Sequoia Fund Shareholders' Meeting[1]

May 7th 2004 – New York, NY

Bill Ruane:

Once again, welcome to the Sequoia Meeting. Last night, to show you how good I am with numbers, I said, "Now, is this the 34th or the 35th meeting? We started in June of 1970." So, at 5:00 in the morning, with my computer-like mind, I was going, "... '71, '72, '73, '74 ...." Now, if I'm wrong, I'm sorry, but I think it's the 34th annual meeting of Sequoia. Thank you very much for coming.

I would like to make a very special announcement, and I'll get right to the point. In many ways, this is a long overdue announcement, but I say it with great feeling and honor.

You are all stockholders of Sequoia. And as you all know, Sequoia is managed by and is very much a part of Ruane, Cunniff & Co. But that name has not been quite accurate for a long time. So I can't tell you how pleased I am to set the record straight and call our firm as it has actually been run: Ruane, Cunniff & Goldfarb.

Bob Goldfarb joined us in 1971, and right from the very beginning — I'm not sure he wasn't already working when he walked out of my office after I asked him to join us — he has been an integral part of everything we've done. Since that time, in so many ways, it has been Ruane, Cunniff & Goldfarb.

Many of you know Bob, and many of you don't. Bob has tended to stay in the background. There have been times when people have wanted to talk to and publicize Bob, but he has preferred just to do his magnificent work for us and stay out of the limelight. But I can tell you that the firm, with that name, Ruane, Cunniff & Goldfarb, will represent what's really happening.

And it represents what's going to happen in the future. We've always been a partnership, and it's been great working together. But I have had virtually nothing to do with the administration of the firm and the selection of the staff. It's all been Bob's doing. Bob has assembled a team that I truly believe is the best on Wall Street. Thank you, Bob, for showing up in '71, and thank you for the enormous contribution that you've made to the absolute compounding of Sequoia Fund. It's a pleasure to put the name of the firm right.

Now, I'll turn to something somewhat related. I was on a panel last night sponsored by the New York Society of Security Analysts. Jim Grant was in charge of this particular panel, which was about Ben Graham. It promised to be the oldest panel ever because it was comprised of those of us who knew Ben Graham. Jim Grant started off by asking me an unusual question. I wasn't prepared for it, but given the climate that we're in I can see why he asked it.

Now, investment funds have been around for a while, and funds of funds have been around a while — and it's not necessarily the worst idea in the world. But now there are funds of funds of funds. And Jim asked me: "What do you think of this?" Well, I really couldn't use the word that expressed my thought at the Penn Club, and I shouldn't use it in a place like this. To be nice, I'd say it's disgusting. Wall Street has created all these different products and all of these specialized mutual funds and packages of investments with layer upon layer of fees. I really think it's ... Ben Graham would not think well of it.

We have this one mutual fund, and Sequoia Fund is Ruane, Cunniff & Goldfarb's largest client. As you all know, we do not spend our time nor are we interested in adding new money from others. That's been true for years. Sequoia's been closed, and our private account business has essentially been closed, although we do try to serve all of the needs of our clients' families. As you know, our other clients have a significant amount of assets, somewhat larger in total than the amount of assets in the Sequoia Fund. There's a lot of overlap in the investments. Our portfolios are very similar because when we have conviction, we basically do the same for everyone. That's the way it should be.

We are part of Wall Street, and we won't deny it. Rick and I started at Kidder Peabody in 1949 and 1950, and our firm has been in business since 1969. But things have changed so much in so many ways. When we read in the papers about the mutual fund business… I really have been shocked by some

[1] Remarks have been edited for clarity.

of the things that the mutual fund business has engaged in, and I think it's really sad.

It doesn't have to be. I was in a group one time when we were discussing organizations to run other people's money. And I thought then that the finest organization you can have is one brilliant person like Warren Buffett or Bob Goldfarb running your money.

Once you get beyond a very small number of clients, though, you start creating a business, which is what we did. If you go into business and promise to do your best for people, you realize that you have to create a structure. If you have a single doctor as your advisor, he is the most valuable person with regard to your health. But the responsibility obviously lies heavily on him. At some point, you have to go from being a one or two-man shop to being a good clinic. You become an entity that goes beyond the reliance on one doctor.

When I look at the organization and see the depth of talent that Ruane, Cunniff & Goldfarb has, I think we have now reached a level of breadth and depth that's sort of ideal. And it is something that the three of us are proud of. We are proud to have served you as we have in the past, and we look forward to serving you in the future, to staying focused on what's important and not straying off course or getting too big.

As Bob will soon describe, our research effort will continue to be what it always has been: fundamental research based on digging into the numbers in the manner that Ben Graham described in *Security Analysis* and kicking the tires. We will try our best, and we'll keep life simple.

I don't think I've said everything the way I wanted to say it, but I'm really a very happy man today to be here with Rick and Bob. Thank you all for being wonderful shareholders. Now I'd like to turn the meeting over to Bob.

Bob Goldfarb:

Thank you. Good morning. I want to join Bill in welcoming you to our 34th Sequoia Annual Meeting. I also want to thank Bill and Rick for their extraordinary generosity. I'm very proud to have had them as friends, mentors and research partners for the past 33 years. I'm honored to have my name alongside theirs. To paraphrase Daniel Webster when he spoke of Dartmouth College, Ruane, Cunniff is a small firm, but there are those who love it. I am one of those who love it.

Periodically I meet with young people who are planning to enter the field of investment management. They are almost always very intelligent and very well-educated. They've already read the right material: Graham and Dodd, Philip Fisher, Warren Buffett. Consequently I find that they already know the answers to many of the questions that they ask me; so the most valuable advice that I can render them is not about investing *per se*. Rather, it's derived from my own experience 33 years ago.

My best counsel is about the people whom they're going to be working with. I tell them that before accepting a job offer, they should give enormous consideration to the character of the people with whom they will be working. It's equally important that they like those people. Indeed, if they like the people, it's much more probable that they're going to like, and even love, their work. And I think that advice extends to areas far beyond investment management.

Bill and Rick have created such a rare and special culture. It's a culture with a strong work ethic at the heart of which is doing our own extremely intensive research. It's a culture of humility, one in which we take our work seriously, but not ourselves. It's a culture without a lot of structure, which fosters creativity and empowers individuals.

The seeds of the culture were clearly planted by Bill and Rick, but the strength of the culture transcends them. Like America itself, the culture is reinforced and strengthened by the men and women who join us. So the notion that our strength emanates from any one, two or three individuals on the dais and that, in the absence of those individuals, the firm would be much weaker is absolutely false.

The truth is that Ruane, Cunniff & Co. is a company of extremely able individuals whose collective strength far exceeds the sum of their individual talents. The great majority of the ideas that have entered Sequoia in the last five years were generated by individuals other than Bill, Rick or me. Moreover the processing

of those ideas, which is so critical to our success, has not been done by the three of us. This is clear proof of the abiding strength of our culture, and is consistent with what Bill said. It's why I consider our greatest achievement to be the assembling of the research talent that's with us today. That's our cornerstone and that should take us far.

Now I'd like to turn to a subject which has been on my mind for some time. My topic is probabilistic investing and how what we do at Sequoia is different from it. Probabilistic investing is a fairly common practice on Wall Street. But lately, the topic of probabilistic thinking has been in the spotlight, thanks at least in part to Robert Rubin's recent book, *In an Uncertain World.* In it the former Treasury Secretary and co-chairman of Goldman Sachs lays out how he relied on thinking probabilistically to make a wide variety of decisions, from the short-term trades he generated on the arbitrage desk at Goldman Sachs to the courses of action he recommended that the federal government take in international currency crises.

In simple terms, probabilistic investors select stocks in much the same way that well-run insurance companies price their policies or skilled gamblers make pari-mutuel bets. They consider a range of potential outcomes, assign probability weightings to those outcomes and commit capital when the probability-weighted odds work out in their favor to some satisfactory degree. Such investors allow that not all of the individual bets will yield profits in the end but argue that a reasonably diversified portfolio of well-chosen commitments should ultimately produce attractive results in the aggregate.

In thinking about this topic over the last couple of years, I have found the work that Michael Mauboussin has done at Credit Suisse First Boston especially valuable. In my opinion, Mauboussin has been one of the most thoughtful and insightful commentators on Wall Street. Bill Miller of Legg Mason is an especially strong advocate of probabilistic investing and clearly an outstanding practitioner of the approach. Robert Rubin himself, of course, put his probabilistic principles where his wallet was during his stellar career at Goldman. And I know other investors who have compiled excellent records using the probabilistic approach. There are many roads to heaven, as the saying goes. And for some, the probabilistic one has been paved with gold.

Probabilistic investing focuses on managing *risk*, but risk defined in a special way. In the risky world of the probabilist, an investor commits capital to a business. He is aware that he does not know what the outcome will be, but he believes that he knows well enough what the distribution of those possible outcomes is. In English, you don't know which cards your opponents around the poker table hold, but you know that there are only 52 cards in the deck. With that certain knowledge and your observations and judgments of the actions of your opponents, you can reasonably assign odds to the possible outcomes of a given hand and bet accordingly.

Probabilistic investors, like good poker players, do not win every hand. But their temperaments are such that they can find enough certainty in the reliability of mathematics to bet that a portfolio with a certain number of profitable positions will more than compensate for a certain number of loss-making positions *and* to sleep at night. The warm milk is that the success or failure of an individual investment decision is distinct from the process itself. In other words, since the probabilistic system factors in some number of clunkers, when an individual stock does indeed come a cropper, that unhappy outcome does not invalidate the process. Why should it? The probabilistic investor figured that some ideas were going to go wrong; he just didn't know which ones. The success or failure of the investment decision and the process by which that decision was reached are thus separate issues.

The success we have experienced at Sequoia has been on another road. Our objection isn't to the probabilistic approach *per se*. All investors, including those at Sequoia, have to think probabilistically. Rather we are concerned that the uncertain world, which the probabilistic investors acknowledge, makes it extremely difficult to assign probabilities with the confidence that we feel is necessary to put our shareholders' capital at risk.

Let me elaborate a little. In the messy uncertain world, stuff just springs up sometimes that, from a probabilistic point of view, simply takes one's breath away. We wonder if five years ago *anyone* would have assigned odds of any consequence to the possibility that Adelphia, Enron, Healthsouth, and WorldCom were fraudulent enterprises whose equity was essentially worthless.

To be sure, we do not worry very much about the rare super-sized examples of corporate malfeasance. These are clearly outliers. What really gives us pause about the probabilistic approach is that the assignment of probabilities implies a greater degree of precision than we are comfortable with. There are many perils in business that are impossible to handicap. How do you assign odds to the possibility, for instance, that a well-run company with sound and thoughtful management will all of a sudden make a sizable acquisition that turns out to be mediocre or even terrible? What is the probability that a brilliant CEO, having spent a lifetime building a great business, will hand over the reins to a lesser talent who turns that outstanding company into an average enterprise? If a company has led its industry for years with innovative products, how likely is it to lose much of its edge to a more nimble competitor with a poor history of new product introductions? Are the odds for any one of these examples one in five, one in seven, one in nine? One can only guess of course. Moreover, whatever probability you choose to assign to avoiding the adverse consequences of a single event, the odds of sidestepping more than one, much less all, of these hazards are inevitably worse. But it is all too easy to succumb to the comforting air of precision that gathers around numbers and forget that a guess times a guess remains a guess. True, all investors have to think probabilistically to some extent, but we simply do not have the temperament to bet 60/40 or even 70/30.

One reason for our caution is that experience has taught us that sometimes the future turns out to be so very different from the past as to have been almost inconceivable at the time. We have owned — and fortunately sold — stocks of a number of companies over the years which are earning significantly less now than they were 15 years ago. I can tell you that the idea that these companies, which were perfectly fine businesses when we owned the stocks, would be worth significantly less today than on the day we sold … well, it never entered our minds. Investors readily acknowledge the existence of slowly declining businesses, but they have a pretty unshakeable belief that it is always the other guy who is holding the old maid.

Experience also teaches that sometimes, seemingly without warning, something truly new does appear under the sun. An innovative disruptive technology comes along in the form of the Internet, say. As investors we believe as Peter Drucker put it, that we live in an *Age of Discontinuity*. Big, disruptive, discontinuous changes happen. Capitalism inevitably works its creative destruction in unexpected ways. And the trouble is, "How do you assign a probability to an event that is unexpected?"

Nearly as important as the fact of fundamental change is the rate of speed at which that change takes place. In our experience, this is also very difficult to gauge. Three or four years ago, the supermarket industry appeared to be a model of stable, steady returns. Many people knew that Wal*Mart was out there in the cornfields of the heartland, but most investors did not realize until recently that the discounter would be causing such an enormous dislocation in the grocery business. Change in business is often like that — it seems to strike suddenly like an earthquake. Only later does the realization arise that tectonic forces were rumbling just below the surface all along. By then the certainties of historical perspective offer little comfort for the pain of investment losses.

While disruption in business is a fact of life, it can also offer compelling investment opportunities. We strive to avoid the disruptees, but we are happy to spot the disrupters. In fact, we even own a few of them, and we would like to own more. The barrier is that the market usually credits the disrupter before it discredits the disruptees. That makes it more difficult to capitalize on the opportunities offered by dramatic changes.

We have mentioned that probabilistic investors believe that good processes can

produce bad results and vice versa. Our experience has been that process and outcome are more closely correlated. The outcomes of our investment decisions are usually the fruit of the process and how we cultivated it. Successful outcomes have generally followed good processes and sound execution, although we have occasionally benefited from a great escape. When we have an adverse outcome, it has been the consequence of a flaw, or flaws, in our process and/or execution. And so, we apply what we learned in our postmortems to future investment decisions. We want to reduce the number of adverse outcomes and increase the number of favorable ones. In other words, we continually strive to reduce uncertainty by improving our processes and execution.

Not surprisingly, we are big believers in thorough analysis and research. Analysis and research for us include not only carefully dissecting the financials but also collecting scuttlebutt, the qualitative information about a company that the late Philip Fisher describes as so important in his book, *Common Stocks and Uncommon Profits*. Again, our goal is to lower the absolute level of uncertainty by raising our level of knowledge before and after we buy the business.

Probabilistic investors do research, too, of course. But they approach the investment decision differently from the way we do at Sequoia. For probabilistic investors, the market is a race track and buying stocks is placing bets at what they believe are favorable odds. The hay-burner that may have just enough left in him to win one more race and pay 10 to 1 is a perfectly acceptable wager. It may or may not work out, but if you spread your risk and figure the odds well on enough races, you can do okay. And occasionally, you get lucky. Earlier I mentioned how we wrestle with the fact that sometimes a great company can lose its edge. But it works the other way too. A mediocre company with a second-rate management up and appoints a dynamic new chief executive, and your two dollar bet pays off big.

There is nothing wrong with good luck, particularly when it's yours. But we approach the market not as if it were Churchill Downs, where the outcome of the wager is clear in a couple of minutes, but as if it were the auction block at Keeneland, where you expect the purchase of a horse to prove itself out over years. Because this is for the long run, we don't want Old Paint. We want a great horse at a great price. And because, unlike at Keeneland, an investment comes with a rider who will be in the saddle for many years, we put as much emphasis on the jockey as we do the horse.

Mohawk and TJX are good examples of terrific thoroughbreds with top-notch jockeys, which we were able to purchase at bargain-basement prices. Of course, great deals are very hard to find. But if we can not get both the business and the price, we are willing to, and have, paid a little more for businesses that we feel are of comparable quality. Time is the friend of the wonderful business, affording it the opportunity to reinvest incremental capital at favorable rates and increase the value of the enterprise. Over time, the price you paid for a terrific company looks cheaper and cheaper. For the inferior business at the cheap price, time may turn out to be the fell destroyer.

We have also been willing to hold positions at relatively high valuations for periods of time when we felt that the company's long-term growth prospects warranted it. And we have established positions in a number of companies that traded and continue to trade at multiples well above our historic norms. Expeditors, Fastenal and Walgreen fall into this latter category. We have owned these and other higher-priced holdings for what we consider relatively short periods of time. The higher multiple, of course, means that we are paying for many years of growth, and so it is too early to declare these investments successes or failures. For now, we will only say, "So far, so good."

In our search for exceptional companies, we employ a number of filters. High on the list, of course, is price — specifically the relationship between price and conservatively estimated intrinsic value. We also look for high returns on capital and strong free cash flows. We expect to see sustainable competitive advantages and reasonable opportunities to invest satisfactory amounts of incremental capital. Still another filter relates to management. Do the people who run the company take an owner-oriented approach to

important issues like compensation, financing, accounting and options issuance? Do they act with honesty and integrity?

Nothing all that unusual about those criteria. But there are other filters as well. By our lights, it is very important to consider a company's culture, although it does not lend itself to scientific analysis. Also difficult to assess but extremely important is what I will call management's business judgment. Is management insightful enough to make the many decisions necessary to protect the franchise and improve the long-term performance of the business, even if it entails taking a hit to reported earnings for a time?

Calibrating such filters is very tricky, however. When does the price of being disciplined become too high? We may protect ourselves from many bad ideas if we insist on being Snow White, but if we drifted a little, as Mae West said, could we capture additional promising opportunities?

Maybe. We have come to understand through experience that the nearly-great business purchased at the right price is not the enemy of satisfactory investment performance. Looking back, we also realize that we have prematurely sold fine businesses when we determined that they were just shy of being as great as we thought they were when we bought them. In many of these cases, we have to fault ourselves for overreacting to what turned out to be small concerns and losing sight of a favorable larger picture.

By far, the more costly of our errors have been those of omission not of commission. For example, we passed on a company with an exceptional franchise and many of the financial characteristics that we find attractive. It installed a new CEO, who had never run a public company before. The new guy immediately ran out and made the biggest acquisition in the company's history. It was a doozy. The acquired company was enjoying peak cyclical earnings and had a history of regulatory problems. That was enough to turn us off. And the acquiring company has done just fine despite the fact that the company it bought has been losing money.

We studied, admired but never bought Whole Foods, an innovative high-end grocery chain. The stores are terrific, and the growth prospects very significant. Management is sharp and deeply committed to the business. The multiple was high, which gave us pause. We would have willingly paid it, but Whole Foods grants options at a rate that is a higher percentage of outstanding shares than we are comfortable with. When we adjusted the earnings for the options issuance, the multiple rose out of our range. Not reaching a little bit higher was a mistake. What we learned was that when a company is in the early stages of very rapid growth and faces no strong competitors, you shouldn't focus unduly on the multiple of near-term earnings if you have a high degree of certainty that five and ten years down the road the earning power then will justify the price you pay now. "The art of being wise," wrote William James "is the art of knowing what to overlook."[2] By that definition, we have not acted wisely all the time.

We got it right with Progressive. Looking back at that decision, however, I have to say that our filtering process certainly raised some questions. The company had a poor record of managing its investment portfolio. We had to view this negative against a long record of underwriting excellence and the bracing honesty of Peter Lewis, the company's visionary chairman, about where and how he had gone wrong.

Today, we are wrestling with a couple of very interesting potential investments. In one case, our concern is: Is management milking the business or is it simply maximizing profits? In another, management readily admits that it is engaging in business practices that boost reported profits at the expense of true economic earnings. Should we pass on the stock because management is running the business for Wall Street?

I don't know yet what decisions we will come to in these two instances, but I do know that I will feel more certain about our decision the more information we collect and the more research we do. Our experience has been very different on this issue from Michael Mauboussin's. He asserts that there is a point after which further information produces dramatically diminishing returns. For us, that simply has not been the case. It is our firm

[2] William James, "Reasoning," *The Principles of Psychology*, (Cambridge, MA, Harvard University Press, 1981) II, p. 992.

conviction that we can increase the probability of success and reduce uncertainty through gathering and processing extraordinary amounts of information and through extensive, intensive and continuous research.

This concludes my formal remarks. At this point I'd like to introduce our research staff. Then we'll be happy to take your questions. On the dais from my right is Joe Quinones who does a terrific job of running our back office. Next to Joe is Greg Alexander, who I think is the earliest hire of the ones whom Bill mentioned. Greg goes back to 1984. And of course, there are Bill, Rick Cunniff, Jon Brandt, and David Poppe. In the audience are Girish Bhakoo, Arman Gogkol-Kline, John Harris, Jake Hennemuth, Terence Paré, and Greg Steinmetz. With that, we'll be happy to take your questions.

Question:

Given Warren Buffett's age, how concerned are you with your investment in Berkshire Hathaway?

Bill Ruane:

Well, I think that being in one's seventies, as I am, does give one pause as to how long one can go on. Warren's health I think I can almost term as excellent. He is 73 years old, but he exercises, which I think is one of the keys. If Warren were here, he would answer that question in an amusing way. Jonny, do remember the number of haircuts?

Jon Brandt:

I don't remember what the exact number was, but a couple of years ago he was talking about people asking him what he would be doing with all the cash Berkshire had. And he said he didn't know how many times there would be situations in the market where he could allocate capital attractively. He said he knows that he's going to get his hair cut on an actuarial basis, whatever it was, 146 times, and that he was going to take in so many calories. And what was the third one?

Bill Ruane:

How many times he would fill up his gasoline tank.

Jon Brandt:

That's it. For the number of calories, I think he was probably just taking the mortality table for what at the time was a 71-year-old man and multiplying by the amount of peanut brittle he eats daily.

Bill Ruane:

I think, as many of you know, at the end of last year Berkshire Hathaway had $31 billion in cash, which was earning something less than one percent after taxes, and about $61 billion in bonds and stocks. In other words, I would think that if the opportunities arose, far more than the $31 billion would be available to invest at much higher returns.

Warren has stated publicly ... and am I right on this, Jon? ... I believe he did it over the weekend, perhaps a number of you were there out in Omaha ... that he thought that he would have an opportunity, and I'm sure he meant personally, to improve the return because of situations that will happen in the future. He made no suggestion that he would do it this year or next year or the year after that. But his comments suggested in my mind that he would be around for a while making those decisions. So, yes, we do think about the longevity factor, and I think it's clear that, so far, we feel that owning Berkshire is a risk well worth taking.

I remember playing with the haircut number and the gasoline number, and as Jonny said, it was probably taken right out of a mortality table. But I recall that it got Buffett into his 80s, but that's a personal opinion. I can tell you, observing his energy up close on occasion, he's just the most remarkable human being I've ever seen in every way, including energy, and directing that energy in so many ways.

What he's best known for is simple stock picking. But if you examine what's happened over the last two or three years you will see that while the market has certainly been unappealing to us except in rare instances, that mind of his is running and giving us a return in other areas where he has shown a remarkable ability to make money — and we're talking about significant amounts of money. One area has been in junk bonds. Another has been in fixed-income arbitrage. More recently, he made a huge investment in foreign currencies. I'm not sure that's an answer, but there is no obvious

single answer. I'm very comfortable with our holding of Berkshire.

Question:

What do you think will happen to the stock when Buffett dies?

Bill Ruane:

At our directors meeting we had to come to some conclusion about how to value the stock in the event of his death. I would think that on the first day after he dies there would be a strong reaction. Depending on what happens, it may even create an opportunity.

Greg Alexander:

You know, someone asks this question every year, and I'd just like to give a very brief answer that I think will be true this year and next year and the year after. The question has really three components. First, the implication must be that the questioner is concerned that the price of Berkshire Hathaway is at a premium to its worth, right? Because if it were selling for a discount to its worth, we wouldn't have to be too worried. Second, maybe there's some implication that the company is a very complex high-wire act and that, should something happen to Warren, all the wheels would stop spinning and the whole thing would crumble. We're not at all worried about that. And last, there is the question that if something happened to him, would the compound rate of growth decline? And I think the answer to that is, "Probably yes, although the return may still be perfectly good." So, the question really goes back to whether you think it's selling at premium the loss of which, probabilistically adjusted, you are unable to bear.

Bob Goldfarb:

And I'd ask Bill this question, because he's known Warren much longer than I have. Is he operating at the top of his game?

Bill Ruane:

I think so, I really do.

Bob Goldfarb:

Yes. I think that's one indicator you'd certainly look for, any sign of deterioration. Just watching him at the annual meeting last week, I think one would come to Bill's conclusion. Then there is what Buffett's done, the investments that he's made in so many different areas that Bill described.

To respond to your question directly, I'd say that there is a high probability that the stock will decline, probably significantly, upon his death. But what the trajectory will be from here to there, who knows? For a while, the stock seemed stuck at 70,000 or so, and it seemed as though his age was weighing on the stock and that it was possible that the traditional Buffett premium that Berkshire enjoyed might be transitioning into a Buffett discount, if you will, for his age. It's possible that in ten years the market will put a discount on Berkshire for that reason. But it's very hard to predict that trajectory. Your guess is as good as ours.

Bill Ruane:

And I think that mind is not only operating at the peak of his...

Bob Goldfarb:

He's running with Arnold.

Bill Ruane:

Oh, yes. I'm sorry we don't have it here, but at the annual meeting, he had a video of himself being punished by Arnold Schwarzenegger for having made some comments right after Warren became his advisor in California. Warren said something about property taxes, which immediately led people to think that Schwarzenegger was going to raise taxes, but Schwarzenegger had said that he was not going to raise taxes. So he called a meeting the next day and had Warren right next to him, and he said, "Warren, if you ever do that again, I'm going to make you do 500 sit-ups." Well, at the annual meeting Warren had a video in which Schwarzenegger took him into an exercise room and told him that he has decided to go ahead and make him do those exercises. So you have this picture of the real Warren Buffett starting to do sit-ups, and then the film goes very, very fast. I never told him this, but I said I think that was Charlie Munger who was doing them that fast. And then he went on to do push-ups just to show Arnold that, you know, this wasn't just a little passing thing that happened. Then he did about 500 push-ups very fast. The next thing you know the camera pans over to Warren with his shirt off looking about twice the size of Arnold Schwarzenegger. Warren is in good

shape, both in mind and in body. For those that know him, he has a great sense of humor, which I think leads to longevity as well.

Question:

Could you comment on the risks posed by the large notional value of derivatives being used today? What are the risks to the major financial institutions, the dealers, and the economy in general? What recommendations would you have for those major financial institutions to reduce their risk?

Bob Goldfarb:

Who would like to take a shot at that one? I should mention that those of our crew who are not on the dais should feel free to stand up if they want to address any of the questions that are asked. Jonny, do you want to start?

Jon Brandt:

I'd be lying if I told you I knew what Citigroup should be doing to reduce its exposure to systemic risk from derivatives. I'm not even going to try that one.

Bill Ruane:

It is hard to believe. Here we are, former owners of Freddie Mac. I think we must have owned it for close to ten years and followed it pretty carefully. We knew the people. They didn't stand out as highly greedy, but they were affected — as I think many people were — by the market's buoyancy. Imagine a company of that size with, what is it? $15 billion in equity, and assets up at the trillion dollar level, with government oversight, and well-known accountants. But there it was coming out and surprising people by understating their earnings by $5 billion. It's unbelievable. Unbelievable.

This is what happens with large derivative activities. When you deal with something like a trillion dollars in assets, and you do it with an asset base where you're buying things on two percent margin, crazy things can happen.

So I agree with Jonny. Trying to predict things like that is very difficult. But derivatives are out there. The question is: What do you do about it? Do you put all your money in the mattress? I don't think you do. I think that if you owned our five or six largest holdings privately, you would continue to go ahead and benefit significantly from owning them. I think we just go on and do our best with good businesses. Still there is no question that there are things that can happen in any economy as a result of dislocations that are very material.

And derivatives are not the only thing to worry about. I certainly recommend Warren's article in *Fortune*, which came out last October or November. It talked about the fact that we as consumers just don't seem to be able to keep ourselves from buying more from abroad than we sell. The differential is a number that's up there at the half trillion dollar level. The world owns quite a bit of us now net, whereas 20, 30 years ago we owned quite a bit of them, net. There is an enormous sum of money invested in fixed income dollar-denominated securities. The common number that everybody hears about is around $1.5 trillion in Treasuries that are held in reserve accounts of various countries like Japan and China. But that very, very significantly understates the amount of dollar-denominated calls on our currency.

The risk is that faith could be lost, and faith is psychology, you know. In the case of the dollar, I'm not trying to say something dramatic is going to happen, but we have been the reserve currency of the world. If rates start to rise substantially, somewhere along the line owners of dollar-denominated debt might say, "Oh, I'm tired of losing money." Or maybe they'll say, "No, I think I'll just stick with the US; it's still the best I can find."

Let's hope that the faith stays there. And more important, let's hope that our country does something about righting this tendency to not handle our financial affairs properly.

Bob Goldfarb:

At the Berkshire meeting, I think Warren said in response to a similar question about derivatives that he wouldn't be concerned as a depositor in a major financial institution. He thinks the government would make those deposits good. To the equity holder, he didn't give the same comfort.

For anybody who has an interest in derivatives and wants to read a book that will make you laugh and make you sick at the same time, I'd follow Charlie Munger in

recommending a book called *F.I.A.S.C.O.* by Frank Partnoy. Some of it just shows what a cesspool the marketing of derivatives is, and it goes back to Bill's comments earlier about what's happened to Wall Street. The writer was at Morgan Stanley, but once you finish the book, and it's a pretty quick read, your opinion of all the major investment houses in New York will diminish regardless of the level at which it is when you begin the book.

Bill Ruane:

Just one more thing on this whole business of the end of the world. I remember in my earlier days, we had people with sandwich signs on the front and the back, you know, advertising haircuts or something else walking down the street. The one thing that you don't want to get into is having a sign that says "The end of the world is going to come on November 14th of 2004." You'd look a little foolish the next day. Getting back to Bob's comments on probabilities, I wouldn't rank any of these disaster scenarios as high probabilities near term. But when you take a number of them that may occur in the next five years, it leads you to be careful about what you own. I've always preached the idea of having a certain amount of your money in the very safest things — I have money in US Treasuries — even if they yield one percent or less, just so you don't have to worry about living through something like that. In a country like ours, as strong as we are, if something terrible happens, it will probably be righted in time.

Question:

Could you please comment on your reasons for selling Cintas?

Greg Steinmetz:

Cintas, for those of you who don't know it, is in the business of supplying uniforms to factories, car repair shops, and to anyone who might get dirty in his work. Cintas had a tremendous record, but we didn't think that the market was going to grow as fast in the future, and we were concerned that the industry was becoming more price-competitive.

Bob Goldfarb:

Yes, that was an example of a high P/E stock that we bought. Our assessment of the probabilities changed over time. And it's still sporting a pretty high P/E. And I have to say that Dick Farmer's enormous sale of his personal stock several months after ours made me feel that we weren't too far off the mark.

Question:

Ordinarily you do not sell a position unless there's a downward change in intrinsic value. Let's take for example Fifth Third. By their standards, last year was a year of only average growth in earnings, compressed margins, a larger than expected loan loss provision, and a slowdown in the data processing unit. In addition, because of the federal letter, they were constrained from making any acquisitions. But these factors have made its price somewhat reasonable for a historically great bank. What do you see? Is this an opportunity to buy or sell? If the answer is to sell, what confluence of factors would prompt you to do this?

Jon Brandt:

Well, first of all, technically we're not allowed to buy more in the fund. And as you say, the price is now reasonable, so I don't think we'd be selling. More generally, I think we spoke about the written agreement last year. They had a bookkeeping error. It was a mistake. It was not a corporate governance issue. It was a reconciliation issue with their general ledger, which would take me too long to explain. But the size of the loss was dwarfed by the loan losses that other banks took on bad credits.

You're correct that Fifth Third had somewhat above average credit losses last year. Most of those came from airplane leases that, again, were a mistake. Not to excuse them or anything. Once a week, Bob Goldfarb asks me why Fifth Third was doing plane leasing. I think they made a mistake. But there was portion control. I think they had less than $200 million on a balance sheet of $90 billion.

And I think their net charge-offs last year were something below 60 basis points. I'd have to double check to get the exact number, but it was certainly a manageable number. A lot of other banks took huge provisions in 2001 and 2002 before they charged off things. Fifth Third follows a policy of trying to work out the loan. Only when all else fails, do they take the

charge-off. So I think there's a lag factor that made them look a little worse: When other banks were improving their credit profile, it looked like Fifth Third was still kind of stuck in the recession.

I still think they are a great bank. I think from $90 billion it will be harder to grow at their historic earnings growth rates. Their P/E is constrained; so they may have trouble adding to their earnings per share growth through acquisitions as they did in the past. But I would still set their record against any other large US bank out there. There are some smaller banks that are growing very fast right now, and they will probably grow faster than Fifth Third. But I still think it's an excellent bank. It has flaws. We all have flaws. But I think we feel quite comfortable with that position.

Bob Goldfarb:

And speaking of aircraft leases, I don't know if you saw that Fannie Mae, with government guaranteed money, was speculating on securities the collateral for which was $300 million in aircraft leases.

Jon Brandt:

That was in its congressional charter, I'm sure. I mean that as a joke, of course. You know, we go out to meet the people in the affiliates. I was at a conference on Wednesday, and the head of Fifth Third's Chicago affiliate was there. He's a very capable guy, and Fifth Third has a three percent market share in Chicago. Chicago has more deposits than I think all but four of the 50 states; so they've got a lot of running room there. There's competition. Banc One has kind of gotten its act together, and Washington Mutual is opening a bucket load of branches in that market. It's not going to be easy. It's street by street combat, but I think Fifth Third will do fine.

Question:

I was wondering what thoughts you have on centralized management versus decentralized management. And the second question is: Are there any rules of thumb that you use to determine a reasonable price to pay for a good company? What type of metrics do you use to determine intrinsic value?

Bob Goldfarb:

In response to the first, I would say that it is critical that the structure of management be suited to the characteristics, needs, and dictates of the business. For example, TJX runs a very centralized enterprise. The key to the business lies in buying distressed merchandise at the right price. The management of the stores isn't as critical. So I wouldn't favor one model or the other. Rather I'd be careful to try to make sure that the model is consistent with the needs of the business.

In answer to your second, I mentioned Whole Foods in my talk. That is an example … I can't remember the nominal P/E at the time we were looking at it. Do you, David?

David Poppe:

Close to 40.

Bob Goldfarb:

Close to 40. And then if you adjust for a five percent rate of options grant, you'd knock off about 25 percent. So you're talking north of 50 times earnings. Earlier I said I thought that we made a mistake in not paying that much for Whole Foods. So there is no given multiple. If you have a strong conviction that a business is inevitably going to grow at a rapid rate for a long time, it is worth paying a very high multiple. Bill Miller, whom I said earlier that I have great respect for, in his most recent quarterly, wrote about how much money he thought he was going to make owning eBay. Clearly, eBay has a very high multiple. And it has a very high rate of options issuance. But if eBay has unusual network characteristics and if it is going to continue to grow very rapidly… I don't know if the adjusted P/E for eBay is 80 or 90 …. I wouldn't necessarily bet that Bill Miller is wrong.

Question:

Mr. Goldfarb, would you and your colleagues have any additional books or publications that you would recommend to us?

Bill Ruane:

I think that Robert Rubin's book was very worthwhile. He didn't spend all of it on his experience as Secretary of the Treasury, but he did go through the structure of his probabilistic thinking, which Bob referred to. I think it's very

worthwhile if you're interested in that kind of thinking.

Question:

You've done a wonderful job for us and it's attracted a lot of attention. I see many of the mutual fund firms being bought and I just wondered what the temptations are for you in that regard? And a second question is: I've had money in an IRA for many years and now I've reached an age where I have to start taking it out. If a lot of us reach the age where we have to start cashing in some of our shares, what does that do to your assets and what does that do to the investors that are still there?

Bob Goldfarb:

In response to your first question, I earlier said that I was uncomfortable dealing with precise probabilities, but in this case, I'm not. The probability of our selling our firm is zero point zero, zero, zero. With regard to your second question, there is a natural rate of attrition in Sequoia. I think there was one year, maybe when the Internet stocks were crashing, when we actually had net inflows. But there is a natural attrition rate. We would hope to more than offset that attrition by the appreciation in the portfolio, even though as we've said before and we'll say again, the future growth rate won't match the historic.

Also we've had cash or Treasuries. So, the redemptions simply reduce the cash except when we do the in-kind distributions.

Greg Alexander:

Joe Quinones is just pointing out that some people do withdraw from their IRAs, but just put it back into a taxable account. My own father does that. So it's not all a net loss to us.

Question:

Would you comment on the usefulness or lack thereof of the federal tax reductions in the last two years and the probability that they will be continued after the election this year.

David Poppe:

I think the rebates the last two years certainly helped put liquidity into the economy. You see it in retail comps. After the tax rebate checks came out, retail comps popped briefly. As for what's going to happen after November, we don't know and I don't think we're investing assuming one outcome or another. Hopefully we're buying companies on their own merits.

Bob Goldfarb:

Looking ahead very long-term, I've seen projections that tax rates are going to have to go up into the 70s in a number of decades if certain projections on entitlement spending are correct. So I wouldn't expect lower tax rates, and over the long-term I could see where rates might be quite a bit higher than they are today.

Question:

Would you comment on the argument that perhaps Warren Buffett has become overly risk averse in relation to investing in public equities. I think he has made no major investment in over a decade. That would obviously include the late 90s, which would be understandable, but also the period a couple of years ago, when at least in relation to today, stocks were a lot cheaper. To give one example, I think the stock of American Express, which of course is already a major holding, was approximately half where it is today shortly after 9/11. It's obviously a company he was very comfortable with, knew inside and out. I wondered if you could comment on that.

Jon Brandt:

I think it's an excellent question. I've been wondering the same thing. I'm not aware of any reason why he couldn't. We looked at it in September 2001 when it was trading in the mid-20s. They had had some problems with their junk bonds in the investment division, which is now called American Express Financial Advisors. It's possible that he was uncomfortable with what they were doing with their balance sheet. I know that I wasn't so happy about their exposure to junk bonds. And there are some accounting things they have been doing that have kind of bothered me. They were using gains on securitization to fund marketing expenditures. And then they were showing another income statement, which supposedly got rid of the securitization income, but it also got rid of the marketing investments. You couldn't really figure out what they were thinking about.

They also had an options issuance rate that was three percent. That may have scared off Warren. Just in the last year, the management

there has made a policy change, and I think they've gone down to one percent. So he may not have been confident that they were going to reduce their options rate. Those are three of the reasons that he might not have bought American Express. But I'd like to ask him that question myself. You could make a very good case that he's been a little too cautious in the publicly traded securities.

I think he's become increasingly comfortable with the type of people who run private companies, as opposed to the type of people who run public companies. It's interesting. The mutual fund company in Wisconsin, Strong Financial, is still for sale. We were just batting around the idea that buying Strong would be a good deal for Berkshire. We had heard that the prices being bid for it were maybe two or three times *pro forma* EBIT. Clearly they had done some inappropriate things. But if somebody who had a great ethical reputation, like Berkshire, had bought it, you would think that the outflows would stop. Now there's a very good reason why Berkshire cannot buy Strong, which came up last week at the Berkshire annual meeting. His view is that there would be a conflict of interest in Berkshire owning a money management firm.

I think Warren is looking for 12 percent pre-tax returns. And you get the sense that he likes to see it pretty soon. And you're just not finding too many publicly traded companies that cheap, even after September 11th, and what was it? March of '03 when the market was low? You never know how close he was to pulling the trigger. He said shortly after September 11th that if the market got down to levels that he found attractive, he'd be in there with a ladle. He wouldn't just be taking little pieces of it, if I'm quoting him correctly. So he hasn't said he won't do it, but I detect a personal preference beyond just the mathematics of financial statements that leads him to prefer buying whole companies. There's a tax benefit as well. But I'd say I've been a little disappointed that he hasn't been more active in the public securities market.

Question:

I hope the answer to my question is zero point zero zero zero. I'd be interested to know if you find that the increased regulation of the mutual fund industry has impacted simply your ability to run your firm.

Joe Quinones:

It really hasn't affected us in any particular way directly mostly because the fund is closed. I still have to answer all the questionnaires from the SEC. And we are also regulated by the New York Stock Exchange. We still have to read all these laws and we have to keep up with them. Every time I do a new prospectus, we always have to add something that never applies to us.

Bob Goldfarb:

The SEC has some rules and regulations that it is considering for mutual funds. I hope that if you ask us the same question next year, we can still respond zero point zero zero, but we're not entirely optimistic.

Question:

From the SEC to the IRS…. one of the reasons that the fund has done so well over the years has been the concentrated portfolio, and your willingness to make a large commitment when you've found something that you think is a real bargain or has a great future. Going forward, if you find something great six months from now, all you can invest is five percent of the fund's assets in it. And I believe that would hold true even if you sold all your Progressive or all your Fifth Third. So the question is, going forward, do you feel you're operating with one hand tied behind your back?

Bob Goldfarb:

Yes, it's definitely a negative. We've acknowledged it in the past; we'll acknowledge it again today. How great a negative it is, we'll see in the future. Even operating within this constraint, I would hope that that our results when compared with the S&P and with other mutual funds will still be favorable.

David Poppe:

The main idea is we need to make fewer errors of omission in the future. We have not struggled for ideas; we have struggled sometimes to execute on those ideas. And I think just as Warren said at the meeting, you never see the errors of omission. That's what we ask ourselves about. I think we can do okay

even with the five percent rule if we can reduce our errors of omissions.

Question:

How has the firm's investment approach changed over the years?

Bob Goldfarb:

When we first started out, we were more of a deep value shop, if you will. We'd buy the best companies we could find that were selling for less than ten times earnings. In 1974 and throughout the remainder of that decade, actually into the early 80s in some sectors, you didn't have to choose between price and quality because terrific companies were available at very low multiples.

We suffered in the 1980s. Our stock selection was exceptional. There used to be rankings of the performance of stocks owned by investment managers and we would be at the very top. Nonetheless Sequoia's performance during the decade of the 80s, pretty much matched that of the S&P because of the drag of the cash. And the drag of the cash was a consequence of our waiting for the day when great companies were going to be selling at single digit multiples again.

We finally woke up in 1990 and realized that great companies except under circumstances of unusually high interest rates should not sell at single digit multiples. When they do, or get close to it like Mohawk and TJX, we pounce. We're just more comfortable with terrific companies, and we're willing to reach a little higher for them. But we're not going to go crazy on the prices that we pay.

Bill Ruane:

I also think that we really haven't changed as much as you might think when we get back to examining the aggregate dollars that we put to work in the last few years. Bob was the one who came up with TJX. I remember his calling me and bringing it to my attention. It just seemed like a no-brainer. And if you take TJX and Mohawk at the prices Bob pounced on them, the amounts involved are very large relative to the aggregate of the smaller positions we've established in excellent companies. There we hope to have an opportunity to increase our holdings at more attractive prices. So, while the list has lengthened, the concentration principle is still well in place.

Greg Alexander:

I was just going to say that the prevailing level of P/E ratios has gone up, and the dispersion of P/E ratios, if you leave out the very high ones, has kind of compressed a little bit. It's rare to see a really unusual company in single digits anymore. So we had to look at the new landscape and see what we thought was inefficiently priced. But if the P/Es hadn't gone up, we might not have changed that much.

Question:

I have another IRA-related question. I know some financial institutions that hold our IRAs will allow us to buy Sequoia shares while others won't. Could you explain how this works?

Bob Goldfarb:

None of them should be allowing new investors to buy Sequoia since the fund is closed. If you have Sequoia in custody at Schwab and want to make an additional investment through them, I assume that Schwab might be willing to do so. But that's all the light that I can shed on it.

Joe Quinones:

We have an agreement with Schwab that allows our existing clients to buy Sequoia. But it's an arrangement between Schwab and the client.

Bob Goldfarb:

But you can't go to Schwab and open an account and buy Sequoia.

Question:

You said in the opening speech how supermarket companies were affected by Wal*Mart's entering their markets. Do you think something similar could be possible in the pharmacy industry and affect Walgreen?

David Poppe:

I suppose there are two potential threats to Walgreen. The first would be if there were some sort of national effort or very widespread effort to force people into mail-order-only pharmacies. For instance, if you had to take Lipitor, you would not be able to get that at a drugstore. That's being dabbled with in some

places. All the information that we've ever been able to gather suggests that consumers greatly prefer having the option to use a pharmacy if, for example, they forget to order the drug until they're out of pills. So unless it were somehow forced on people, I don't think it would happen. That said, mail-order is gaining share at a rapid rate.

The second threat would be if there were some forms of price competition injected into the pharmacy business. As you know, right now most people have insurance. You pay the same price, or your insurance company pays the same price for the prescription wherever you get it filled. So Wal*Mart cannot sell you prescriptions for a lower price than Walgreen unless you are uninsured and thus a so-called cash-payer. If stores were encouraged to bid the lowest — I'll fill your Lipitor at a lower rate than Walgreen will — that could be a real problem.

There are a couple of reasons why I'm not sure that would happen. One is that the lower the price of a drug gets, the more people use it, and the insurance company has a vested interest in not having people overuse the plans. And having high co-pays, for example, is a way to restrict usage a little bit.

Even if a price war were to happen, we believe that Walgreen's cost to fill is comparable with mail-order and certainly lower than any other retailer, including Wal*Mart. The number and the velocity of the scripts that go through the store every day make Walgreen a very, very efficient operation. So Wal*Mart would have to be willing to lose money to generate the front end traffic. That is a theoretical possibility. But you have antitrust implications, and Wal*Mart is totally rational. I'm not even suggesting that they would do that.

Those would be the two threats. Mail-order is probably a higher order threat in our minds than price competition and it is something that we watch very closely. Anybody who owns Walgreen or any pharmacy stock should also be watching it very closely.

Question:

I was wondering if you could comment on your holdings in Progressive in light of the rationale given by the UBS analyst for the reduced rating on the stock, and then in light of the recent insider selling.

John Harris:

I saw the UBS report, which came out recently. I think that there are those on Wall Street who are more focused on what the company will earn over the next couple of years than we are. We view Progressive as a very long-term holding, and we believe that its lead on the competition may well be increasing.

Now it's certainly true that the market for auto insurance has been extremely favorable over the last couple of years. And as a result, Progressive is earning margins that I think all of us thought were never possible. There's little doubt in my mind that there may be a year in which earnings growth is flat or could very well be significantly negative. And I don't think that would bother us one iota. But if you're worried about how a stock will trade over the next year or two, when you know that the earnings may well decline, and you're worried that that's the basis on which your clients invest, then I could see, as a research analyst, that you would feel it's your duty to downgrade the stock.

We're taking a different view than most of the clients of Wall Street firms. So while I can appreciate why the analyst made the recommendation, I don't think that it's a big concern of ours.

As far as the insider selling is concerned, Peter Lewis has a prearranged plan to sell shares. And he has sold shares on a scheduled basis for a couple of years now. Peter, as Bob mentioned earlier, is an extraordinarily honest man. Peter lives a lavish lifestyle and he enjoys it. He needs to finance it somehow, and this is how he does it.

That being said, I believe that virtually all of Peter's liquid net worth is in Progressive stock. And I know he's extremely comfortable with Glen Renwick and Tom Forrester who are running the company now. I can't remember if you add up what he's scheduled over the next two years. I think it's something on the order of $200 million worth of stock. But Peter owns shares that are worth north of $1.5 billion. He still has got a lot of skin in the game alongside us. So I think we're comfortable with it.

Bob Goldfarb:

In addition to his lifestyle, Peter is one of the outstanding philanthropists in the United States. I suspect that charities are the beneficiaries of a very large percentage of the proceeds from these sales. He's also, I think it's been in the newspapers, partnered with George Soros in an effort to defeat President Bush. And so that's been a more recent call on Progressive stock for him. But his selling doesn't bother us one iota. There's been a little increase in selling from a couple of the other insiders, but nothing material or widespread

Question:

I hope the one question rule isn't in effect here like it was for the Berkshire meeting, but I'll make it very fast. Regarding Berkshire, I might have my facts wrong, but I read somewhere that it's a bet on how well their super cat insurance will do in the future. And it's kind of uncharted territory for them. I don't know if that's right. Also, Mr. Buffett said he thought that Berkshire could only match the S&P return going forward because Berkshire's so large. I was thinking that that doesn't seem that great if that's true.

Jon Brandt:

Taking your second question first, I think he said that he expects Berkshire to modestly or moderately outperform the S&P. I don't think he said that Berkshire would only match the S&P.

On the first question, whether Berkshire is a bet on super cat…. Super cat provides a significant portion of Berkshire's profits. But it is not as if it's 50%. And you can't take last year's reported profits from super cat as normal. It might have been a larger percentage last year because there were no catastrophes. I think the combined ratio in the cat business was something like 15%. An interesting question is: If you're going to model the company's earnings going forward, where would you estimate the combined ratio to be? The business has averaged something below 50 over the last 12 years. That's probably too optimistic for the future.

Berkshire will have large losses in super cat in some years. But I don't think you should be too concerned about that. I think you have to look at it over a ten or even a 20-year period. Berkshire will be in the best position to write new business if a level five hurricane hits Miami, or a 9.0 earthquake strikes California. According to the 2003 annual, Berkshire could write a check for $6.7 billion. But it makes that much, pre-tax, in less than a year. It can afford to pay a claim like that. So, yes it's an important business for Berkshire going forward. But Berkshire is not by any stretch of the imagination a bet on the super cat business.

Question:

You mentioned owning US Treasuries, but that doesn't really protect you against the scenario of the dollar falling over the next five years, which Buffett predicted. Are there any currencies or foreign bonds that give you some protection against that risk?

Greg Alexander:

I'm sort of sympathetic to the Canadian dollar. They spend like a socialist country, but they tax like one, too. As a result, they don't have a big budget deficit. They also have a pretty good trade situation compared with ours. Although I think there is some possibility that the US trade deficit, the current account deficit, is not as large as it's reported to be. If you add up all the current account deficits in the world, it comes to a negative $200 billion. So, it's possible that, because so much of the export of the United States is intellectual capital, it is not counted as accurately as some of the physical imports that we get.

Question:

To pick up on Bill's earlier comment about having cash or short term Treasuries both personally and as you run money at the firm, what level of cash historically have you guys felt comfortable with?

Bob Goldfarb:

Our goal is to be fully invested, and cash is only the residual of our inability to find investments that meet our standards. So it is important that shareholders not look at their *pro rata* share of Sequoia's cash as being liquid. You should assume that this cash could be invested totally in stocks tomorrow.

Question:

If I could follow up, Bill, what's your comfort level with keeping some money out of the stock market, even though obviously you're always comfortable with being a long term investor?

Bill Ruane:

I totally agree with Bob that we would love to be 100 percent invested in very attractive stocks. But I've always felt that when I finally got to the point where I could do it ... for many years I couldn't do it ... that it's a very wise thing to have funds equal to anywhere from three to five years of your likely spending out of the stock market. Over any five-year period ... and we found this out in the first five years that we were in operation ... a market can do anything. So start off with the principle of not borrowing money to buy stocks. Once you go beyond that, I think it's common sense to have a reserve.

Bob Goldfarb:

I'd add that I agree with Bill, but in some part it's a function of your personal psyche and degree of risk aversion. People have different tolerances for risk, and you know your own psyche better than anyone else.

Question:

I want to get back to the beginning of the meeting when you were talking about structural risk and change in America vis-à-vis the rest of the world. And I wanted to know if a fund like Sequoia would be looking at companies which are more involved in places like China or India as a long term strategy if America is going to be relatively smaller?

Bob Goldfarb:

I would say it's possible, but I wouldn't count on our doing that. Our research process just works much better generally with companies that are domiciled and do significant business in the United States. For instance the question with regard to Walgreen, Wal*Mart and the drugstore business — if you were asking us about a drugstore chain in India, I don't think we'd have the same level of comfort. Could we do it? Yeah, maybe if we had a group of analysts on the ground over there. But that gets back to this gentleman's question earlier about what kind of structure is best. And my answer was that the structure should be suited to the demands of the business. We're centralized, and we get a lot of benefits from all being together. I just don't think we could implement or execute the scuttlebutt element nearly as well in most foreign countries as we can in the United States.

Bill Ruane:

I agree with Bob ... there could be circumstances where we would own a foreign stock. We owned Guinness at one point. But basically there's enough risk in the thousands of stocks we can consider in this country without having to go abroad unless there's something unbelievably compelling.

One big reason is that suddenly you're playing by two sets of rules, and it's tough enough to play by the one set of rules that we know very well. I'm always reminded of that.

One incident came to our attention when we owned Salomon Brothers in the early 1990s. Salomon made a deal with a Swiss and a Russian partner to drill for oil in Siberia I think, and it was one hell of a deal. They put up over $100 million to drill in an area that had an enormous amount of oil. And they were going to share the proceeds from it. These wells had been drilled in the 1930s, and there was something about the technology of drilling — I don't recall precisely what — that would have allowed them to keep the wells going during the winter time. It's cold enough in the summer time there. All they really had to do was put down the right kind of pipe, and the stuff was going to come forth in huge amounts. The reached ... all of these details are a little inaccurate, believe me, but you'll get the principle in a minute ... they reached very significant production levels. And the Russian government... we're talking about oil at $15 a barrel at the time ... Russia just imposed a $5 a barrel export tax. Well, ball game's over. I mean, it had nothing to do with the fundamental idea of making a lot of money at the oil head. The minute they did that .... and I'm not saying they were aiming at Salomon ... they just took away all of the profit, and perhaps more. You had two different sets of rules.

Question:

In light of your professed willingness and desire to concentrate in your best ideas, I'm puzzled why the fund has about 1/25th of one percent of its assets in Costco. Why have it at all? I believe as a firm your 13-F indicates that there's a different weighting of Costco in the private accounts than in Sequoia, although the difference is not huge, by any means. Why are there different weightings?

Bob Goldfarb:

We had reasons for not buying more, and we don't regret that it's a small position. We have great admiration for Costco's management: Jim Sinegal, Jeff Brotman, and Richard Galanti. They have three constituencies: One is their employees; the second is their members; and their third is the shareholders. And I think the latter constituency arguably hasn't gotten its fair share of the revenues. Management has acknowledged that recently and declared an intention to increase profit margins significantly. It will be interesting to see if they are successful in meeting their new margin target.

David Poppe:

Bob, if I could jump in for one second, I think more broadly speaking, the reason slivers sometimes show up in Sequoia and other accounts is that we have a price, and the stock is at that price for only a brief period of time. We want to buy Company X for $30, and it's just not $30 for very long. We adhere to our discipline for better or worse, and so sometimes we end up not getting very much of a position.

Jon Brandt:

And to continue to hold it doesn't hurt us.

Question:

Could you comment on your holding in Ethan Allen, and the special dividend?

David Poppe:

The special dividend is $3 per share, and I don't know what else to say. It's now almost four years that we've owned it, and it's been a very difficult environment. We pride ourselves on our research, but I'm not sure we realized how difficult the environment would be.

I think during this period Mr. Kathwari has done an amazingly good job of maintaining the business that he has and accumulating a lot of cash. And it's good that he's returning it to shareholders. One thing that really strikes me....I was talking to a friend who's an Ethan Allen owner the other day ... is that he could do it again in a year. He's at a point now where he's accumulating so much cash, he's going to return 7.5 percent of the market cap, and he could accumulate that much cash again in another 12 months and do it again. I suppose the question you have to ask is, "Is he unable at this point to find ways to grow the business?"

I think that's a very fair question, and that's one that we are asking. I think the answer is he doesn't have a lot of growth opportunities, or he doesn't see things he wants to buy. He doesn't need to invest in a new US plant, and so he's going to return the money to the owners, which is wonderful. We applaud that. And the good news is that over the next year he'll accumulate that much cash again. Then he can decide whether he's going to return it to the owners or find new things that he wants to invest in.

It is a difficult environment. Deflation is real in furniture. Ethan still has a good-sized US manufacturing base that's going to be tricky to maintain going forward. So far he's done a very good job in a world where his competitors for the most part have had much deeper troughs than Ethan Allen had during 2001-2002. All things considered, I think the business is very healthy.

Question:

Can you comment on Fastenal? I think in the prospectus you sent to shareholders a couple of weeks ago, you mentioned that you regretted selling off a little piece some time last year. Given that the stock has a high P/E and that you did recently sell a little bit of it, what is your view of the prospects for the company?

Greg Steinmetz:

Fastenal operates hardware stores for commercial customers. It seemed very expensive last year at a time when we weren't seeing the earnings growth that we had been hoping for. We always had great faith in the management and their ability to keep opening stores. At the time that we began to take our position in early 2001 I think they had about 900 stores.

They're now up to 1,300. We always knew they could keep opening stores, but we were hoping that there would be a little more earnings growth when the economy turned. We decided that the P/E was very high by our standards, and so we sold a little bit. But we kept most of it, because we still thought that the rapid growth would resume, and that's exactly what happened. They reported their April numbers the other day, and their sales were up more than 21 percent. Their results last quarter ... sales were up 21 percent ... earnings were up 49 percent, and they're growing much faster than the industry. When you get growth like that, you can support a high valuation. We're glad that we kept as much as we did.

Bob Goldfarb:

The decision to keep as much as we did was Greg's, and I want to applaud him for it.

Question:

In Mr. Goldfarb's opening remarks he talked about a mental model for decision-making, and focused on some of the pros and cons of the probabilistic model for decision making. I was wondering if you could talk a little bit about the appropriateness of that model in super catastrophe insurance underwriting, as well as some of the other models for decision-making in that business, as opposed to common stock selection and portfolio management.

Jon Brandt:

Bob should probably answer this question, but I think you can say that that model was very appropriate for pricing insurance risks. For some people it's been very successful in the investing field. We just don't feel as comfortable with it. We have a different path to heaven, as it were, and it's probably more nuanced. As Bob conceded, we're all probabilistic investors to a degree. It's just a question of how comfortable you are with uncertainty in an investment. Bob kind of said it in the speech. Bob, do you have anything to add?

Bob Goldfarb:

No. I wouldn't want to write super cat policies myself. But Ajit himself is a master. Together with Warren, it's an awesome combination.

Question:

You referred earlier to buying quality companies at single digit P/Es. I'm just wondering if you guys have any thoughts on homebuilders.

Jon Brandt:

We looked at them. So far it looks like it was a mistake not to buy them. We wrestled a little bit with their debt. NVR based in McLean, Virginia doesn't have much debt. They do a lot of options on land, and they partner with the local developers to do the entitlement and so on. They have the cleanest balance sheet and excellent margins. The Baltimore and Washington markets, where their building is concentrated, have been very supply constrained.

But we took a look at their footnotes, and the rate of options issuance was very high. It's since come down a little bit. Greg Alexander made an interesting point. NVR is also buying back a lot of stock, which is a positive. I think they used to have 21 million shares, and now it's something like seven. Quoting Bill, I'm sure these figures are inaccurate, but kind of directionally they're correct. Greg was saying that maybe they were issuing two percent of their shares when they had 20 million shares, which I guess would be 400,000. But they just kept issuing 400,000 shares in options. When they got down to 7 million, it was more than five percent. I think one year it was 8 percent.

It may have been a mistake not to buy any of them. Many of them have done very well. Lennar has done very well. But it's been hard to differentiate them. When you asked each of them what the difference was between one and the other, one would say, "Well, we do more starter homes." The other one, like Toll, would be higher end. The environment for home building right now is exceedingly benign, and everyone is making a fortune. We assume that at some point every business faces challenges. It is very difficult to figure out which of these companies is going to remain extremely profitable in the face of a difficult environment. And usually we feel less comfortable taking a basket approach than we do picking a terrific company. So we kind of took a pass. Greg, do you have anything to add?

Greg Steinmetz:

Historically, they have been cyclical companies and they got clobbered when rates went up. They say that now is different, and whenever you hear that, you've got to wonder, "Well, is it really different?" If rates go up two points, what happens to affordability? We don't know the answer to that.

Bob Goldfarb:

I'd also be a little concerned about the deterioration of credit standards in terms of how much money you have to put down to buy a house. In some cases, it's less than you'd have to put down if you wanted to rent the place.

Jon Brandt:

We don't think that the credit standards are like what happened in the mobile home business. But the amount of money that people put down to pay a house … it isn't what it used to be. And Warren Buffett was saying last week about how he wouldn't take 20 basis points as a guarantor of the country's mortgages.

He doesn't think there's been tremendous speculation in house prices. But take down the average price of the homes sold by five or ten percent, which is not a heroic assumption, and recall that the margins are quite sensitive for home builders. What looks like seven times earnings could be 15 times earnings without too much of an adjustment.

Question:

I have a quick question regarding Berkshire's 2002 annual letter. In it Warren Buffett mentioned a company in Des Moines called Homemakers. I've never heard of that company. I've never heard him mention it any time previously. And I'm wondering whether you know anything about that company.

Jon Brandt:

It's a small furniture chain. I believe that it was purchased by Nebraska Furniture Mart. I remember when I saw that in the annual, I was like you. I thought, "This was never announced." It's a very small but locally dominant firm in Des Moines.

Question:

I wondered if you would comment on Danaher Corporation and specifically talk a little about its management.

Terence Paré:

Danaher is a small position. It's basically an industrial conglomerate that may be familiar to most people because it manufactures Craftsman hand tools. The company is run by Larry Culp, who took over about three years ago from George Sherman. The Rales brothers own a significant piece of the company.

I'm not exactly sure what your interest is. But our interest in the company at the time that we bought it was that it had a terrific record for acquisitions and for thereby increasing its earnings. The industries that it tends to concentrate in are generally slow-growth. But Danaher likes to take over companies and then introduce manufacturing efficiencies and thereby get a little more juice out of the orange.

The company's management has changed that strategy a little bit over the years and has moved more toward buying companies that sell industrial, branded, manufactured goods. For instance, the company recently bought Gendex, which manufactures dental machinery and a company called VideoJet, which makes industrial printers.

I wish we owned more of it at a lower price. Let me put it that way. It always seems to be a little bit more expensive than we're willing to pay. Part of the reason for our unwillingness is the way it goes about growing. Acquisitions can be very tricky, and you can always do one that goes wrong. That said, every quarter and every year, the company seems to prove us wrong. It buys another company. It turns out well. And the price just keeps going up.

Question:

Can you compare and contrast Progressive's business model and Geico's?

John Harris:

The biggest difference between the two models is that Geico sells only through the direct channel, where it is the clear market leader. The direct business makes up roughly 15% of the US personal auto insurance market, and it is gaining share. Progressive sells direct too, but 70% of its business comes from the independent agency channel, where it enjoys the leading market share.

Another difference is that Progressive's roots are in non-standard and it is strongest in the lower tiers, although it has been successful in its efforts to move up-market into the higher tiers. Geico grew up in the preferred and ultra-preferred tiers, which account for the majority of its business. Geico began expanding into non-standard in recent years. Progressive also has about 10% of its business in commercial auto insurance. Geico isn't in that business at all.

Managements of the two companies have also taken different approaches towards marketing and operations. As a direct writer, Geico's focus has been on low-cost distribution. That's the front end of the business. Progressive has for many decades concentrated on the back end — namely claims, on the logic that losses account for the great majority of total expenses. Progressive has focused more on lowering its loss ratio and so it has been willing to invest relatively more to manage claims and contain loss costs. In the last 15 years, Progressive has attacked expenses on the front end as well, reducing them from north of 30% of premiums to around 20%.

Bob Goldfarb:

I think we probably must adjourn. We thank you all for attending, and we look forward to seeing you next year.