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SEMPER AUGUSTUS
Investments Group LLC

CLIENT LETTER **November 20, 2000**

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- Risk Still Exists
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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.

The "new era" commencing in 1927 involved at bottom the abandonment of the analytical approach; and while emphasis was still seemingly placed on facts and figures, these were manipulated by a sort of pseudo-analysis to support the delusions of the period. The market collapse in October 1929 was no surprise to such analysts as had kept their heads, but the extent of the business collapse which later developed, with its devastating effects on established earning power, again threw their calculations out of gear. Hence the ultimate result was that serious analysis suffered a double discrediting: the first—prior to the crash—due to the persistence of imaginary values, and the second—after the crash—due to the disappearance of real values.

-Benjamin Graham
David L. Dodd
Security Analysis, 1934

Price Matters

The capital markets are rationalizing themselves. Many expensive assets are depreciating and some undervalued assets are appreciating. Essential to any successful and sustainable investment program is the notion that the price paid for any security must, at a minimum, be reasonable. Ben Graham illustrated that point following the spectacular rise and fall of asset prices in the late 1920's and early 1930's. In the past few years, much of the investment community has forgotten, or disregarded Graham's well-founded principles. Semper Augustus has not.

By sticking to our knitting, we have managed to distinguish our equity portfolios from the majority of investment managers. Having kept pace with the 20% returns posted last year by the Standard & Poor's 500, our 2000 returns year-to-date have been quite gratifying. Despite the declines experienced so far by most of the broad market averages (DJIA, S&P 500, Nasdaq), our 2000 equity returns are generally higher than last year's. Knock on wood. Sustainable? To answer that, we should review why our returns this year have managed to outperform the S&P by over 20%.

We have often written and talked about the pronounced tiering in the stock market in recent years (see our newsletter from July 12, 1999: Large Cap Stocks Still Overvalued: Some Bargains in Small Caps and Mid Caps). "New era" advocates, in the late 1920's and today, insisted new technologies rendered fundamental investment analysis obsolete. Wall Street suspended its fiduciary duty and endorsed and brought myriad technology, internet, communications and biotech companies public at preposterous valuations. Professional and amateur investors alike made assumptions about future sales and profits which left absolutely no margin for error. The valuations of these "new era" companies and of many well established large cap stocks soared to ridiculous levels. The source of capital fueling the rise had in part flowed from redemptions and reallocation away from underperforming investment managers, typically of value or nontechnology persuasions.

View from a Tech Peak

The 1920's "new era" peaked on September 3, 1929 with stocks falling 89% over the next three years. The current "new era" may have ended on March 10, 2000. The Nasdaq, on the heels of an 86% rise in 1999, had risen 24% to a peak of 5048. The venerable Dow Jones Industrials, representative of the "old economy" (despite its reconfiguration in recent years to include "new economy" stalwarts like Microsoft, Intel, and Hewlett Packard) had declined nearly 14% for the year to 9928. More telling than the divergence between indices like the Dow and the Nasdaq was the continued erosion in breadth since the spring of 1998. As the popular market averages rose in recent years, the average stock declined.

During the first half of this year we were buying exceptional businesses at attractive prices. The valuation gap between the companies we acquired and the go-go tech and big cap sectors was as wide as the Grand Canyon.

On March 10, we did some quick math and drafted a note to Barron's. The note highlighted the imbalances between the value of technology stocks (Nasdaq Composite) and big caps (NYSE). The market capitalization of the Nasdaq, at $8 trillion was nearly the same size as the value of stocks on the NYSE at $10.8 trillion. Despite the closeness in market cap, total annual profits for those firms listed on the NYSE were 10 times those for Nasdaq Composite companies ($330 billion versus $33 billion). The Nasdaq traded at 242 times 1999 earnings while the NYSE traded at "only" 33 times profits. The companies in our portfolios traded at approximately 14 times. We concluded by stating:

> **There are terrific bargains in the real economy. Companies who generate free cash, grow internally much faster than GDP, earn exceptional returns on capital and equity employed, and who are run by very talented managers, can be bought at bear-market-low-type multiples.**

We did not know with precision that sanity would begin to return on March 10. The Nasdaq has since dropped over 40%. Most of our companies have seen their share prices advance significantly. We bought our stocks at discounts, by our measure, to the intrinsic worth of the underlying companies. Some of the discount has now closed. Why are our stocks up? We believe many investors are again focusing on important variables: earnings, cash flow, realistic growth rates, capital structure, competition, management integrity and accounting integrity. Our companies stack up favorably and others are now taking notice of many of our undervalued gems.

Risk Still Exists

The correction of some of the excesses is healthy. Yet, the markets may not be close to an eventual bottom. Over-extended consumers represent over two-thirds of the economy. Many companies have over-built—look at the internet, communications, semiconductor, movie theatre, manufactured housing, and retail industries. Should the declines in the popular averages continue, many consumers will lack the wherewithal, financially or psychologically, to continue their unbridled spending.

As spending slows, businesses cut back on their operations. When businesses eliminate unnecessary or marginal employees, consumer spending slows further. This most unvirtuous progression is typical of the end of the business cycle, which too many pundits predict has been repealed. The risks to the equity investor are still high.

Valuations remain stretched by any historical measure. Prices relative to earnings, sales, cash flow, dividends and book value dwarf extremes reached at prior market peaks. Earnings and profit margins, now on the high side of time-tested ranges, are slowing. The Federal Reserve is still tight, having raised short-term rates 1.75% since June 1999. Central banks around the globe followed suit. Market breadth remains poor. Households and institutions are already more fully invested in stocks than at any other time in history. A high allocation to stocks leaves few cash reserves (dry powder) for purchasing equities. The annual personal savings rate is negative. Investor sentiment, which we view as a contrary indicator, is still high. Sentiment should be lower due to the big declines in tech stocks and the failure of many dot.coms. The United States is highly dependent on foreign ownership of both our stock and bond markets. Markets are exposed if foreign investors repatriate capital. This risk is exacerbated by a burgeoning current account deficit. Margin debt is as high relative to both GDP and to the aggregate value of the stock market as at any time in our history. The Fed gets an "F" for not using Regulation T and raising margin requirements.

Risk Factors

- Consumers overextended
- Corporations overextended
- Rising unemployment
- Valuations
- Profit margin deterioration
- Tight monetary policy
- Equity allocation
- Negative personal savings rate
- Sentiment too high
- Foreign ownership of U.S. assets
- Trade deficit
- Margin debt

Strategy

Worried? You bet we are. Will our stocks decline if the market continues south? Despite gains this year, perpetual gains in a hostile climate can not be expected. A goal should be to minimize losses. We should clarify that we have no idea when the "market" will move in any direction. We did not know on March 10 that the techs had peaked. Our job is to measure the intrinsic value of individual businesses with some degree of confidence. Identifying and buying growing companies at a discount to the fair market value of the business establishes a dual margin of safety. Our role should be perceived as risk managers.

Our first margin of safety is price. Price matters. From a current return standpoint, we have been fortunate to see the gap close this year between the price we paid for our companies and their intrinsic worth. Unfortunately, the gap is smaller today that it was earlier in the year. Our stocks have appreciated faster than our businesses have grown. We say "unfortunately" because we prefer having undervalued companies to buy. Long-term gains in the intrinsic value of a company are more important than short-term gains in stock prices. The market has a way of fairly pricing stocks over long periods. Provided a company performs well, its stock price will invariably reflect the performance. The only time an investor should want high stock prices is when money is needed. Short-term fluctuations in share prices give us opportunities to deploy cash. Investors typically have at least some cash (from dividends, sales proceeds, allocation, savings, etc…). Investing cash in good businesses at discounted prices simply makes sense.

Our second margin of safety is the underlying or organic growth in the companies we own. The value of the company should advance at the same rate over time as the business grows itself. Even if we are somewhat wrong on the valuation, provided the business grows faster than our estimate of growth, we should eventually be o.k. The key is to not significantly overpay. If the underlying growth proves lower, or our estimate of fair value is too high, then what seemed like a good price may not ultimately be the case. Price matters.

As we wrap up 2000 and get ready to celebrate Thanksgiving, the holidays and the real millennium, we want to wish everyone the very best. As you make your rounds at the stores during your holiday shopping, bear in mind what Ben Graham and David Dodd knew when they wrote *Security Analysis*—price matters. In other words, unless you happen to be shopping for your friends at Semper Augustus, keep a discriminatingly tight rein on the purse strings.

For those of you who enjoyed Ben Graham's quotations at the beginning of this letter, we have included more of our favorites from the 1934 edition of *Security Analysis*:

Stocks Should Have Elements of Safety:

The "common stock insanity" was a monumental example of a sound principle grievously misapplied. Its history teaches us more about the nature of human beings than the nature of common stocks. Long before the "new-era" gospel was being preached, there were principles guiding the selection of common stocks for investment as distinguished from speculation. Broadly speaking, an investment stock was required to meet the same tests of safety and stability as were expected of a bond. Common stocks passing these tests generally gave a good account of themselves as investments and in addition held possibilities of appreciation in value which were not shared by bonds. P.8

On Being Early:

A rigid observance of old-time canons of common-stock investment would have dictated the sale of one's holdings at a substantial profit very early in the upswing and a heroic abstinence from further participation in the market until at some point after the 1929 collapse when prices were again attractive in relation to earnings and other analytical factors. No doubt this would have resulted in making repurchases too soon—as matters turned out—with consequent paper or actual losses. But whatever the net result, the fact remains that the common-stock investor, proceeding along old-time conservative lines, had opportunities of profit commensurate with and risks he ran—an advantage not possessed by the typical bond buyer. P.8

For a Comparison to the Recent IPO Markets:

In 1928 and 1929 there occurred a wholesale and disastrous relaxation of the standards of safety previously observed by the reputable houses of issue. This was shown in the sale of many new offerings of inferior grade, aided in part by questionable methods of presenting the facts to the public. The general collapse in values affected these unsound and unseasoned issues with particular severity, so that the losses suffered by investors in many of these flotations have been little short of appalling. P.9

Psychology vs. Fundamental Analysis:

One of the striking features of the past five years has been the domination of the financial scene by purely psychological elements. In previous bull markets the rise in stock prices remained in fairly close relationship with the improvement in business during the greater part of the cycle; it was only in its invariably short-lived culminating phase that quotations were forced to disproportionate heights by the unbridled optimism of the speculative contingent. But in the 1921-1933 cycle this "culminating phase" lasted for years instead of months, and it drew its support not from a group of speculators but from the entire financial community. The "new-era" doctrine—that "good" stocks (or "blue chips") were sound investments regardless of how high the price paid for them—was at bottom only a means of rationalizing under the title of "investment" the well-nigh universal capitulation to the gam-

Recent Discussions:

Energy/Energy Services

March 23, 1999 Letter:

Diamond Offshore

Schlumberger

Transocean Offshore

Broad Market Profile

July 12, 1999 Letter

Property Casualty Insurance

August 6, 1999 Letter:

Mercury General

Predictions/Microsoft

January 1, 2000 Letter:

Predictions for the Next Fifteen Years

In This Letter:

Price Matters

bling fever. We suggest that this psychological phenomenon is closely related to the dominant value, viz., good-will, management, expected earning power, etc. Such value factors, while undoubtedly real, are not susceptible to mathematical calculation; hence the standards by which they are measured are to a great extent arbitrary and can suffer the widest variations in accordance with the prevalent psychology. The investing class was the more easily led to ascribe reality to purely speculative valuations of these intangibles because it was dealing in good part with surplus wealth, to which it was not impelled by force of necessity to apply the old-established acid test that the principal value be justified by the income. P.11

Speculation and Investment:

We must recognize that the psychology of the speculator militates strongly against his success. For, by relation of cause and effect, he is most optimistic when prices are highest and most despondent when they are at bottom. Hence, in the nature of things, only the exceptional speculator can prove consistently successful, and most of his companions must fail. For this reason, training in speculation, however intelligent and thorough, is likely to prove a misfortune to the individual, since it may lead him into market activities which, starting in most cases with small successes, almost invariably end in major disaster. If investment is likely to prove unsatisfactory and speculation is certain to be dangerous, to what may the intelligent student turn? Perhaps he would be well advised to devote his attention to the field of undervalued securities—issues which are selling well below the levels apparently justified by a careful analysis of the relevant facts. P.12

In the latest cycle, many operating companies, largely tech, included gains from investment portfolio holdings as part of operating income:

The fact that the operations of financial institutions generally—such as investment trusts, banks, and insurance companies—must necessarily reflect changes in security values, makes their shares a dangerous medium for widespread public dealings. Since in these enterprises an increase in security values may be held to be part of the year's profits, there is an inevitable tendency to regard the gains made in good times as part of the "earning power," and to value the shares accordingly. This results of course in an absurd overvaluation, to be followed by collapse and a correspondingly excessive depreciation. Such violent fluctuations are particularly harmful in the case of financial institutions because they may affect public confidence. It is true also that rampant speculation (called "investment") in bank and insurance-company stocks leads to the ill-advised launching of new enterprises, to the unwise expansion of old ones, and to a general relaxation of established standards of conservatism and even of probity. P.359

On Less-than-Conservative Accounting:

The basing of common-stock values on reported per-share earnings has made it much easier for managements to exercise an arbitrary and unwholesome control over the price level of their shares. While it should be emphasized that the overwhelming majority of managements are honest, it must be emphasized that loose or "purposive" accounting is a highly contagious disease. P.365

*When an enterprise pursues questionable accounting policies, **all** its securities must be shunned by the investor, no matter how safe or attractive some of them may appear. You cannot make a quantitative deduction to allow for an unscrupulous management; the only way to deal with such situations is to avoid them.* P. 378

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