lump sum distributions, etc.), deferring company contributions, and even overstating the discount rate (see Mr. Smith Goes to Washington) have led to a very real crisis. Pundits who say the issue is manageable may be correct. Aside from an immediate and sustainable stock market rally, the solution is neither happy nor inexpensive for shareholders and their claims against the profits and equity of the firms. Our annual reduction of $75 billion for the S&P 500 for unexpensed pension expense may be too conservative. Then again, the market may return 15% a year for the next 10 years and remedy the problem. Don't bank on it.

Mr. Smith Goes to Washington

Fred Smith "gets it." As Chairman, President and Chief Executive Officer at FedEx, he is the man charged with maximizing earnings per share. He gets that at $5.5 billion, his pension plan is exactly the same size as the tangible net worth of his company. We wonder which one he spends more time on? He clearly gets that changes in the discount rate, estimated return on plan assets, and assumed future increases in wages drive pension cost. A lower discount rate has a "negative effect on pension expense." We assume he means negative to FedEx earnings and not to his pensioners. He gets that a "decrease in the assumed expected long-term rate of return has a negative effect on pension expense." He also gets that "an increase in estimated future increase in salaries and wages will have a negative effect on pension expense."

So what does Fred assume? Regarding expected returns on plan assets, Fred assumes that his stock picking savants in Memphis are better and faster than any others in the S&P 500 defined benefit investment derby. The average plan still assumes an impossible 9.2% annual return. Fred thought his guys and gals would do no less than 10.9% in 2002 and expects 10.1% in 2003. Fred and his lieutenants point out in their 2002 annual report, "Our 2002 expected long-term rate of return of 10.9% reflects our active investment management program, which has consistently outperformed the related market indices over the past 10 years. Also, because of our relatively young workforce, we are able to maintain more of our pension assets invested in *higher-returning, longer-term equity investments*" (emphasis added). Note that were he to drop the expected return to the same rate 6.5% Warren Buffett uses at Berkshire, his pension expense would rise by $250 million, and would reduce after tax profits by nearly 1/4. Lowering the expected returns for FedEx's equity heavy plan to Semper Augustus' 10-year projected return for the S&P 500, 3.16%, increases FedEx's pension expense by $426 million. Fred gets expected return.

Fred also gets interest rates. Regarding expectations for wage inflation, FedEx actually correlates estimated future salary increases to changes in the market-based discount rate. You should reread that sentence. As the level of market rates is beyond Fred's control (must give him fits), this move is a stroke of genius. Any decline in the discount rate will be offset by a correspondent decline in estimated wage changes. In 2002, the discount rate (Moody's Aa Corporate) fell from 7.7% to 7.1%, raising pension cost by $60 million. The wage inflation rate was thus lowered from 4% to 3.3%, lowering pension cost by $50 million. Fred has lowered his wage inflation assumption by 1.7% over two years, shaving pretax pension expense by $119 million. Creative is an underwhelming description.

Now imagine a scenario where the rates fall by more than 3.3%. Would Fred dare, with all of his union exposure, try to claim a NEGATIVE inflation rate for salary changes, i.e. expected salary cuts each year! Good luck, Fred.

Our mention of Fred's inability to control market rates is not entirely true. Fred can not manipulate the discount rate used in FAS 87 calculations, which are disclosed in the annual report. However, he gets the fact that there are indeed two discount rates at play in the corporate pension world. Under ERISA regulations, the present value of future obligations is not the PBO, as calculated under FAS 87, but the ABO. The Accumulated Benefit Obligation, which drives required funding, does not take salary inflation into account (good for Fred) and uses the yield on 30-year US Treasuries instead of higher yielding corporates. Also good for Fred, but not good enough.

FedEx's ABO is $5.1 billion versus a $6.2 billion PBO. In fact, while the plan is underfunded by $717 million per FAS 87, it remains overfunded by $413 million under ERISA. When Fred realized that government bonds and governing bodies (the Pension Benefit Guaranty Corporation under ERISA) were involved, he did what any fast thinking and wheel-greasing captain of industry would do — Mr. Smith went to Washington.

We can picture the scene. Hopping a red eye out of Memphis in the back of one of his 647 planes (now that's a fleet of corporate jets) he made it overnight to Capitol Hill for an early express personal delivery. Arriving at 9:30, earlier than any Senator or Congressman, he waited for an audience with the first arrival, who turned out to be his good friend, Senator Lott. "Boy Freddie, am I happy to see you," relieved to actually see anybody not wielding a microphone.

"Hey T. Lo, I need a favor," pleaded Fred. "I've got a PBGC discount rate problem as mean as a PBGV after a squirrel. Those eggheads are using the long bond. It's unpatriotic. Any God loving American like yourself would much rather use something intelligent like the Moody's Aa Corporate."

"Hey Freddie," chirped the recent Majority Leader, ecstatic that he might have something to work on. "Those 'ol boys over at ERISA are tough. But with '04 right around the corner and me knowing who butters my biscuits, I'd be happy to make a few calls and see what I can do."

Fred went back to Tennessee. Senator Lott went to work. He had his staffers make some calls to figure out what a discount rate was. He went to lunch. By the end of the month, he formed a committee to look into the issue. Being expert at baseline budgeting, scoring, sampling, redistributing and other forms of governmental higher math, the committee had an easy solution. They knew that the Moody's Aa Corporate was pie in the sky. What they resolved to do was compromise. The result was the Job Creation and Worker Assistance Act (a.k.a. the Bailout Freddie Act). Continue to use the 30-year US Treasury, but since rates had fallen so much, use 90 to 120% of the four year rolling average of the 30-year US Treasury, now a 28-year Treasury. Simple enough.

At the end of the day, Fred won the battle. By raising the discount rate used under ERISA, FedEx's pension expense was lowered and the company avoided moving a big number on the balance sheet. FedEx only carries a $19 million pension liability on the balance sheet.

Way to go, Fred. Jimmy Stewart would have been proud. By the way, Congress will repeal the "relief" in 2004, just days after the big election. Unless, of course, Fred requires another bailout.

As Semper Augustus makes adjustments to FedEx's profits for our internal valuation, pension adjustment alone reduces pretax profits by $623 million, $405 million after-tax, or $1.36 per share (we make aggregate downward accounting adjustments of $1.75 per share). FedEx reported profits of $2.39 for fiscal year ended May '02 (including $0.21 from the 9/11 government assistance). Our assumptions:

- 70/30 equity/fixed mix; Expected return on plan assets of 4%: $414 million pretax.
- Fair value of plan assets: 10% below reported ($550 million below $5.5 billion of reported assets). The company "uses a calculated value method to determine the value of plan assets at the measurement date, which helps mitigate short term volatility in market performance." Read: they smooth: $30 million pretax.
- Rate of increase in future comp levels: 5% (the company now uses 3.3%, down from 5% as recently as 2002): $119 million pretax.
- Discount rate: 6.5% (versus 7.1% in 2002): $60 million pretax.

Compensation Paid in Stock Options

The profligate use of employee stock options continues to plague the fortunes of non-employee shareholders. We project companies in the S&P 500 will grant 2.5% of outstanding shares to employees as stock options in 2003. Compare this highly dilutive percentage with 1% grants six years ago and only 1/10 of one percent grants in 1982. We estimate in 1982, fewer than 300,000 employees were granted stock options. By 1990, nearly 1 million options were granted to employees. In 2000, over 11 million employees received options. Granted, but unexercised options amount to an overhang of over 15% of total shares outstanding, up from 5% ten years ago.

During 2002, Coca-Cola led a charge of 65 S&P 500 firms announcing intentions to begin expensing compensation paid in options beginning in 2003. Despite the hoopla and media attention, the surface has barely been scratched. Expensing will generally only be done prospectively, over the vesting period of the options granted. A firm that grants options with a five-year vesting schedule (typical of many options) will only reorganize as expense 1/5, 20% of the cost of the options in 2003. Only five years down the road will full expense be recognized, assuming continuity in vesting schedules applied to option grants. We cynically suppose vesting schedules will elongate.

These companies now expensing compensation paid as stock options would continue to ignore the cost of prior year grants in the income statement (perfectly allowed under FAS 123, which only requires disclosure of a pro forma expense in the footnotes).

The real cost of option compensation is lethal to shareholders. The cost flowing through the P&L in 2003 is not. Here are our top-down assumptions for the S&P 500 to demonstrate how little of the true cost will be recognized in 2003. As always, this macro illustration is general. An analyst should make requisite adjustments on a company-by-company basis:

- 13%, or 65 out of 500 S&P 500 firms, to expense in '03.
- Assuming five-year vesting schedules, only 2.6% (13% over 5 years) of the real cost will hit the P&L.
- S&P 500 market capitalization at 12/31/02: $8.15 trillion.
- Assumed option grants @ 2.5% of outstanding shares for '03.
- $8.15 trillion x 2.5% = $202.7 billion.
- Pre-tax expense @ approximately 1/3 of face value of grant = $67.56 billion, $7.33 per share.
- After-tax expense at 35% marginal rate = $43.9 billion, $4.76/share.
- Actual after-tax expense on P&L @ 2.6% = $1.14 billion, $0.12/share.
- Unexpensed cost is thus $42.76 billion, $4.64/share.
- Full expense would shave Wall Street expected profits by 8.3% and our "normalized" 5% margin by 11.6%.

This analysis may prove somewhat high or low depending on several variables, including actual market cap of each company on grant date, actual vesting schedules employed, volatility and interest rate assumptions and dividend yields at grant dates. Our guess is the numbers are pretty close, however.

We think FAS 123, particularly the use of the Black-Scholes option pricing model, has major shortcomings. Black-Scholes disregards the "intrinsic value" of the underlying stock of the company (not to be confused with the degree to which the options are "in the money"). For example, a company making two separate grants in a year at two different strike prices would calculate the grant made at the higher strike price as more costly. To illustrate:

1 million shares @ $60/share; approximate expense: $13 million
1 million shares @$40/share; approximate expense: $8.7 million

In the example, the higher expense is driven by the higher share price at the time of grant. From our perspective, reality couldn't be farther from the truth. If Semper Augustus assumes the intrinsic value of the stock at $50, then giving away shares at $40 is clearly more expensive than at $60. Conceivably then, as the S&P 500 is overvalued by 29%, grants above fair value may impact the option expense somewhat less:

- At 680, S&P 500 market cap = $6.27 trillion.
- 2.5% of $6.27 trillion / 3 = $52.25 billion, $5.67 per share
- After tax, "normalized" option grants would be $3.69.

We do not make this "less costly" reduction for our aggregate valuation of the S&P 500. In our experience, option grants made where the stock price subsequently falls below the strike price tend to be either repriced or repaid with entirely new grants at lower (and more expensive, in our view) price points. We do make the adjustment when valuing an individual business. Uncontrolled nausea results from companies "giving away" their shares at prices south of fair value.

Black-Scholes further disregards company repurchases of shares to offset the dilution that takes place upon exercise. These repurchases are often made at prices in excess of the intrinsic worth of the firm and are thus extremely costly to the shareholders. In other words, the cash spent to repurchase is not inuring for shareholder benefit.

One tangential question -- Should the government be subsidizing unexpensed compensation programs of the nations largest firms? Our answer is no.

One last point and adjustment regarding options. Firms with non-qualified option plans (versus incentive stock option plans), receive a tax credit representing the difference between the exercise (strike) price paid by the employee upon exercise to the company and the market price of the stock at the time of exercise. The credit is treated as operational, reducing tax rates and enhancing profits despite the lack of the expense on the income statement for the cost of the grant itself. To clarify, companies are receiving a tax credit against expenses that are not treated as expenses. As our option cost is after-tax, to normalize, we must exclude the credit. We reduce estimated credits from operating earnings by $20 billion for the S&P 500, $2.17 per share. The credit was as high as $35 billion in 2000. The credit should shrink as stock prices fall closer to or below strike prices.

Write-offs: Restructuring Charges and Write-downs

Between 1988 and 2002, the companies making up the S&P 500 generated $4.88 trillion in operating earnings and $4.24 trillion in reported profits. The difference between the two measures, an improbable $640 billion, represents the aggregate amount of write-offs taken by these firms. The amount equals nearly one-third of the present book value of the S&P 500. We think both restructuring charges from current operations and write-downs of depreciable, depletable and amortizable assets should be included in assessing the ongoing profitability of a company.

A portion of write-offs represent legitimate charges and should be rightly excluded from operating profits. Representative of these charges would be those recently taken under FAS 142 for goodwill impairment, and a decade ago under FAS 106 for post-retirement charges.

Interestingly, beginning today, FASB introduces a new standard, FAS 146, the net effect of which will smooth big bath write-offs. Firms will only be allowed to recognize a write-down (assets already paid for) or a restructuring (to be paid for in the future) as those expenses are truly incurred. For instance, if Ford had waited until 2003 to announce the contemplated future closure of its Explorer and minivan plant here in St. Louis, they would have to spread the charges over the periods when they actually close the plant and actually sack employees. Heavens, perhaps Ford never really intended to close the plant, but only to avoid ongoing real costs on the income statement. But then we're not that cynical. In effect, the charges will look more like ongoing expenses rather than one big bath, as well they should. It will thus be tougher for firms to bury cash expenses, past and future, in the write-off. Good for FASB.

For our macro analysis of S&P 500 write-off adjustments, we exclude 25% of write-offs over a rolling 6-year period. Write-offs generally increase during recessions as managements bury ongoing expenses and past mistakes in large, one-off, big bath charges. Who would notice or care when profits are already depressed? A moving average smooths out the distortions of timing on the occurrence of the charges. Our exclusion of 25% of the charges allows for the legitimate non-operating FAS 106 and 142 type charges.

S&P Introduces Core Earnings

While we are in the mood for dishing out praise, good as well for Standard and Poor's - the same outfit with the active managers of the passive index. Now that "aggressive accounting" has become such a hot issue, the analyst community has been compelled to move toward a more conservative and realistic measurement of profitability from a corporation's principal business. S&P has adopted a series of adjustments to operating and reported profits that will close, somewhat, the yawning gap between these measures and true cash profitability or core profitability. They are calling this earnings measure "Core Earnings."

In short, S&P has adopted, and is trending toward, some of the capital preserving adjustments that Semper Augustus has always made. The folks at S&P are doing a tremendous service for the entire investment community. They can only be faulted for, perhaps, being so late to the party. Had the world assessed real profits, instead of inflated and manipulated profits, the equity bubble might have never happened. Society would be spared from dealing with the fallout and ramifications of extraordinary wealth destruction. Then again, it's probably naïve to protect investors from themselves. You can't change human nature.

At a minimum, however, it should be increasingly difficult for managements and Wall Street to tout inflated pro forma and operating profits if a core earnings number is readily available, realistic and excessively lower. At the trigger, the buyer of stocks better be able to rationalize the difference between core and operating results.

S&P will include and exclude the following items from core earnings:

Items included in and excluded from Standard & Poor's Core Earnings	
Included in Core Earnings	**Excluded from Core Earnings**
Employee stock option grant expense	Goodwill impairment changes[2]
Restructuring charges from ongoing operations[1]	Gains/losses from asset sales[2]
Write-downs of depreciable or amortizable operating assets	Pension Gains
Pension costs	Litigation or insurance settlements and proceeds
Purchased research and development expenses[1]	Reversal of prior year charges and provisions
Merger/acquisition related expenses[1]	
Unrealized gain/losses from hedging activities[1]	
[1]Treatment under GAAP is the same as under Standard & Poor's Core Earnings. [2]Treatment for Operating Earnings is the same as under Standard & Poor's Core Earnings.	

Source: Standard & Poor's

Note the items denoted (1) are the same as under GAAP. The (1) inclusions largely account for the difference between operating and reported earnings. The primary difference between reported earnings and core earnings are for treatment of stock options as compensation expense and for pension cost and and gains.

Semper Augustus' treatment of pension expense and option credits (S&P completely ignores the credits) is somewhat different than S&P's. In fact, we totally disagree with the S&P approach to pension plan adjustments. Their method makes no adjustments for extraordinary or aggressive assumptions. They also fail to adjust for those who smooth and those who do not. In the aggregate though, the net result is perhaps logically quite similar. Our reduction for pension accounting, options, and write-offs are from operating earnings.

We reduce operating profits by $188 billion, $20.41 per share. For the twelve months ended June 30, 2002, S&P Core earnings were $18.48, $23.50 below operating earnings of $46.00, a difference representing $213 billion. For 2001, S&P core earnings were $16.76 versus $38.85 operating, a $22.09 difference, or $204 billion. It's hard to believe that anybody is whacking earnings more than Semper Augustus. However, we are probably more conservative on a company-by-company basis.

Critics of S&P's approach (and with our approach) will claim that historical data do not exist for core earnings and thus an "apples to apples" analysis can not be done. We disagree. It is only recently that stock option plans grew out of control. Regarding pensions, never before have plan liabilities been as large relative to the size of the principal business of the firms. The recent swing from overfunded to the massive underfunding we now face is unprecedented. There exists plenty of historical data regarding write-offs. Further, a good analyst will conduct a long-term analysis of the financials of a company. Reliance upon one or two years of data is fairly meaningless. Those without the time or skill to conduct such a long-term analysis should not be picking stocks, neither as professionals, as amateurs, nor as Wall Street analysts.

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In This Letter:

Getting There. Maybe

CONCLUSION

Despite the media hype, Congressional involvement, company and Wall Street acknowledgment of the "accounting issue," very little has been done so far to clear up the mess. Fine with us. As long as footnote disclosure is adequate and free of fraud, we can make the requisite adjustments. However, if those responsible truly do clean house and the quality of reported earnings materially improves and companies give less of themselves away to employees, our universe of attractive companies to buy should expand. We hope for no less.

ON PERMANENCE

Buffett observes, "gaining small advantages annually over the index *must* prove rewarding." No kidding. To put his track record in perspective, consider that our four-year advantage over the S&P 500 has built a nice cushion at 15.5% annually over the index. We can decline up to 46.1% and still have a record above the index, albeit a negative one at that point. Our cumulative record would fall from a positive 40.3% to a negative 24.4%.

Berkshire Hathaway can fall over 98% in value, either by book value or share price, and still have a track record over 38 years in excess of the S&P's 10% annual gain over the same period.

In Buffett's case, the cushion is so immense as to seem impossible. Berkshire has compounded at 22.4% since Buffett obtained control in 1964. His outperformance totals 12.4% better than the S&P's 9.97% annual gain. Berkshire's book value can fall from $42,000 (our '02 estimate) per share to $714. The stock price can fall from $72,750 to $946.While we are certain Berkshire's shareholders, ourselves included, would not be thrilled by such a decline, the enormity of Warren's success over a very long period is staggering. Words can not begin to describe the feat. Permanence is the best we can come up with.

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