

**COLUMBIA BUSINESS SCHOOL
THE HEILBRUNN CENTER FOR
GRAHAM AND DODD INVESTING**

The Graham + Dodd Luncheon Symposium

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MR. BRUCE BERKOWITZ: -places please. Thank you.

[off-mic comments]

MR. BERKOWITZ: All right, before I turn this panel over to its very distinguished chairman, who is Seth Klarmann, I would like to introduce the person who has made all of this possible, next in importance only to David Darden [phonetic], Benjamin Graham, Erin Bellissimo. [applause]

MS. ERIN BELLISSIMO: Thank you, Bruce. My name's Erin Bellissimo and I'm the director of the Heilbrun Center for Graham and Dodd Investing at Columbia Business School, and we're delighted to welcome you here today for what I'm sure will be a terrific day of panel. And we're very honored to have the ten editors, and authors, and contributors of the Sixth Edition of Security Analysis. It was nearly 75 years ago that here at Columbia Business School, Professors Benjamin Graham and David Dodd drafted the first edition. So without further ado, all of the information on the panelists—I think they need no further introduction but their bios and backgrounds are on your chairs. I'll turn the proceedings over to Seth. Thank you.

MR. SETH KLARMANN: Good morning, whatever time it is. It's great to have this incredible turnout, and to celebrate the publication of the new edition of Security Analysis, and also to honor the tradition of Graham and Dodd which Columbia has excelled at. Certainly no other university comes close as a value investing university.

I'd also like to just begin very quickly by thanking my fellow editors and the collaborators as well as the people at McGraw-Hill and especially Leah Spiro who put this all together and let this new edition happen in such a solid way. And I think this will be something, I hope, that people refer back to for many years.

Our panel will talk about investment approaches and how we have all followed the wisdom and the teachings of Graham and Dodd. But I think in recognition of the unusual environment

that we're living in, we're also going to spend a fair amount of time talking about how we're adapting the principles to this current environment, not normal everyday environments.

We'll begin where each of us will spend sort of three to five minutes talking about our firm, our approach, how we're organized, and then I have some questions, and then we'll open it up to the floor for further questions. So my firm is the Baupost Group. We got started 26 years ago. We're up in Boston. We began as kind of an expanded family office running money for three families, \$27 million, when we opened our doors. And over the years we've taken in additional money, very selectively. Many years we've been closed for new money, but at times we've opened up when we saw great opportunity, and so we've added some institutional clients along the way and many families along the way to the point where today, with some very nice compounding, we're running about \$15 billion. We've run it all with one approach. There are numerous entities because of the timing and tax characteristics of creating those entities but it's one approach. Every client gets the same thing.

We've worked really hard to be fair with our clients. We think if we treat our clients right everything else takes care of itself. So we eat home cooking, all the partners of the firm invest their net worths in the firm which let us be one of the very largest clients collectively of the firm, and it reduces conflicts and creates congruent interests. In addition, we have certain principles that we will never violate. For example, we feel like the first and foremost responsibility of every investor is preservation of capital. It's nice to make money but it's also important always to remember that losing money is excruciating and leverage can wipe you out. So we don't leverage the funds ever. The only debt we ever use is recourse debt on a real estate asset or a private asset that we might have but even that is very limited.

We, unlike many investment firms, are not afraid to hold cash. We feel as though it's not necessarily the best thing for marketing because it seems like an odd thing to do, especially in a world where everyone's mandate is to not hold cash, but our view has always been when you find great things to do you do them, when you don't find great things to do you wait because they're bound to show up at some point. We have

a multi-strategy approach within our partnerships where we follow the equity markets globally, the debt markets globally, and private markets like the real estate market as well. And we put all of that in the same entity for all of our clients.

The approach is very collaborative, very team oriented. We don't pay people off of personal bottom lines we pay people based on the success of the firm, and they can advance based on their own growth, and we let people grow at their own pace.

In terms of the investing I would say that there is no exact formula for what we do. We try to use all the value investing principles we know. The world is imperfect. The world doesn't just dish up net, nets all the time. The world doesn't dish up stocks trading below cash all the time, doesn't deliver fine businesses at eight times earnings all the time. So we look very hard for mis-pricings, for information asymmetries, for supply / demand imbalances, and we find ourselves at various times heavily in distress debt or no position in distress debt, significantly involved in equities and uninvolved in equities, very focused on private markets or uninvolved because you can create the same assets cheaper in the public market. So in a nutshell that's our approach. Very opportunistic. We try to be not siloed the way many people are. We don't have industry analysts we have generalists who can move quickly from working one day on a drug stock, to another day on the distress debt of a bank, and another day even potentially on a mortgage security or real estate investment. That's not easy but it does provide constant stimulation, a lot of cross training, which people enjoy, and it also means that our resources will always be deployed in the most interesting areas all the time.

So that's Baupost in a nutshell. David?

MR. DAVID ABRAMS: Hi, David Abrams. The name of my firm is Abrams Capital. Baupost was taken. [laughter] But I started my career in New York doing merger arbitrage and trading distressed bonds, and then had the good fortune in 1987 to meet Seth. And he said why don't you come work with me? I said well I don't want to leave New York. He said well just try it for a year. So that sounded good and that was 1988. I stayed at Baupost for ten years and then left

about ten years ago. Literally sat out the last great storms of '98 on the beach and when the world blew up I said wow, investing actually looks fun again, so maybe it's time to plug in the Bloomberg again.

If I were to describe my firm we sound very much like what Seth just described about his firm. We get lumped in with hedge funds but we really consider ourselves an investment partnership. We're pretty much long only. Occasionally we do a little bit on the short side but mostly in bonds at par that can only go down, but very little. We care less about the volatility than others and try to find limited partners who are like-minded. That's sometimes easier, sometimes more difficult. It's a lot easier on the way up, than on the way down is what I find. But we have really a great group of limited partners.

And beyond that we're pretty flexible. You know, somebody said yeah, there's good assets and bad assets but good prices and bad prices supercede whether the assets are good or bad. So we'll be flexible. We'll buy public, we'll buy private. We think the line is pretty blurry if there's much of a line at all. And we'll buy debt, we'll buy equity, try to be open minded, try to steal good ideas from other people. A lot of my best ideas have been stolen from people in this room. And other than that just try to make it through the difficult times, and find something intelligent to do from time to time, and it's kind of amazing how it works out over time.

MR. HOWARD MARKS: My name is Howard Marks, I'm the chairman of Oaktree Capital Management, and it's interesting to be on this panel because our business model is completely different from Seth and David's. Unlike them I started off in the institutional world and I can't say that word without thinking of my dad who used to say that marriage is a wonderful institution for people who like to live in institutions. [laughter] But I got my first job at Citibank 40 years ago as an equity analyst for the summer and put in the years in equities before I was very fortunate to move to what was called the bond department. And I was asked to start up funds, and convertibles, and high yield bonds in 1978, and I think ours was the first high yield bond fund from a mainstream financial institution. And then I switched to Trust Company of the West and in '88 we started what I think was the first dedicated distress debt fund from a

mainstream institution. So our capital is much more institutional and it's much more institutional in nature, in behavior, and much more dedicated than the flexibility of Seth and David. We have 19 strategies which range from high yield, to convert, to distress, to private equity, to real estate, to mezzanine, and so forth, and we have them in both open end and closed end formats depending on which they are.

So our capital does not have the flexibility that theirs does. We probably have, I would imagine, our average client is a larger client and makes a larger investment with us. And what we do to combat what you might think is the rigidity of the capital is that we tell people what we think of the various markets, and we encourage them to get in or out, or at least we tell them the facts at any point in time as to risks and returns. And in the area where we operate funds we raise larger funds at what we think are the better times, and smaller funds at what we think are the worst times, and sometimes we don't raise a fund at all we just let capital run off. So I think that we do not maximize the values of moving the capital but I think that we help our clients get into the right categories, at the right times, in the right degree.

We have a very strongly held investment philosophy, which not surprisingly is a value philosophy, and the same philosophy works across all of our asset categories. You know, I've worked in two big places where they had, as I describe it they had 50 strategies run 50 ways: top down, bottom up, aggressive, defensive, agnostic, forecasting, you name it. And we only have one philosophy and all the money is run the same way. There are six tenets. The first two are by far the most important. The first one says that the number one job of the money manager is not to make a lot of money, it's not to beat the market, it's not to be in the top quartile, the number one job is to not lose money, and it's to control the risk. And our motto for the company as a whole is that if we avoid the losers the winners take care of themselves.

There are many, many different ways to make money in the investment business and the one I describe as ours, it's not necessarily the only right one but it's the one we like. You know, one way to be very successful in the investment business is to invest in opportunistic areas for long periods of time and not have losers, and that's pretty much a

sufficient condition. And I think we've been able to do that. And that leads to the second one which we believe in consistency. It is not our goal to be in the top quartile every year, every individual year. You can't do that and to do that you have to take risks which are in my opinion unsuitable. But if you can have a whole bunch of decent years, and an occasional really good one, and never a terrible one, I think you'll put together a long term record that you'll be happy with and your clients will be happy with.

So we now have \$58 billion across our many strategies and I think we've been able to uphold a reputation for serving the client, which is job one.

MR. KLARMANN: I should have said at the beginning but it's just a great honor to be on the same panel with two people from whom, arguably, I'm separated at birth. Howard is just a fabulous writer, and a very clear and deep thinker, and very prolific as well in his articulations. And I have often thought that if only I could live up to his standard that we often are thinking the exact same thing at the same time and so it's great to have connected over the last few years and be together today.

David is the fund that when anybody asks me about David's fund I will say it is the fund closest to our fund. That David and I disagree on merits of an investment usually about once a decade, if that, and so there's a certain congruity of thought which is just—it makes sometimes for a boring conversation but a great relationship. We really do see the world very similarly most of the time and usually benefit from each other's ideas.

So to jump into investing in the current market, let me begin by asking how are you responding to this environment? What are you doing the same, what are you doing differently, what are you excited about in this environment? Let's start with David.

MR. ABRAMS: I think in some very fundamental way, which is really what the security analysis book is about to me at the core, is we do things the exact same regardless of the market. We look at things, we look for a margin of safety, we look at the math, we look at all the things that one would look at to analyze individual securities, and when they're really cheap

we buy them, and when they're not that cheap we don't buy them, and we're happy to hold cash.

Today there's a lot of cheap stuff out there. I mean, it's kind of eye-popping. I think the biggest area is the debt area. That's where we've been really focusing 100 percent of our time and efforts right now. We've been selling some stocks, we've been deploying cash that we had. Everything that we buy goes down every day but you know, we look at the economics of it and the price and I think it's some of the best opportunities that I've ever seen.

I actually was signing a bunch of trade tickets the other day for a few days—I'd been out for a couple days. I handed them to an assistant, I said make me copies of these because we're just going to remember that we bought this one at this price, and this one at that price, and this one at another price. So it's making me incredibly excited. Of course in the short term, you know, every tick's a down tick, and that's kind of our, my short story of what we're doing today.

MR. MARKS: Well as I said, our money doesn't migrate the way David describes but we try to adjust our capital. We raised a very large distress debt fund in '01 / '02, 3-1/2 billion, and then we raised a billion two fund as that one ran off in '04 and so forth. And then at the beginning '07 we said we think something's coming so we raised 3-1/2 billion dollars in our Fund 7, which became fully invested around the time of the Bear Sterns meltdown. And then we raised 11 billion for our Fund 7B, which we're currently investing, and we're investing that on a steady, gradual pace. If we knew there were better opportunities ahead we wouldn't invest anything today and if we knew that today was the bottom we wouldn't invest—have anything left for tomorrow. But we're not smart enough to know that so we're investing in a steady, gradual pace.

I think the big difference in this environment is that so much of the opportunity is in the financials. And historically we've been an investor in manufacturing, and retail, and transportation / distribution, and not too much in the financials. But I think that the soul of value investing, one of the things at the root, is kind of an attitude of it is what it is. And our number one job is to figure out what's going on in the market today and what's the

appropriate response. And what's going on today of course is the total lack of confidence, probably overdone, in the financials. And thus securities, as David says, at once in a lifetime prices, which tend to happen every few years.
[laughter]

MR. ABRAMS: Thank God. [laughter]

MR. MARKS: Financials seem to have higher leverage, and inherently lower transparency, and you have to adjust your mind set. But cheapness covers all and I think that's what we're seeing today.

MR. KLARMANN: It feels weird to answer my own question but the one thing I want to say on this point is that every investor should be in a position where they can identify what their edge is. That if you are investing and you don't have an edge you probably shouldn't be. And so we think about that a lot, that there are a lot of really formidable competitors, a lot of money that's flowed into the hands of very capable value investors, long-term oriented, smart people. There are obviously also people that know a huge amount about industries, industry specialists, corporate executive, former executives, and so it's very competitive out there most of the time. So much of the time we have drifted into less liquid or more obscure parts of the universe. It's why we're in real estate. We got in when the RTC was formed and the government was selling assets at pretty crazy prices because there were no buyers. And so absence of competition is another key thing for us. That we'd rather not try to outsmart somebody, we're not sure we could, we'd rather try to hunt where they're not looking.

In this environment what's so unique is you're not buying from really sophisticated sellers, you're buying from panicked, out of their mind, margin called, desperate people. It's sad that things have come that way. You're buying from some of the smartest trading desks on Wall Street who have a mandate from above, reduce leverage, get out of it, I don't care. And so even as you're taking advantage of opportunities using the same analysis you've always used but with a much higher batting average because unlike most of the time you look at 100 things and find one or two, now you look at ten things and find three or four. But the competition seems to have gone away because uniquely at this moment,

unless you're Howard with a large pool of money or David with having prepared for this kind of environment, and versatile, and able to maneuver around, a lot of people came into this leveraged, a lot of people are now down well into the double digits and are worried about redemptions, they don't have quality clients, they have short term money. And so the combination of pressures on people cause an awful lot of smart people to be on the sidelines right now or facing actual redemptions and forced to sell things they'd actually rather be buying. So I think that's another thing about the current environment that, in a way, you don't even have to be as smart as before. You just have to be in the game, have money, not be in terrible trouble as an investor.

So let me ask you now, how has the current environment surprised you? In what ways were you prepared for it? What do you wish you had done differently if anything? Howard?

MR. MARKS: Well I wish I had shorted subprime. I mean, I think we prepared pretty well. We sold the vast majority of our assets and we raised small funds in the high risk low return years, and we have essentially no leverage, and we locked up a lot of money for a long time, and the only thing we didn't do is go short. And you know, I feel okay about how we prepared. Now all we have to do is execute.

MR. ABRAMS: I would say that one of the things that surprises me about the environment, I think if you had said a year ago, could Fannie Mae, Freddie Mac, AIG, Lehmann, Bear, could they all go bankrupt? You'd be like, yeah it could happen, right? But like would it happen? I think it's a big difference between could and would as we're all seeing. And then of course there's the add-on factor which to me is sort of the biggest single factor, I mean, the stuff that we're buying today will make money so long as there's kind of economic life in the U.S. But there's this short term freeze-up in the debt markets with so many companies, so many industries, state governments, relying on short term financing, is a little bit different than we've ever seen, even back in '02. And '98 was so short that, you know, maybe it happened but it was so short. This has been going on and building, and building, building for a while so I think that's a little bit different.

I think that when markets move really dramatically up or down most people, if they're honest, would say well we own some things that we--there's some things in retrospect we maybe wish we hadn't done and I think that's true with us in a small way but a very small way.

So I think we've done what we could do and I think one of the most important things, something that Seth alluded to, particularly for funds like ours, - - Howard raises these locked up funds, and their locked in, and then they invest, and they liquidate, but for folks like Seth and me, having the right client base is just really crucial. It's actually something I really learned, one of the many, many things I learned from Seth, and so we've been really, really careful to not take in hot money or the fund of funds, and so that's been good. I only did this once but actually I did have to fire a client once and I was glad I did because I knew that if that person was around now, that would be the wrong kind of person to be around right now.

And I guess the other thing that is really surprising is everybody's out of liquidity. The banks, hedge funds, mutual funds, our institutional clients, endowments, across the country, everybody is out. And it's a combination of the leverage, what's going on, all the commitments to private equity where people thought you'd get inflows and outflows, well it's only outflows. All that kind of thing. So that's a little bit surprising to me.

MR. MARKS: Seth, can I add one thing before you--

MR. KLARMANN: yes.

MR. MARKS: When I think about preparing, and think about what's unfolding, and listen to David, what I realize is that I didn't predict one thing that's happening this year. What I did predict is something bad would happen and when I say it is what it is I believe that it's our job to look in the environment and say what's going on? How are our investors behaving? What actions have they taken? What structures can now be done that shouldn't be done? And that kind of thing, and respond. You know, if you went back a year and a half ago, what you see in the paper is global wall of liquidity. That's all we heard about. There's this money coming, and it's coming, and it can't stop, and it's infinite, and it will always take every asset higher and higher. And when you

hear that stuff you know there's something wrong and you don't know how it's going to end but you know it can't go on and-- Who was it, Herb Stein, who said anything that can't continue will end? And when behavior is ridiculous and risk is ignored it will stop, and the end will be ugly. And the more ridiculous the excesses on the up side the uglier the unwind.

MR. KLARMANN: Yeah, I love that point, Howard, that Jim Grant called liquidity and credit money of the mind and it's there and then it's not there, it's amorphous, you can't see it, it's not real. And in a way to me, anybody that ever says how can the market go down, there's a wall of liquidity? Or there are structural imbalances. As long as I've been alive there have been structural imbalances. Most of the time they don't matter. Once in a while they really matter. That's what's hard, that if you run your portfolio to be fine in an upward market, if you're in the game, you will have exposures that you wish you didn't have in a worse market. In terms of our firm I tried so hard to learn the lessons, to me, of '98 in particular, which were don't be unprepared for something out of the blue that's really bad. To some extent we were prepared but you're never prepared enough. We had a lot of macro protection in terms of credit default protection on bonds we didn't own, just betting that credit spreads would widen. That's been incredibly helpful. But we got really tired of buying market puts or anything like that because they inevitably are expensive and expire worthless. And so you always, as an investor, have terrible tradeoffs. Do you overpay for insurance or do you go uninsured? And it's just one of those dilemmas that there's no perfect answer to.

My surprises of this environment are, you know, when Warren Buffet put out his job description for—I'm sure there's several in the room that applied—to replace him someday, he said that one of the criteria that he was looking for was somebody who could deal with things and even anticipate things that had never happened before. And that was prophetic and incredibly important for investors. That all of us every day, every week, every month, have to deal with things that we've never seen before. In any previous downturn in my investment career some things would be getting killed while other things would be recovering. In this environment it's been straight down for everything. We've

had almost no respite so the idea that you'd be able to recycle money out of one bargain that then recovered into another one has just not happened. You need to be prepared for that. That anybody that says that they see five and ten standard deviation events every couple of years is obviously not thinking correctly about probabilities. So things happen and we need to be ready.

In my mind the other thing that comes up and I think it's because we run investment portfolios but we also run businesses, one of the things I've tried hard to do, I have a wonderful team, best team in the world, except if David would come back it would be better, and when you have a team you can't be the whole show, and I don't want to be the whole show. One of these days it will be them and not me. So as I bring that team along, and train them, and work with them, and try to keep them, that one of the things I've worked really hard to do is give them some rope. And so things that I saw coming a little bit they may not have seen coming as well and I have been wrestling for a year and a quarter, when do I say I'm just blowing this out and buying something different, and when do I say if you really like it I have confidence in you, that's fine. And those things are very hard. I don't know how conscious everybody is about that but however you're set up as a firm, it's not just any of us. We all have wonderful teams and we couldn't be where we are without that, but that's another tough one. That one of my dilemmas is I know the team is in many ways better than I am so do I impose my fear on them, that maybe the world will get worse, knowing that many times in the last decade or two I've thought it would get worse and it didn't get worse. So those are very tough ones and in some ways I should have been more forceful but in some ways they've learned a lot and we have benefited from me standing back as much over the years as we've benefited from me overreaching.

So let me ask both of you, there are value investors that are doing fairly well in this environment, losing less than others, and there are some value investors that had well publicized problems, especially those very heavily exposed to financials. What do you think the impact to the environment will be on the reputation of Graham and Dodd and the lessons of value investing? How will the world look at value

investing at some point when we get through the valley and are back on the improve?

MR. MARKS: Well first of all, Seth, I have shocking news for you. The world doesn't care about value investing and has never heard of it. [laughter]

MR. KLARMANN: But several hundred people right here do. [laughter]

MR. MARKS: Yes, okay, well to the extent that this is the world. [laughter]

MR. KLARMANN: But thank you for the wakeup call though.

MR. MARKS: I think that what it will show is what you've been saying in the last 15 minutes, is that definitions can't be fixed. What we learn is techniques. You know, you just can't be carved in stone as to what you like, what you don't like, what something good is. Each of our funds that's been successful has done a lot of things that the predecessors never did and a lot of the things that the earlier fund did we had to drop because they stopped working or everybody else figured them out. And you had to keep moving and, you know, the other thing is that there's nothing that you can teach anybody that will work all the time. Every great investor has bad periods. The ones who stick to their approach the most diligently probably have the worst periods because approaches go in and out of favor. So I believe that there will be some very, very successful value investors coming out of this and not all of them.

MR. ABRAMS: I guess I would say to this that, a little bit different from Howard, I've actually never seen people be successful over a long period of time without being value investors. To me, it's sort of like the E equals mc squared of money and investing. That all things equal, the lower the price of something you have both less risk and more return. And people either get that instantaneously or they never get it. The good news, I guess--this would agree with what Howard says--is that most people just never get it which is really what keeps us in business. So I'm thankful for that.

But you do need to think and just a little bit of the point I think I tried to make in the essay I wrote for the book, that there is no one, unlike E equals mc squared, there is no one

formula to investing. There's no easy way. The success comes through really thinking about things, looking at the underlying economics, trying to understand those economics, and then looking at where you can buy those economics in the market. And so people have a formula and think oh, okay, I have the formula so it's easy. I can buy stuff at book value. Well book value today of a financial institution might not mean what it did 20, 30 years ago. You can think of a lot of examples about that. So I think that for anybody who really understands what Graham and Dodd were about and that fundamental equation that the lower the price, you have both less risk and more return, the current period is just going to be validation of that.

MR. KLARMANN: So I think we have about 20 minutes left. Why don't we open this up for questions from the floor for the panel?

MR. MARKS: Doesn't look like we're going to need 20 minutes.
[laughter]

MR. KLARMANN: Maybe this is because everybody wants lunch but let me ask, well, you think of your questions. Let me ask one more that I have. I know David wrote about this somewhat in his piece as I did in mine. There clearly has been some kind of mania in terms of the institutional investment plunge into alternative investments. Obviously there will be impacts in this environment and yet there's still latecomers to that game, pension funds that are interested or until very recently have been interested in increasing allocations into this space. What do both of you think about alternative investments—hedge funds, private equity, venture capital, anything else you want to count? And what do you think the current environment will do to the flood of money in? Howard?

MR. MARKS: I think that the number one thing that everybody in this room has to know and I know you and David know it too, fairly well, there's no such thing as a good idea or a bad idea in the investment world. It's a good idea at a price, it's a bad idea at a price. And so saying tech stocks are good is just as silly as saying the nifty fifty were good, or us saying that alternative investments are good. They're good if they're done at the right price by somebody with skill. Period. And you know, investors are always looking

for the silver bullet, the investment that has high return with low risk and they run from one thing to the next hoping to find it, and it doesn't exist out there other than in the ability to discern value relative to price consistently. And so if you go back to '03, say, and high grade bonds were paying 3, 4, 5 percent and stocks were defrocked, and - - expected to give 11 but now 6 or 7. The institution that needed 8 for its actuarial assumptions despaired of getting the 8 from traditional mania, and they said well we have to go to alternatives. But you know, nothing works all the time and if enough money flows into any market sector then it ceases to work. And I think that's in part what has happened. So you know, you need price to value and skill.

MR. ABRAMS: I guess I would kind of break this up into a couple of pieces. The alternative investment space, shall we say, it's comprised of a lot of sub-sectors, and they're pretty different from one another—private equity, from venture, or from long / short, from opportunistic funds like Baupost and our firm. I think that clearly when you charge-- And the other thing too that's a little bit of a misnomer is alternatives, I think. It's like, alternatives to what? Well in the end it's just one pool of investments. I mean, some people might like companies that are growing, and some people might like them to be leveraged, and some people might want to buy debt, and some people might want to buy at a discount, and some people like to pay par. Whatever it is. But you're all in that same pool. And the critics of the industry are right. To earn the fees you've got to do something special and it's hard. I mean, we work really, really hard to do that. He's been doing it for 26 years. But not everybody is going to be able to do that, and there's going to be a lot of disappointments, and you're seeing that now in a lot of ways.

I think you're going to see huge outflows right now, from now through the end of the year. Private equity clearly is a disaster. I mean, just an unmitigated disaster, right? And by the way that means that the results of a lot of endowments for the last year are totally overstated because according to their private equity GPs, they say private equity was like flat to up. How about down 20 to down 80, right? I mean, that's the economic reality of it. So you know, there will be a lot of disappointments but for the people that are—and

you know, this room is actually just chock full of a lot of people. They're going to keep doing what they've been doing for 10, or 15, or 20 years and they'll be successful because they actually get better as you get older. So I see a big split.

The other thing too is like over the last few years, because our firm has been successful, a lot of new firms would start up, people would come by and ask me for advice. Well you know, what do you do? And I say the first and most important thing is make sure that you choose your clients carefully and most people would either look at me like I had three heads, like you've got to be kidding me, like that's quaint. I actually had one very, very successful guy say, you know, that's really quaint and old-fashioned, like, you don't understand the new marketplace. Well we'll see. And I had other people say well that's great but that's not possible, and I'm like you know, I think it is possible. If you're an investor, if you're leading your firm, leaders have to lead, and you have to lead with discipline. So I think those are some of the things.

And the final thing too, within the whole industry is the long / short side. People have to, whether you're managing a fund like that or investing in a fund like that, you have to be doing some fairly deep soul searching now because the government's after you, politicians are after you, there's no way to do it without taking counter-party risk, and how do you feel safe with counter-party risk? Maybe it will subside and it will be fine but you know, you've got to be doing some deep soul searching now.

MR. KLARMANN: David and Howard's remarks remind me of that wonderful quote from Jean Marie Evelard [phonetic] a number of years ago when he was getting redemptions because he was not chasing overpriced stocks and he said I'd rather lose half my clients than lose half my clients' money. And I think all of us have internalized the need to do the right thing, to stand apart from the crowd when necessary, to put your clients' interests first, and it's sad but it's a world where not everybody can do that or chooses to do that for whatever is in their head. And it's obviously the only way to be able to look in the mirror and stand yourself at the end of the day.

In the possible absence of questions from the floor I have one other one for you guys. [off-mic comments] Just tell us quickly, what's the biggest one or two mistakes you ever made and the lessons, especially the lessons, that you took away from that so you'll never make those again?

All right, I'll go first. [laughter] They're really easy. One is stay away from bad people. When you're with bad people if you fight them you end up wasting a huge amount of time, you're not going to change them, and so there are a lot of cheap stocks that should be cheap because they think that your money is their money and they're not going to change. So we've learned the hard way in a few situations many years ago, when it's a really bad person just let it be somebody else's problem.

The second is beware of leverage, not in your portfolio but in the underlying companies. The biggest mistakes we've made have been where we thought our value was covered easily but where we were not in the senior-most position and there was a lot of debt in front of us. Then, a relatively small change in the value greatly impacts those securities. I remember, I believe it was InterCo Bonds [phonetic] that were not the juniorest bonds but also below the senior and when the company failed to execute on a business plan, the economy got a little bit worse, the bonds that we had bought at 50 were trading in the 20s, and we were lucky to get out at that price, we felt. So be really careful, especially in this environment. Stock can look incredibly cheap but the leverage that they have won't be the leverage that they'll be able to roll when it comes due. That's become an obvious lesson now but it's something, luckily, we learned for small dollars a long time ago. And you can never imagine how little amount of actual debt can seem really large just when you have a big problem. That leverage is really an enemy of being able to take a long term perspective because you can drown in a pond that is only one foot deep on average. Leverage has that effect sometimes.

MR. ABRAMS: I guess I would certainly agree with those points about staying away from bad people. I think some of the biggest individual investment mistakes have been in fraudulent situations, which is always tough to guard against if somebody is trying to purposely deceive you. But as long

as you get an inkling of that and stay away. And fighting with bad people is definitely not a great use of time.

I think the biggest lesson for me, which really just reinforced this last year watching all the disasters, is no leverage in my life. We don't have—I don't have any mortgage since a long, long time ago. Bought my first house and paid off the mortgage fairly quickly. No leverage in the portfolio. We run with some cash almost all the time, sometimes a lot. And this is just an environment where you know, you've just got to make it over the canyon and if you don't have any leverage you're in a much better position to make it over the canyon.

MR. MARKS: Well you know, at the end of '07 I wrote out a list of what I thought were the lessons of '07 and I thought that the most important one, the best one, was that investment survival has to be achieved in the short run, not on average in the long run. And that leads to your point about drowning in shallow water. But the upshot of that is that investors have to make it through the low points and because ensuring the ability to do so under adverse circumstances is incompatible with maximizing returns in good times, investors must choose between the two. And that's really the key to survival. And you know, incredible as it sounds, and we tend to lose track of this, survival is an essential component in success.

The other thing I'll just mention in terms of a mistake we made, probably the biggest percentage loss we ever had in an investment was where we ignored the dictum of lasting assets. And we bought the debt of a technology company which had a very good technological position in the market but, you know, one of the cornerstones of distressed debt investing is for the most part not putting in more money. And we learned the hard way that if you have a technological advantage and you don't feed it for a year then you don't have it anymore. So you know, this is a very important kind of lesson to learn and hopefully with small dollars.

MR. KLARMANN: Yes sir?

MALE VOICE: In 2007 and you know, Baupost maybe had its best year, one of its best years, and I think from your end of your 2007 letter you talked about how it was an area maybe that you hadn't previously invested and you had to bring in

all different factors from within the firm in terms of getting the insights. And I was wondering if you could just maybe comment a little bit about the insights, and how you came about the insights, and the success that you had in one particular area, and then how that process played itself out.

MR. KLARMANN: Yeah. I don't recognize you as a client so I'm glad you were able to get our letter somehow. [laughter] Uncle Jim. [laughter]

'07 was a good year and a bad year for our firm. Clearly one of, I think, the best nominal return. But it all came from one general thing which was seeing excesses in credit in a variety of ways and having very low cost protection against them, credit default swaps essentially. So while we don't usually have macro views and didn't have a really strong macro view we felt that the risk / return was just unbelievable. That for a very limited amount of risk, a limited amount of dollars that we would lose if the entire thing was wrong and we lost all the premiums we'd have to pay, we ended up being fortunate in timing and it turned out to be a very profitable year. We harvested that for the most part last year.

And the process was because we work in a team environment and a very open seating environment—I have a private office. I'm never in it. I sit on the trading desk. We just talk all day long and when one of the members of the team pointed out that there were some real mispricings in that area we did more work, we assigned more analysts to work on it, and over time we developed greater and greater conviction that he was on to something, and then we sized the position appropriately.

I have a story that is just—it's a really important anecdote to tell you—that somebody else at another firm had I think a much bigger position in the same thing who I ran into. I hadn't met at the time but met in the last six months. And he told me how effectively, as David said, he shorted bonds at 100 but when his risk model told him at 97 that he had too much risk now because he had three points of profit and that was a lot of dollars, he took almost the whole position off. It highlights this sort of foolishness of trusting a computerized risk model rather than your own eyes, and ears, and judgments. That if every day you're marking to market

and you are afraid to lose a nickel of it back you're going to be truncating your best ideas before they ever get going.

So it's just food for thought. What fell into place for us, and you read the letter, most people probably didn't get to see it, is we handled it really well from beginning to end. We were thorough in our work, we had a lot of the team working on it, complete buy-in from all the partners in the firm, so it was easy to take a view like that. And then we monitored developments, understood markets, added to the position opportunistically when risk models might have said to take it off we actually added to it because the facts had changed and it was even more attractive, and held the great majority of it for very close to full realization of the potential. I pat ourselves on the back because I know how many things we don't do that well and it's important, as I said at the morning remarks that many of you may not have heard, process is everything in investment firms.

Today is a moment where many firms have a broken process. They're getting redemptions, they're getting margin calls, they're down 25 percent, they can't think straight, there are recriminations, who's the idiot who bought this? So when your process is broken you can't invest well. It's hard enough to invest well when your process is good. So we were fortunate that our process was good and we had a good idea that we capitalized on.

Next question?

MALE VOICE: Yeah, just a question for the panel. If you can just talk a little bit more, expand on quantifying risk. Obviously you're talking a lot about low risk and higher returns, and if you can just expand on that and kind of how it pertains to equities and debt in terms of what you guys do.

MR. KLARMANN: Howard is the risk god, so...

MR. MARKS: I personally think that quantifying risk is an oxymoron. [laughter] I think that risk cannot be measured in numbers. Seth can tell me, he can look at something and give me the probability of losing 20 percent, and David can give me the probability of losing 50 percent, and somebody else can tell me the chances of having a loss, and they'll all be different, and nobody will look at it the same way,

and the numbers won't be comparable because David's inherently more optimistic than Seth is. And I think that the business about volatility being risk is a con job which was perpetrated primarily because volatility is machinable. It's measurable prospectively. You can apply it to the future. You can compare the volatility of one asset class with another. But I think that the job of measuring risk requires the same thing as the job of measuring prospective return which is a superior skill on the part of the individual. And you know, you have risk managers who Seth just talked about who knew everything about statistics and nothing about investments who just got in the way in the last few years.

MR. KLARMANN: Yeah, it's just funny because this is why I say I'm separated at birth with Howard, that when people ask me what's your risk I'll say seven. [laughter] It doesn't mean anything. [laughter] How do you...? David?

MR. MARKS: And to add one last thing. And if you want to think about trying to measure the risk of an investment you're thinking about taking, think about some of the investments you've made in the past and completed, and think about whether or not they were risky. I mean, the fact that something worked doesn't mean it wasn't risky. The fact that something didn't work doesn't mean it was risky. And if you recognize that you can't measure it in retrospect then clearly you can't measure and quantify it in prospect.

MR. ABRAMS: The only thing I'd add to all of that is just to pick up on the last thing that Howard said which is, you know, just because you did something and it worked doesn't mean that it wasn't risky or wasn't smart. I mean just look, the classic example—may make a few enemies by saying this—but everybody knew, I think at the time, that Blackstone bought the EOP properties at the top of the market. The fact they managed to flip a few for an even greater profit doesn't make them smart. Truthfully, if you were a smart investor you'd say God I was lucky, we should never invest with those guys again.

MR. KLARMANN: You will make enemies when that's printed in the front page of something. [laughter] So it's fitting I think in many ways for Chris Stavord [phonetic] to have the last question. I know Chris was an important person in the early

part of David's career and also in mine, and a formidable value investor in his own right. So Chris?

MR. CHRIS STAVORD: Before there was a Securities and Exchange Commission, bear raids were extremely common. There was no up-tick rule. Joe Kennedy, one of the biggest bear raiders of the late 20's and early 30's became the first SEC chairman and put in the up-tick rule precisely to stop bear raiding. In my opinion the SEC re-legalized bear raiding in July of '07 by getting rid of the up-tick rule. I infer they did so under pressure from the quant funds and dealers which couldn't conduct shorting, or certain kinds of dealers. Dealers were always exempt. A quant fund buying and shorting four or five hundred stocks a day can't really function with an up-tick rule in place.

My own inference is that bear raiding was a factor in the demise of both Bear and Lehmann. Not only was there no up-tick rule where you had over a hundred million shares of Lehmann trading with no up-tick but you have the advent of credit default swaps which in my opinion are like axe-murdering [laughs] because the volume of credit default swaps is so much larger than any one issue and the potential profits are so huge that you can--there's just an enormous incentive to do everything you can in terms of influencing the press and lobbying to knock down stocks and bonds.

Well now the SEC seems to be cracking down on short selling. The list of restricted securities, eight or nine hundred restricted securities--by the way, which can be evaded by shorting dually listed stocks and using options, shorting indexes, and so forth. If the SEC really cracks down on short selling would it make a difference? That's the question.

MR. MARKS: I think there's nothing wrong with short selling. There's something wrong, as you indicate, with abusive short selling which is what bear raids were. And I don't think that selling what you don't own is any worse than buying what you don't own. And I think that the ability of selling to make stocks go down is no worse than the ability of buying to make stocks go up to excessive prices. One is not more socially undesirable than the other.

But I think that abusive short selling is a very bad thing, and difficult to detect, and prevent, and penalize. So

there's a complexity there and I don't think there's an easy answer.

MR. STAVORD: But do you on the panel feel anything or hear anything about the SEC really trying to make this a major issue rather than just eventually ignoring it in a few weeks?

MR. ABRAMS: I think it's going to be hard to say. I mean, I agree with Howard that it's a complex issue because first of all I don't believe that short sellers made Lehmann go broke. I mean, Lehmann went broke because they were levered a zillion to one and had a bunch of crummy assets. And all of a sudden people said why should I lend to them? You know, I think that's the fundamental reason why they went broke. On the other hand allowing people to do momentum shorting, which you would, is maybe not the wisest thing. I think that in terms of going after short sellers, I think as you watch the debates in Congress it's pretty horrifying what the political, you know, the political appetite for blood is. And short sellers are a good target. Maybe they're an unfair target. And so as somebody who is more of an analyst than an ideologue I just try to look at what's coming down the pike and that's why I said I think if you're in that business you've got to be deeply thoughtful about it because I don't think it's going to abate any time soon.

MR. KLARMANN: I guess I have a few other quick responses. First of all, it obviously would be a tremendous loss for humanity if a quant fund ceased to exist. [laughter] I think that financials perhaps in the current environment are different. That if somebody shorted a stock at 10, and 8, and 6, and 4, and it was unleveraged, and a good solid business, a value investor would love that because you'd be able to buy more and more shares at fabulous prices. So you're pointing out something circular about the financial businesses and over-leveraged business is heavily dependent on credit. It's not short sellers or anyone else. We have virtually no shorts, we're not in that business, but they didn't cause those companies to get in stupid positions. The companies managed to do that on their own.

The other thing I'd say to you is I know that this panel and all the contributors to the book—I know everybody quite well—every single one of us would love for excesses to be investigated and cleaned up. All we ever have wanted is a

clean playing field, a fair opportunity to invest. So there's an article in the paper I think yesterday about the odd quarterly marks of some heavily held hedge fund positions that gyrated up sharply right before the close, and happens just about every quarter as you well know. And so if people want to go through quarterly marks, and not disclosed groups, and people who send emails, and talk to the media, and bear raid companies, bring it on. I think that it will only be better for people that just want to be smart, and invest every day, and have no unfair advantage, but have the fair advantage of working hard and finding bargains in the Graham and Dodd style.

Thank you. Thanks everybody. I don't know if Erin's going to say something? [applause] There's lunch outside and we'll come back in 15 minutes, we'll start promptly.

[applause]

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MR. BRUCE GREENWALD: 10,000 year events. Mainly there is a close connection in what the previous panel said to what this panel is going to be talking about. If you'll notice, the last panel speakers talked a great deal about concentrating on process and consistency. Now, the basis of that process is clearly the classic that we're celebrating today, which is security analysis. We are extremely fortunate today in having people on this panel who are part of the living tradition that has been generated by that original work. Most notably, obviously, in the developments associated with Omaha, Nebraska and the chairman of - - Hathaway. But, I think, really developments in applying, extending those principals that are part of this broad and very intellectually vital community of value investors.

So what I'm going to do--and I don't think they have to stand up--is just start and ask, starting with Tom Russo - - to describe how they came to value investing and how they extended those principals to what they do today.

MR. THOMAS RUSSO: My contribution in the area that I speak about is global value investing. And it's the application of the principals that are provided in the book to a global market. I was commenting the other night about the bear market that we're all living in with a friend and colleague, David Winters, over dinner. I said to him in the midst of this bear market I recall when I started the Sequoia [phonetic] fund where I learned principals of actually investing. They would talk about the market in 1973, 1974 and they said it was misery. You'd go to work everyday and you'd show up and the market would go down. Then you'd go home, come back the next day, happen again. For two years the markets were down 25% two years in a row. And that's what you face every single day. David said that's easy, global value investors come to work each day and the market goes down. They go home, turn on their Bloomberg [phonetic] and the market goes down all night.

[Laughter]

MR. RUSSO: And then you get to come back the next day and start all over again. So I think that's the situation of global value equity today.

You know I had the privilege of studying under an investment professor, much like Bruce, who in 1981 said don't be prevental only 5% of the word's population is in the US; 95% is abroad. At the time it was very touch to invest overseas. It was difficult to settle trades. It was difficult to convert currencies and difficult to establish custodial relationships. And it was, quite frankly, very difficult to get information about international investing. You'd have to send away for annual reports. They sometimes come back; they sometimes wouldn't. Information inefficiency was a big part of investing. And at the same time the opportunities were compelling and they were big and broad and attractive.

If you think about what's happened since then, you fast forward to today. Last year, for example, at the very height of the emerging market boom it was very easy to invest abroad. Every broker wanted to sell you funds. And the markets were awash with capital. And they certainly signed up with a bad, disappointing period. But I'd say the start to applying global value principals was a very natural extension for me, at least, because I focus on food,

beverage, and tobacco and media companies. And the migration from looking at the domestic companies requires that you study the international ones so you understand the business. So if you want to understand the beer business you can't stop with Anheuser Busch. You have to understand what Heineken and Bev [phonetic] and Carian [phonetic] and Fosters and the rest of the world is doing. So once you have to analyze the companies that compete with the domestic businesses it's a simple step to think about which ones are more attractively positioned, which have more shareholder minded managers, which ones are more attractively priced. I mentioned David early on. I'd say the earliest experience I had in the actual assessment of companies was at the Sequoia fund in the early 1980's, at which point I remember my colleague, Gregory Alexander, at the time. I think we met with Rupert Murdoch [phonetic] at the time when he still had three newspapers in Australia. The world has changed. The foreign companies have grown up and the opportunities to deploy money abroad has certainly opened up because the information is more freely available.

I think no matter where you invest the single most important lesson you want to not forget is to invest with people who are owner minded. I've done that through family control companies. You can figure out other ways to determine. But make sure that they invest on your behalf. That's the most important thing. So that's it.

MR. GREENWALD: Yeah, okay. Glen?

MR. GLEN GREENBERG: The question was how we got to the value camp.

MALE VOICE: How you started and how started presumably with security analysis in the intelligent-

MR. GREENBERG: [Interposing] all right. I was born in New York. I grew up in Cleveland. That was important growing up in Cleveland. It was very easy for me because my career began after business school July 1st, 1973. I joined the trusted investments department at Morgan Guarantee, which at that time was by far the biggest pension fund manager. And they had been led-the prior leader was a man named Longstreath Hinton [phonetic], who understood the advantages of investing in a growing business and not focusing only on dividends. So we're talking about the period probably in the 40's and 50's.

And so Morgan Guarantee had a great investment record by identifying growing companies that had a long runway ahead of them. And by understanding that good growing business with high reinvestment rates, that that was probably preferable to buying a - - industrial with a 5 or 6% current yield. And they had ridden that success to the point where they had by far the most pension assets under management. They were considered, by far, the most important institutional money manager.

And I joined them in the summer of 1973. And my value light went on with my first assignment. First of all my group head came over and I had taken off my jacket. And he informed me that at Morgan Guarantee they didn't wear short sleeved shirts.

[Laughter]

MR. GREENBERG: I had just gone shopping for my first suits and my first shirts and they were all short sleeved because it was the middle of summer. That was the environment. He handed me an annual report to a company called Arcada National. None of you have heard of it, I imagine. He said that a money manager had gotten some in and he didn't know anything about it and would I take a look at it and tell him what I thought. So I analyzed it. It was not atypical for that period. It was a conglomerate. It was in two businesses. It was in the PBX business, which was switch the equipment for telephone, which was very new and advanced at that time and which was losing money, which I knew nothing about. And then the second business they were in was a logical extension. They owned the oldest stand of first growth Redwood in California.

[Laughter]

MR. GREENBERG: And Japanese loved this stuff. And the dollar was weak against the yen. There was just a huge market. They could sell everything they cut each year and they made a handsome profit for selling these logs. And I checked around and I found out that that Redwood stand was worth three times what the company was selling for assuming the PBX was worth nothing. So I think that converted me to the idea of being a value investor. It was obviously a lot easier than--well maybe it's not--it was a lot easier then. There were a lot of things that stood out. How are you going to lose money on

something like this? At the time, however, Morgan Guarantee had ridden the success of what's now called the Nifty Fifty. And the great growth companies, instead of setting a 10 times earnings and 11 times earnings, which they did when they didn't pay a dividend and everyone wanted dividends, were now trading at 50 or 60 or 70 times earnings. And they were entering a period which they had never been through, which was characterized by serious world recession and very rapidly rising inflation. And many of them weren't prepared for that. And Morgan's portfolio was loaded with that. And within the course of the first year and a half I was there the portfolios lost over 40% of their value.

And I, then, was promoted, out of my utter brilliance, from being a research analyst to being what I refer to as a money mis-manager. I joined the august team of people responsible for the huge sum of money that Morgan managed. And my job, they gave me all the clients' pension accounts that were paper companies because I followed the paper industry in my one year, one of my two years of research. So I also had clericalists because papers and chemicals, you know, sort of all the same. And my job was to go around and explain to these boards of directors and CEOs and so forth how we manage to loose 40% of their money but they should, you know, stick with us.

And I would say that those two--this would come to mind--those two experiences of looking at something which was so obviously mis-priced and then having to go and explain to people why you lost 40% of their money in stuff that was obviously adversely effected by the environment and never deserved to be selling for the price that it was selling at, how there could be a mindset like that. You know it converted me to a person who likes to feel that I'm getting something at a bargain price. I think I'll leave it there and pass it onto Bruce.

MR. GREENWALD: Bruce.

MR. BRUCE GREENWALD: Well my story's a little different. And I think I'm beyond the statute of limitations so I can tell it to you. I dropped out of high school and became a book maker. And that was my beginning.

MR. GREENWALD: This was a gamboling book maker, not a book-book maker.

MR. BRUCE BERKOWITZ: Not a bind-

MR. GREENWALD: [Interposing] Okay.

[Laughter]

MR. BERKOWITZ: Right.

[Laughter]

MR. GREENWALD: Just want to be clear.

MR. BERKOWITZ: And I was absolutely, as a 15 year old boy, was absolutely fascinating to take bets, to have a sense of having better information, having sense of understanding odds that typical blue-collar person didn't understand, the counting of cash, trying to understand whether or not they could pay, who they owe, who owed them, so on and so forth. It was great but then I found out that I had to deal with a few unsavory characters and decided that it would be a very short career. And I also knew that as a minor I had one free pass-in terms of going to jail that is.

So I stopped being a book maker, went back to high school, finished, went to the only university who would take a 1.2 cumm., which was the University of Massachusetts, and then started working for a finance professor to pay my food bills and did a few things and graduated, became a management consultant, moved to London. And made some money for the first time in my life, still not as much money as I was making at 15 years old, but I was slowly getting up there. It only took about 15 years to get back to that point. And then I got a few bucks, opened up an account at a major brokerage firm, did horribly, found out that the broker did well. And I said gee, if you can't beat them you might as well join them and went into the business. That's when interest rates were very high and you could buy almost any bonds and you could buy warrants in all these exotic strips and cats and tigers. And they were stripping US treasuries. Went great, I made a lot of money.

And then interest rates went low and I decided gee, I have all this money now-well relatively speaking-money for the first time in my life. And there's no way I'm going to do with my money what I was just doing. And I'm not going to do it with anybody else's money. So I searched and searched and low and behold I came across Graham and Dodd. And the light

bulb went on. It's like oh my God, I can legally make a lot of money.

[Laughter]

MR. BERKOWITZ: I can't believe this. It's like unbelievable. And I read it and I read it. And it took me 10-20 years to understand it all. And some of it I still don't understand. But I finally kind of figured it out. It's all about counting the cash, owner's earnings, how much money you can put in your pocket. Can you kill the business? How long is the business going to be around? And it's about telling the truth. It's about not being in denial. About understand the mistakes you make, defining what risk is. It's permanent loss. It's not volatility. Don't guess. Keep it simple. Your thesis should be on the back of a postcard if it's right. Be prepared for the unknown; it happens. And more and more that's how I came to it. So I all started from being a juvenile delinquent at the age of 15.

[Laughter]

MR. GREENWALD: Okay. I hope that we've established the redemptive power of reading this book.

[Laughter]

MR. GREENWALD: But what I would also—I think it would be useful to talk about too—and I guess I got to answer my own question—is once you have that quasar-religious—or in Bruce's case super-religious—experience, what is it that you then bring to a process that goes beyond what Graham and Dodd did. And I think the interesting thing about this morning's discussion with Seth was the point of which in the book Graham and Dodd themselves punt, which is they go through all this really superb analysis that stood the test of time and then they say basically buy bonds. And it's actually worse than Seth said. He said for most investors US government savings bonds are where you should be. I mean practice—that was because when they looked at the environment and they looked at risk properly defined, that is where they saw the methods and opportunities controlling risk. And it seems to me what the panelists you're being exposed to today have done—and in particular Warren Buffet has also done in going beyond that—is that is that they have begun to think about managing risk in much more sophisticated ways. And one of

those ways, by the way, is just to start exactly where Bruce started, which is to start with the cash flows.

And the experience Graham had of cash flows, buying cash flows in 1930 or '31, was that those cash flows couldn't vanish. So that by 1935, 1036 these companies had no profits at all. The depression is as much an evaporation of profitability as it is an evaporation of sort of euphoria and excess valuations of existing profitability. And I think one of the real lessons that this panel—and in particular I think the missing member of this panel, which is Warren Buffet—too to heart is you had better understand the determinance of those cash flows. In doing your forecast you had better understand companies and industries rather than just taking a historical average and slapping them a multiple on it. And I think, you know, in the experience among others, of listening to Glen, that he is an absolute master of that. It is understanding when a company's superior returns because that's what makes a good business that you want to invest in for the long run for tax purposes, are going to be sustainable in the face of the relentless force of competition.

And it's something that Graham was aware of. But in his world he didn't see any chance of resisting that relentless force of competition, that if a company produced 20-30% returns on capital you turned around 5-10 years later, those returns were going to be gone. I think we have a much more sophisticated view of what business models are like when they survive. Why it is that Coca-Cola, for example, has produced superior returns for 100 years now whereas other firms have produced those returns for short periods of time, notably the internet people.

So that's the first lesson I think. I think understanding sources of competitive advantage in a sophisticated way is a discipline that's now far advanced beyond what Graham ever envisioned. The only thing he writes about in the book is basically research and development. And it means that you can look at cash flows and particular advantage growing cash flows, in ways that you never could before and begin to think about what the risks are that you're exposing yourself to when you pay eight or nine times those cash flows that could evaporate. So I think the first big development that I think was implacably talked about in the last panel and is talked

about in this panel is understanding those business models, some of which fell apart when the Nifty Fifty fell apart and some of which didn't. So that's the first lesson. And I think it's very much a lesson in risk management. I think that when Seth buys a fractional share of a business he has a good idea of how likely those earnings are to be sustainable.

But I think the second lesson is something that I, at least, have learned more recently in listening to these investors, and that is you also want to begin to do active risk management so that when you have a portfolio of good companies at good prices there are always events, as we've experienced in the last year, that can come out of left field. The best example I remember of this is—and it's a real—there's another lesson in this which is going to be the reverse of Bruce's. If you have a choice between teaching and taking a real job it's much more dangerous to take a real job. So the one job I almost took in my life was working for long term capital management. And I remember sitting next to Larry Hill Abram [phonetic] who was the genius of the firm, in the May before the firm collapsed, at a birthday party in Connecticut. And he was talking about risk. And he was saying you know the characteristic of this market is that risk is going away. Bob Martin, who has got a Nobel Prize in work for long term capital management, has taught the world what efficient markets really look like. And as markets get more and more efficient risk is going down and down.

And I'm saying to myself thinking, with reference to the last point, we are sitting in the middle of one of the biggest bubbles in history and this guy thinks risk is disappearing. This is the time to protect you. So, of course, I didn't go to work for them. And here I am today happy and just as rich as I would have been otherwise.

[Laughter]

MALE VOICE: In that environment I think—and it was something also that came up in connection with when you worry about macro factors. It's not that you're trying to outguess the people forecasting the economy. It's that you want to have a sense of when there are macro-vulnerabilities and when there are vulnerabilities in the market because people have bizarre attitudes towards risk. And in that situation you want to buy insurance and you want to learn to buy insurance. And I

think increasingly value investors will do this in a way that Seth refused to talk about this morning, but in a way that is most cost efficient. And I'll talk a little bit about what was cheap insurance. And it is not just in mortgages that people went crazy starting in early, mid of late 1960-2006, rather, middle of 2007. You could get credit default swaps in the summer of 2007 on almost any debt at ridiculous prices. The most ridiculous was you could get a contract that would pay the full face value of Dubai's sovereign debt, if they defaulted, at four basis points. What the market was saying was that this country with a short history, living in the most dangerous part of the world, subject to the greatest possible probably variation in economic and social and other conditions had one chance in 2,500 years of defaulting in their debt. Once you see that you know that that's crazy. But I think you also ought to have a sense that that is an opportunity to buy quite general insurance. Because what's driving that sort of situation is a perception about risk, broadly in the economy, that is pervasive. And I think that is, by the way, one of the things that the bail out's also have not begun to address.

You can take advantage of those opportunities. If you had bought those credit default swaps at those four basis points when you needed the money early this year they were trading at 86 basis points simply because of the change in the psychological atmosphere, you would've made 21 times your money and protected yourself against any potential loss. So I think the other skill that people in this audience are going to have to develop outside the per view of traditional Graham and Dodd investing, which is also a matter of risk control, is how to buy cheap insurance and how to have a sense where given the general attitude towards risk—and it's of course, ironically enough, when the insurance is cheapest that you probably need it the most because it's precisely at that point that things are most overvalued. And I think that's the second really important development, which is to be good at buying insurance and formal risk management.

All right, the next question then is when—one of the things that's also developed is when people talk about process, value investors are becoming specialized by industry. And I wonder if when the investors on this panel think about the

process that the last panel was talking about they think about different processes for different industries.

MALE VOICE: - - .

MALE VOICE: Yeah.

MALE VOICE: So I believe deeply in the notion of specialization because I think you pick up insights typical to an industry and it allows you to access across an industry the best opportunities. And from my perspective to do that globally, actually, opens up the universe. So we have focused on the consumer side of the investment role. And in part because the consumer brand is an insurance against some of the competitive factors that you referred to that you - - insure again. So that new start up coming after Coca-Cola is, in fact, the historical value of the Coca-Cola brand. It's not just the brand, it's the distribution and it's the benefits of pricing because of scale and a whole series of other advantages. But ultimately the brand is terribly valuable. And so I think the global view of managing across the industries are fine.

You know in terms of your observations about insurance, just to step back for one quick second, I think you can insure against mistakes by becoming a more specialized in your knowledge that comes from staying within a handful of industries. But more broadly, you can insure against your capital becoming stale by looking for businesses that have the capacity to grow. And so in the emerging markets, the developing markets, the global investor, from an Americas perspective is you take a business that might be otherwise constrained domestically and they have the ability to deploy the capital in foreign markets. And that insures you, in some ways, against the risk of your capital becoming stale.

As an investor the process of making those investments in foreign markets often will suppress the profits of the supported company that's doing it. And so as a value investor you have the opportunity to buy future income streams at evaluations that today reflect only the start up losses. And so you have an opportunity to have a current price with businesses that are investing in the future to insure against your stale capital at too low of price because of the cost of developing the new markets. And as those

costs convert to profits you're going to have a chance to make double rates of returns.

MR. GREENWALD: Glen?

MR. GREENBERG: I want to be responsive to the question, so can you repeat the question?

MR. GREENWALD: Oh [Laughter], okay. The question was that one obvious direction in which the Graham and Dodd tradition can develop is industry specialization. And when you apply it do you do it differently for different kind of industries?

MR. GREENBERG: We've always been generalist every since the first two years when I was an industry specialist. And I worked for--after I left Morgan I wanted to get out of money mismanagement and I wanted to go work for the smartest person I could find who would hire me. And I found an extremely talented investor. And he had everything in his head so he taught us to put everything in our head. And he wasn't afraid to look at anything. So I plumped down there and my first assignment was to analyze corn futures. He gave me another easy one just to bring me up to speed. He asked me to look at the Pen Central [phonetic] reorganization and tell him whether he should buy the preferreds or what he should buy. I told him he shouldn't buy any and that lost him a lot of money.

He had the view that you could analyze anything if you are an intelligent person and you sat down and applied yourself to it. So I think what you do, first of all, if you are an intelligent person you do have the ability to do that. The second thing is you look at everything with fresh eyes. The third thing is you're comparing what you know about this business, the risks and the opportunities, with all of the other opportunities that you've looked at. As an investor it's certainly nice to be able to go to where the fish are as apposed to be fishing in a part of the stream where there's never any fish. So you know you can go wherever you think there may be opportunity. It certainly makes reading the newspaper more interesting.

But I've also found most of our investments I can summarize in a sentence. So if I can summarize it in a sentence that means essentially I understand why I own it and I understand the big force which is going to drive it forward. It also

means I understand why it's selling so cheap. I understand what other people think and I disagree with them based on my analysis. But at least I understand the broad range. I also look in the newspaper and I see that most stocks, within a year, will have a 50% price swing. So it shouldn't come as any surprise that even in a normal year stocks are perceived very differently. So in a time of stress and a time of deleveraging, of course, stocks should sell at a very, very broad range.

I also say that this is probably the most exciting time in my life. 1973 and '74 I was watching a lot of grown men who basically had their manhood taken away. There were no women in that group at that time. And they basically staggered around the halls and they looked like everyone in their family had died. And I certainly don't want to repeat that now. But during the last few years, to look at stocks, there really wasn't much to choose. The really good businesses were priced like really good business and the crummy businesses were the ones that were quote somewhat cheap and they had issues. There wasn't a lot to do if you were honest with yourself as an investor. At least there wasn't much for us to do. And it was very frustrating. Of course our portfolios were at all time highs. That wasn't so bad. But when you looked in the portfolios and drilled down in there we really didn't believe that we were going to make high rates of return or make adequate rates of return.

Now, paradoxically of course, we've lost a lot of money for our clients, but there's so much to look at. There's so many businesses that have been pulverized. And so many of our own have been pulverized. So there's the opportunity if you haven't already bought too much to buy more. So this is an unbelievably exciting time. And I think it really helps to be able—we're working on three, four, five, six, seven—there's four of, us by the way, in the business—we're working on three, four, five, six, seven things at all times right now whereas a year or two ago we may have been having one thing that we're rattling around the office and all sort of looking at with not much enthusiasm. And I think it really helps to be a generalist.

Risk is definitely what somebody says. It's the risk that you're going to mis-analyze some business, that its outlook is going to be much worse than you think. And therefore the

stock will never trade where you think it's going to trade. And they're going to eventually sell it because you realize that mistake and you're going to have a loss for your clients. And that's what we try to avoid by understanding the businesses that we look at.

I think the other aspect—I'd like to address your point Bruce about risk protection and the Dubai credit insurance. That was an investment. That investment might not have been available to us 10 years ago or 20 years ago, but I don't view it as you have your basic portfolio of Comcast, Ryan Air, and Eaton, and then you have your Dubai hedge swaps as a hedge against it. I mean that's certainly a way to think about it. But I view it as totally independent decisions. I mean if you make the decision that you're going to buy Dubai credit default swaps for the sound reasoning that you elaborated that's an investment decision. It's not, I think, tied to the decision to own what you think are good business. It may be a very intelligent investment decision, but it's a separate one. And I think people get very distracted. It's very distracting to suddenly look at the panoply of investment opportunities and decide you got to play in all of them. I mean actually what got us to this problem today is people did exactly what you did. They saw all these great ways they could either speculate on something or they could hedge something. I mean that's what screwed us up. And you're advocating it.

[Laughter]

MR. GREENBERG: In Columbia Business School forum there's a tape going back there. This is going out to the world. Anyway, I had to mention that. It's a separate decision. What you say makes sense, but I think it's separate from what we try to do is try to identify a good business one that's going to have a good runway, as you say, that we think can continue to generate a lot of cash for a long period of time, and decide that we're buying at a price that's going to give us a rate of return as high as anything we can find. I'll leave it there and pass it onto Bruce.

MR. BERKOWITZ: This is a question that I've given great thought to over the past couple of years given that we - - are generalist. So one thing we started to do was to hire operational people, people that actually knew how to manage a

few thousand people, knew how to turn around a company, could give us some insights rather than a bunch of on chair philosophers sitting around the table discussing what could be or what might be. But what we do now is we react to stresses in various industries. And when we find companies that go over proverbial cliffs we try and count the cash and then we try and kill the business. And we try every way to kill the business. We-

MALE VOICE: [Interposing] this is post redemptive metaphor, right?

MR. BERKOWITZ: Yes.

MALE VOICE: Okay.

[Laughter]

MALE VOICE: Sorry. This doesn't apply to most of your holdings does it?

MR. BERKOWITZ: We look at every way to see how the business is going to get hurt, how it's franchise is going to get hurt, how that free cash flow, that owner earnings, is going to be diminished under various different scenarios. And if it's an industry we're not well versed in we don't want to be a patsy and we want to develop an edge. So we will go to the key law firms in that industry. We'll try and find the best lobbyists in that industry. We'll go to consultants. We'll go to regulators. We'll go to the politicians that are involved in geographic area. We'll go anywhere we can to get the public information to give us some type of sort of institutional 20, 30 year background on that industry. And if it means hiring somebody that's been in the industry for 20 or 30 years we'll do it. But we'd rather put the people on retainer so that when we're done with that industry and we move on we go through the same process.

So that is now what we try and do in every investment, to try and become an expert. We're generalists, but we need to find the non-Wall Street people who have lived and breathed and suffered and gained in the industries and businesses we're now looking at.

MALE VOICE: Okay. I mean I think the obvious example of this is that I hope that nobody out there thinks that they could invest in financials with the same basic machinery that they

would invest in industrial companies or the kind of natural resource companies that Glen talked about at the beginning. Now some times you may do part of the same basic analysis. If you're talking about the Fanny May or Freddy Mac you want to know what the barriers of entry are in the business, how well they're going to cooperate with each other on the rates for insuring mortgages. And therefore sort of what the earnings power is. But I think it's, for example, characteristic of financials that they have these hugely levered balance sheets and that you're going to do a quite separate analysis of the exposure that you see there in a way that you probably don't have to worry about for an industrial company.

To give you an example, actually this was something that was done before they collapsed. Fanny May and Freddy Mac, in particular, looked like it was going to be able to produce sustainable earnings of—and it was a Duopoly [phonetic]—4 billion a year. A reason multiple not given the growth turned out to be an implied value of about \$50 billion. But if you stop there, which is sort of the earnings power approach, or even looked at book value, which was like 20 billion, and it looked like you had protection, you would be in big trouble. They had \$750 billion worth of mortgages. Thornburg had just done a CMO which was not sub prime, which was not the worst kind of all day, but was really just jumbos. And they had sold it at a 6% discount. And I assumed to sell that—this was back in March or April—they had to pick their best mortgages. So you take off 6.2% off that 750 billion and the whole value is gone.

So I think that enviably if you think about the issue of financials—and I'd be interested in the reaction of the rest of the panel—in this challenge of investing as a value investor in financials, you have to have an ability to work the details of that balance sheet, to have sources of information about likely marks to market before you can ever do that. And that's really a very specialized and particular function.

So I think the answer is yes, you have to begin to adapt by industry. And I'd just be interested in your reactions to sort of this issue of in this environment where people have pointed out that the opportunities involve financials are there special approaches that you would take and could

illustrate to getting comfortable as a value investor in investing in companies with these hugely levered balance sheets? Do you want to start Bruce or do you want-

MR. BERKOWITZ: [Interposing] sure, I'll start. In the early '90, last time we had late 80's early 90's panic in the financial industry, I think it was easy to tell what companies were owned and who they owned. Today I find it impossible to understand what they own, who they own, who the counterparties are, what the strength of the counterparties. I just can't figure it out. There are expectations. But in terms of a Freddy or a Fanny, it was beyond my ability to understand what was going on. It was beyond my ability to understand the derivative of - - business of AIG. And I guess in the words of Warren Buffet, it definitely went into the too tough pile.

MALE VOICE: We had--thinking back to the late 80's, early 90's--we had our usual unbalanced portfolio. We had 70% of our client's money in what we called financials some of them were auto insurers. Freddy Mac was one, American Express was one, Marshall and Illsly was one. We had savings banks, remember they were doing the IPO on savings banks at very attractive prices. We had several of those. We had 70% of our money.

It was pretty easy to understand the businesses then and it's pretty easy to understand where they were--I remember one savings bank network, Long Island Savings Bank, Long Island City it was called. They became public and they hadn't made a loan in something like seven years. So they had old mortgages from the books. They took the money that they raised, which they didn't need. They just went public at half book so they could enrich themselves. So you were buying this pool of old season mortgages and Fanny Mays and Freddie Mac securities. And you're buying them at half price. And the old guy that ran it was well in his 70's. But that was typical of the situation at that time in terms of you bought Freddie Mac when a typical mortgage was 20% down. You had a lot of asset protection. Their losses typically ran three or four basis points.

A horrible year like 1991 it got away from their core. They put 3% of their assets into commercial mortgages like apartment complexes and things like that. And then they started announcing that in Atlanta they figured they lost a

third of their money. They had big exposure to New York and there was a lot of fraud. There was a lot of just stupidity on their part in terms of analyzing. So the stock took a tremendous dive. It went from well over 100 down to \$30 a share. Fortunately those losses weren't fatal and they learned their lesson.

But still, even at that time, aside from that detour, which almost sank the company, their basic business was very sound business and a fairly easy business to understand. And you didn't have the accounting principals like 135 or accounting for derivatives, which are really confusing, to confuse the picture. So it doesn't matter if it's a financial. You can't analyze a financial. But now if you were looking at Freddie Mac and saying that they 300 or 400 billion of sub prime mortgages. They didn't have sub prime mortgages in those days. And a lot of mortgages weren't 20%. They were 5% down or 2% down. Oh but don't worry because they're all insured. It was a very different business. And Warren Buffet owned it. I think the people at Rowan [phonetic] owned it. We owned it. A lot of smart people thought this was a fabulous business. There's two competitors. They basically keep market share where it's traditionally been, 60/40 Fannie/Freddie. But it's a great business. You get 17 basis points for guaranteeing a mortgage. Your overhead are 7 basis points and your losses are 5 basis points. It's all cash.

And then when they got in the business of borrowing money to buy mortgages, the owned portfolio, they were earning well over 20% on their equity in that business. So they could take all their free cash flow and earn 20% on equity. Does that sound like an attractive investment at 7 times earnings or 8 times earnings? Does to me. But you could get to a point a year ago when you were looking at these businesses. Their assets were entirely different and the use of derivatives was beyond anybody's understanding. So the business has changed. So you, as an investor, look at them and you make a decision. This isn't the same business that I used to own. And I think it's true of banks, I think it's true of insurance companies. So many stupid things were done that sure you can't look at the balance sheet of any financial today and be sure of what they own. However it is interesting that US Bank Corp and Wells Fargo are trading

higher than they were a year ago while all these other banks around them have gone out of business.

So I'm not smart enough and well connected enough to be able to make those two stocks, you know, my bank stocks. But I think as a general investor most of us would have to say this industry's changing because of the fancy kind of mortgages that are being written and because of the low down payments. And because of the fact that over the history of of the United States home prices never fell on a national basis and that everybody became so comfortable with that history that it never occurred to them that they could fall 16% in one year or 40% in many important markets.

The analogy I always use is that if you're walking through a forest and it's been raining for a month the chances of a forest fire are pretty low. But if you're walking through that same forest and it hasn't rained for a year you don't know if a forest fire will occur. But you ought to be smart enough to say the probability of it occurring are a heck of a lot greater than it would be under normal rain circumstances. And I think you do the same thing when you look at any analysis, including financials. And today the forest fire's already occurred. So it's a very different kind of analysis. I think I'm not equipped as a value investor to be able to do it.

MALE VOICE: I think the metaphor of the forest fire is a good one. And particularly the forests that are the most dry for investors are those where the managements self - - and they most likely push their business to their own benefit to a dangerous extreme. The Freddie Mac that Glen just described is a perfectly wonderful business according to the comments by Berkshire [phonetic], ended up becoming increasingly less secure as they tried to push its growth beyond what the business purpose would generate naturally. So they levered up. They increased their risk profile. And they did it all because it was incented properly for the management to do it. So if you were to think about forest fires and where you could avoid those risks it just so happens that Berkshire owns both Wells and US Bank Corp. And I think the reason that those have stood out amongst the rest is they have this owner minded management.

It's a very traitorous world, as evidenced by the fact that the third bank that Berkshire owns is M&T Bank. And they would speak as highly about the management of M&T Bank as any company in their portfolio. But the management in M&T Bank, in November of last year, put on \$135 million worth of mortgage securities that he wrote off entirely by February of this year. And this is one of the real stand out bankers. So I think my observations about banks in general is that we have the historical example of going back to '93 and buying Freddie and having it do so well because it was still in the early days when it wasn't quite so positioned riskily.

And then you also have the example of Citibank when the Saudi prince came in and bought it at \$10 and made ten times his money over the following years. So there's a history of being able to come in and understand banks and buy them opportunistically. But today it seems to me that the earnings tend to be overstated both because the banks borrow short because the cost of doing so is less and they don't fix the terms of their liabilities where it would cost more, but it would give them more survivability. And they produce volumes of underwritings and placements that generate current reported earnings so that management can get paid on that. But it really ends up risking the banks balance sheet. And so I think the earnings end up overstated and so you really can't buy them off of the apparent appealing low multiple. So it's a risky area to tread.

MR. GREENWALD: Okay, what I would like to do is have people come to the microphones and ask their own questions. Since that process seems to take a small amount of time what I thought I'd do while people are doing that is pose one last question, which is, of course, the crucial question for this panel, which is, in a gap gaining security analysis to today's circumstances where do you see the greatest opportunities. And I want to start with you Tom. And then we'll work back this way.

MR. RUSSO: I see it in the international markets. I see it in consumer products companies. They're not compelling cheap. They're cheaper today than they were a month or two months ago, but they're sort of priced off of existing earnings. But the market doesn't fully value the ability to deploy capital at high rates in developing markets where the consumers are just beginning to march up the disposable

income curve. So I think the businesses that we own that are able to deploy capital and do so at high rates are the area we'll end up profiting the most from.

If you were to think of something that's, I think sort of extreme in the marketplace today, I would say that the--and I'm not sure how to take advantage of this as an investor--I'm puzzled, as Jim Grant said, about the extraordinary low rates of return on US treasury and the quality that that suggested. And also puzzled by the recent strength in the US dollar as an owner of foreign companies--and I suppose that's an area that's compelling value--we are disadvantaged over the past months when the dollar strengthened as a flight to quality currency. And it's a puzzle in some ways, but it gives us a chance to buy more foreign with stronger dollars. We take advantage of it right now.

MR. GREENWALD: Glen?

MR. GREENBERG: We have no money because we're fully invested. We were smart. I'll show you why we don't try to time the market. We were at 25% cash for 16 years because we couldn't find enough good opportunities. And as soon as the opportunities appeared, like four months ago, five months ago, six months ago, we got fully invested. So anything we do now is to upgrade what we already own.

You're sort of asking what the biggest dislocation that we see right now is?

MALE VOICE: Right.

MR. GREENBERG: The latest two purchases we made--and that's not always a good indication of whether something will do well or not--we got interested in what's classified as machinery companies. And I think that would be the group like Cooper Industries, Egon [phonetic] and Ingra saw Rand [phonetic]. We - - Ingra saw Rand. And Egon we have 10% of our money in each. and they are getting crushed. And I think it's because conceptually one says those are late cycle type business, right, non-residential construction, capital spending. And that people have the impression that their earnings are going to get demolished. And historically, when their business mix was different and they were just tied to autos or just tied to trucks, that might have been the case. But both companies have a fine set of businesses which are

steady stable. They totally changed their portfolio since more recently than 10 years ago. But they've never been tried through a cycle. And so the big bet that the markets - their earnings are going to behave like they traditionally have, which is shrink and their sales don't do very well and then they recover sort of midway through an economic cycle. An dour bet is that—I mean Edon today is selling at a 14% free cash flow yield on the earnings that their management predicted for this year. People think their earnings are going to absolutely collapse.

Interestingly I went to a meeting for Cooper Industries, which is big in all sort of electrical things that support utilities and lighting. And they're selling at 10 ½% earnings. And that's 87% of their business. 45% of Edon's business is in the same area. And this company, as I say, is selling at 7 times earnings. So that's putting about a four multiple, three multiple, on all their other businesses, which are clearly worth, you know, a lot more than that. But that's just an area. And I think there are others in that group, but the most impressed ones are the ones that I've mentioned. You can look and see, they all have very high free cash flow yields. Clearly the expectations are that their earnings are going to disappear. And I don't believe it's so.

MR. GREENWALD: Bruce?

MR. BERKOWITZ: Well I really don't like to give out ideas, so I just have one question. Are there any fair home fund shareholders in the audience.

[Laughter]

MR. BERKOWITZ: Okay, everyone else just please hold your ears.

[Laughter]

MR. BERKOWITZ: We're looking for double digits free cash flow yields and we're looking for businesses that are vital to the national interest, sort of life, liberty, and the pursuit of happiness these days. And one good example that we've invested in is Pfizer. 10 years ago 30, 40, 50 times earnings couldn't get enough of it. Today 7-7 ½ times earnings, great free cash flow, very much reminiscent of Philip Morris, the old days, with their distribution system

where they took their brand of products and generic products through the same distribution system. Very much reminiscent of Exxon Mobile where Merchant Bank was really to the oil and gas industry where they're cutting down their cost significantly and now partnering up with those lucky enough and skillful enough to come up with the next set of great drugs. So what could be better? AAA quality company, over 7% dividend, double digit free cash flow yield, lots and lots of cash in the bank, great new CEO, baby boomers are just hitting retirement age, growing middle class all around the world, great established products. And the whole pharma world is changing now. The fat, happy, stupid times of the past are now over. Giving away to generics isn't going to happen as easily as the past. So great company, great price, good new management. That's why.

MR. GREENWALD: All right, that's a good note to end on. We'll take questions from the audience if there are any.

MALE VOICE: For Bruce Berkowitz, in Fairhome [phonetic] are you allowed to own distressed debt? And if so is that an area you might allocate capital to in the future. And for the whole panel, kind of inverting Bruce's question, are there any sub prime like areas or obvious things people ought to be avoiding at this stake of the game?

MR. BERKOWITZ: Yes, we have owned distress debt, we owned WorldCom bonds towards the end, Will Tell [phonetic]. We came late to that party. We had to sort of learn from a few others in the party how to do it. But we think we understand that intricate dance now. Yes, we've done it. We'll do more. We've just had a change in our fund - - to allow us to do more and more to go beyond the normal constraints of a mutual fund. We'll be doing more. Did I miss a part of the question?

MR. GREENWALD: No, the second part of the question was—I'm blanking on it now.

[Off mic]

MR. GREENWALD: Oh yeah, are there areas, potentially, to avoid. I mean I'll tell you one that I think is going to go off the cliff and that's commercial real estate. I mean it's selling at—it's not selling at all—it's valued at multiples that are ridiculous by historic standards for low interest rates and

in this kind of credit environment make no sense at all. So that's one, I think. Any others that people see, sort of looking out there as potential? And this is a pretty careful panel. I mean you're not going to see a lot of it in consumer non-durables, right?

MALE VOICE: No. Highly leveraged balance sheet companies that continually depend upon the kindness of strangers, we've seen it time and time again.

MR. GREENWALD: Glen?

MR. GREENBERG: Talking about areas to avoid?

MALE VOICE: Yeah.

MR. GREENBERG: We don't do distressed. We just do US common stocks for the most part. Occasionally go to Mexico or in the winter and summertime up in Canada. That's about as far as we go. We don't do anything exotic. And we're not smart enough to do that. Not smart enough to do what we think we normally do. Things to avoid. I think things to avoid are things to lose all your money.

[Laughter]

MR. GREENBERG: No, I don't say that as a joke. I say that really seriously. If you could lose all your money don't buy it would be my view. It's hard to make it back. So if there's something that offers great potential but it turns on whether they can get this next financing done or something like that and there's a time limit and they're going to go out of business, we probably wouldn't buy it. We wouldn't buy something if it had 100% down or 50% down and 150% up we just wouldn't buy. We just try and stay away from that.

MALE VOICE: You're absolutely right on that. A lot of statistics just doesn't apply to investing. It's one thing if you can spin a roulette wheel 30,000 times. But you die, you die, on investment and you don't have a chance to spin again.

MALE VOICE: However I will say it— because we've owned heavily leveraged companies. A lot of the companies we own, as you can imagine, are pretty predictable, steady, Iron Mountain, Comcast. We owned Citizens Communication, which was Telco. They're not exactly exciting and they carry a lot of debt. We've seen times when the credit market has convulsed.

Sometimes the debt of these companies will trade at 14%, but it doesn't mean that the business is ending. There are convulsions I think. So then you're basically talking about what's the quality of the business that's got the debt. There may be a lot that carry debt that shouldn't be carrying it and that causes a general panic among all stocks that have a lot of debt outstanding or are valued traditionally on an - - basis or whatever. It doesn't mean they're bad businesses. They'll recover. But you go through these convulsions at the start of the credit markets and can spread to the equity markets temporarily.

MR. GREENWALD: Yes, next question.

MALE VOICE: Can you comment on how you've developed your investment policies to have your best decision making on the exit?

MR. GREENWALD: Yeah, how do you decide the exit positions? What's your sell strategy?

MALE VOICE: You want me to start with that?

MALE VOICE: Yeah.

MALE VOICE: There are four of us and we discuss every idea. We investigate every idea together and we discuss it and we come to a conclusion. We don't buy if one or two people say I'm not in favor. I'm going to make this up, let's say we put a 10% position in something based on the fundamentals as we see them. If that stock goes up 50% and nothing's really changed it's now a 15% position. So the question we always ask is at today's prices given everything we know about the business and the returns we think we're going to get do we want to have a 15% position in it. The answer could be yes. But if nothing's changed the answer might be no, actually we'd rather have something like a 5% position because it's 50% higher than where we put in 10. So it's sort of a dynamic process. And going in is the same way. We might start out buying a 5% position and then depending on what we learn and what the stock does we might end up making it into a very large decision as we get comfortable and decide that's what we want. So getting out is more a decision of what else do we have on our plate that's better, which in the last 16 years has been nothing. And what kind of rate of return do we think we're going to earn if we hold this business for a

long time. And if that starts to drop towards 10% we're gone even if the alternative is a money market fund at 3%. We won't be in a stock that according to our calculations might only give us a 10% rate of return.

MALE VOICE: - - .

MALE VOICE: Yeah, after the same comments about the portfolio sizing and waiting, so during the evolution of a portfolio shares that go up become higher weighted than you originally intended them to be. And they've also changed in their risk relative to the evaluation. So there's a general moderation around the portfolio to reflect those types of movement. At the same time, most of my investors expect from me to be an equity investor. They have other people doing bonds, other pools of capital for them. So I'm an equity investor - - . And I'm pretty generally fully invested. so if I want to buy something else that's more attractively priced the natural evolution is to reduce the portfolio around those that are either known now, through subsequent research, to not hold up or else ones that have become more fully valued than they were expected to go when they positioned the portfolio. So it's a dynamic. Ultimately I like to find business that will grow over time sufficiently that will hold them for the tax on the unrealized gain. That would be the ideal situation. But we do have trading around that to raise case to buy new ideas.

MR. GREENWALD: Bruce?

MR. BERKOWITZ: Terms of investing, it helps us to think of a mythical investor, Fred. And we have all of Fred's money. Fred's worked very hard for his money. Fred's going to need his money in the future. And we don't want to loose any of Fred's money. So rule number one, don't loose. And then we try and make as much as we can for Fred. And of course we look at stocks as junior bonds, the most junior bonds. We compared them to risk free rates. We want to start off with the kind of double digit cash flow yield. And we hope that that free cash flow yield grows. And we then try and codify what we do in terms of the percentages we would own, based upon the various free cash flow yields we have. And in fact we're just starting a process now, it's funny I have it in my hand. This is a pilot's checklist for a certain type of plane. And what we're starting to institute at our firm is

for every function, including the investment function, to have a daily checklist. You know with the plane, before you start the engines what do you do. What do you do after you start them. So what do you do after you go into an investment, how you monitor it on a daily or weekly basis, what are you checking for, at what prices do you sell. We're trying to develop to better codify the idea I've discussed.

MR. GREENWALD: All right, thank you very much for your patience. Thank you very much for the panel for a very valuable discussion.

[Applause]

MR. GREENWALD: If you could be back here in ten minutes we can get close to on schedule.

[Off mic]

MR. GREENWALD: I hope so.

[END TAPE Heilbrunn_Graham-Dodd_Breakfast_session2_10_2__08_NEW]

[START TAPE SESSION 3]

MR. JAMES GRANT: Hey, good afternoon and welcome back. You are in the presence of the Panel to discuss *Security Analysis* and the Evolution of Investment Philosophy. My fellow Panelists Roger Lowenstein, the Financial Journalist and author of the terrific book on *Buffett and Ezra Merkin* the Managing Partner of Gabriel Capital have together huddled to discuss what the evolution of Investment Philosophy might mean.

Merkin

We are working on this, but pending a resolution of a topic of our Panel. I am going to begin by asking Roger to help us think about the evolution of investment ideas through the career and life and thought of one man. That is to say, Warren Buffett who certainly has evolved in the way he does business and the way he thinks about markets. Having begin where we're beginning with *Security Analysis*.

MR. ROGER LOWENSTEIN: Jim thanks. Warren has evolved, if you think about it early in his career he owned stocks like Geico, Washington Post, American Express. And today, you know, he's got this newspaper, the Washington Post and insurers like Geico and credit card companies like American Express. And really what Warren's career demonstrates, I

think, is not so much the evolution of *Security Analysis*, if it's done right, but the evolution of Wall Street and how the locus of speculation adopts different guises or different, you know, chameleon like colors with each generation or each decade or now really these bubbles seem to burst much more frequently. These black swans seem, you know, they're not just on every other pond they're all over the pond.

When Warren, you know his first experience, which I'd relate to this was in the 60's. Then there was the very beginnings of the computer area, the hot stocks were the so-called, jet age, space age stocks. And of course the conglomerates, and he announced that just as one of our Panelists had earlier today, with respect to financial stocks, I think it was Bruce Berkowitz, when he said he couldn't understand financial stocks. Warren, you know, looked out at this universe of companies buying, you know, they renamed themselves. They put hyphens in their names to make it sound as though they were all going to be, you know hired by the Defense Department. Discover something in the moon that was worthwhile. And he said, as Bruce said today, I don't understand it. Of course, he did something that you know still stands I think as unique. He not only didn't understand and admitted he didn't understand it, but he quit, you know and that's—I mean Bill Paracelsus [phonetic] quits but he's done it, you know, so many times now that's it hard to take him seriously.

But Buffett walked away and by the time he, you know, the next round was the sacred stocks, everyone by the early 70's had learned the Buffett lesson that these conglomerates and these new fangled technologies stocks weren't to be trusted. So the rage then was for the safe stocks. Safe stocks like General Electric and all the others, the well known the Favorite 50, and of course they got up to earnings multiples of 70 or 80 times and Morgan Guarenteve [phonetic], another of our Panelists former employers. I, you know, put a real good chunk of their endowment into the Favorite 50. And this was done by people who, you know, they invested in these stocks precisely because they wanted to avoid the areas of the Go-Go Stocks. And they got burned. And of course, Buffett was in the sidelines then.

And you know, to just leap ahead because there's been so many of these in the dot.com era, you know by then I was hearing

all the time then that Buffett had lost his touch because he didn't appreciate the glories of Yahoo at 200 times earnings, and you know on and on and on. By the way, he came back and bought Amazon's deep discounted bonds, they were very discounted by the time he bought them. But I think his career demonstrates that the locus of speculation adapts and Wall Street makes the mistake because it says, "Well the form is different. I'll never buy, you know, I'll never buy conglomerates again. I'll never buy Nifty 50 safe stocks again. I'll never buy TEK Stocks again, I'll just go into something safe like, you know household mortgages." And you know Warren's career is an example of what Graham says in the Part One of *Security Analysis*, that it's not the form of the Security that determines whether it's investment or speculation it's relative price and value. You know that ain't changed.

MR. GRANT: Thank you Roger. Say Ezra, tell if you would a little bit about the present day and about what it is like in the evolved workout and distressed area. Here we have distress filling pages one through 56 of any newspaper you can read. And yet it seems that the stress has not yet become manifest in, for example Leverage Loan Market in which banks lend or other creditors lend to highly leverage companies when which defaults, you know third quarter were less than 2%. So how does a Practitioner negotiate this with so much rhetorical distress and not so much prep as there will be actual financial opportunity.

MR. EZRA MERKIN: I guess carefully is the short answer. The longer answer is I think to expand a little bit the focus on the lens that you're using and talk about a broader field of distressed. And begin to talk a little bit about how distressed opportunities tend to sequence themselves. And this time around, it may not necessarily be the classic cooperate obligations that bat first or are batted in the first position, but may come around a little bit later.

If generally speaking what we have seen in financial markets and in corporate balance sheets the last period of time, Roger and I were speculating a decade in terms of the timing of one of his books and one of his books to be. Has been one enormous party generally speaking after enormous parties appeared as followed, called briefly clean up. And since we've had, I think, one of the mother of all parties, to some

extent I think we might have the mother of all clean-ups. Something that one need not turn to the business section to read. But one can read about until one's heart's content or dismay on the principal new sections of newspapers.

Hard on the heels of clean up is, I think, a thesis that's worth thinking about, which is hard on the heels of clean up comes opportunity. So the process of clean up is generally speaking a process through which assets trade from weak hands to strong hands. And do so at a discount to their value. That is partly the premises of the bills that we've all been reading for the last two weeks, and may or may not result in something that becomes Law every, or by the weekend. But generally, what happens is obligations of various sorts begin to trade at discounts to where their workout value is. And makers of promises that unfortunately are broken begin to take those off their balance sheets and begin to move them to stronger hands.

What one needs to qualify as a stronger hand, in the first instance is capital. And one needs to have a fairly strong since that one will be there at the end of the story. And at the end of the game one will get paid. And the process of rationalizing the values of those promises is one that one can take advantage for oneself and for one's clients.

So if generally speaking we're in the business of buy broken promises, and broken promises are the talk of the town and the talk of the country, there is an interesting sequence of how these things are likely to play out. And I have a view that is, at the moment, a view and certainly nothing that as yet reaches the level of strong conviction. But to some extent, I think, it's going to be a form of LOFI, Last Out First In.

And where we see, at the moment, compelling value is actually in mortgages. That is, and in particular, residential mortgages. Mindful of some of the things and some of the cautions that other Panelists expressed over the course of the morning and the early afternoon. Take if you do a fair amount of work on a highly, highly value added basis. Looking at mortgages, not in bulks and not in indices and specific individual properties at very, very specific prices one can begin to develop some aspirations of rates of return that actually look rather interesting even after one has

stressed those returns for continuing economic declines and continuing declines of the value of property.

What then I think comes in after that perhaps might be more along the lines of what Jim was asking, one is mindful of a simple table that tends to present, to my way of thinking, the availability of what I would call optimistic capital. And that is the spread between—it's a very broad index, this is not a very tutored table. The spread between the Merrill Lynch High Yield Index and Treasuries, which is something that's been kept for us, something approaching 25 or 27 years. The last huge gap out in that Index was in the summer and into the year of 2001, 2002 that gap peaked about 2100 basis points over. That is folks were willing to put money to work for return in high yield. It's not necessarily distressed high yield, almost everything in the Merrill Lynch High Yield Index is a current coupon payer, and therefore one would argue at least by some measure of quality, not distressed. That spread has widened, has narrowed to as low as something under 300 for presumably the same menu of risk returns. And has, with the accomplishments of September, widened out again to something over 1000. Whether we widen out to a whole new level, a record widen is something we'll see, but at some point it gets kind of interesting.

MR. GRANT: Good. Ezra can you go back to Morgan's for a second and talk about the—how you look at the structure. You're looking at structures themselves, like a tranch of a given CDO or given RMBS. You're looking at individual whole loans, or many individual whole loans or how are you—

MR. MERKIN: [interposing] We look at the structures mostly to see if we can sell something as a hedge against individual positions. But it's heavily geared to individual positions, individual mortgages, individual properties with individual risk characteristics and rates of return.

Not so surprisingly, there are some fairly significant disparities between individual positions and broader indices, when those disparities work to permit us to narrow risk in a way that is disproportionate to the narrowing of the upside, we might use them as hedges.

MR. GRANT: Yeah, okay. Roger I want to read to you, and in deed to everyone else, a passage from an essay that appeared in the Saturday Evening Post in the 1930's. In fact, in 19—just

before the truly brutal Stock Market wreck in 1937. You know in baseball a pitcher will throw once at your head. And then to let you know that it wasn't an accident threw again.

So the Stock Market was down 90% in 1929, 33, and just to make sure that people knew that was not a fluke it was down 50% again in 1937. And on the eve of that break someone from Brown Brothers, fellow named Robert Lovitt [phonetic] wrote a cautionary piece in the Saturday Evening Post, then a great mass magazine circulation, mass circulation magazine. A cautionary piece about common stocks and bonds, in deed, bonds and stocks as classes of investment assets. So the securities themselves, there was nothing secure about them.

And he closed with this, "For our part we are convinced that the only permanent investment is one which has become a total and irretrievable loss."

So that was—Brown Brothers were probably never really edgy. And I dare say this was kind of a censorious point of view in 1930, mid 1930's. That is that securities were inherently unsecure, and the businesses themselves were just as mortal as the people who owned them. So tell us, please, how we came from that to stocks at a long run.

MR. LOWENSTEIN: Well, you know, they've outlawed throwing bean balls at hitters in baseball. But they haven't outlawed repeat depressions, right? I think the way we got the stocks for the long run was the country had a fabulous period of prosperity really after, beginning after World War II. And then you know, had a nasty break in the 70's, really a decade where the country did not have a lot of prosperity and the Stock Market went nowhere. I think you and I probably differ on this, but since the 70's on average things have been pretty good. And rates of growth have been pretty good. And the Stock Markets given good returns, and I think what happens then is that people forget that, you know, the average may be good, but you can, you know, as someone said earlier you can drown in a pool whose average water is, you know, an inch deep.

So I think people—Graham said if you extrapolate any trend far enough into the future you can get any desired result. And he makes a brilliant distinction in the 1940, even in the 1934 addition between extrapolating from the average earnings and extrapolating from the trend. I think it's a very viable

to look at a company and say on average it's earned such and such over the last ten years. If you look at the trend, say in the last three years, or much higher you can get some pretty big numbers if you go five, eight years out. But basically, again the Graham wisdom that you get more in trouble with a good idea than a bad one, basically we've had prosperity in the last 25 years. And people can take prosperity to far and they can extrapolate it far.

MR. GRANT: Ezra can you compare the present moment with other such junctures in your career? Because you know, not so long ago people were saying that distress is going to be tough because there's so much money in the sidelines. That there's so much fallow land and so few opportunities that, you know when will all of this money find employment, and how high will the returns be? Suddenly it seems as if there were, at least the prospect, of a lot of opportunities and not so much capital. Does this, you know, kind of—does this sequence of perceptions where with what you've seen in earlier cycles of distress and opportunity?

MR. MERKIN: Well it certainly needs adjustment I think for all sides, but you know when I came into the business there weren't a lot of people doing this and opportunities were generally a series of one off's as distinct from enormous trends within trends.

You talk about prior junctures, one of the things I'm mindful of, actually Jim, is a piece you wrote an Op-Ed piece you did for the Times. I guess either three or four years ago, I don't remember exactly when, but it was this time of the year at some market top and at some enormous burst of enthusiasm in the country in which your message was, the world thinks that cycles are repealed only at tops. And adapting that and perhaps giving you an idea for another Op-Ed piece if there's something you feel for and you'll certainly do it more oftenly than I can. People think that cycles get repealed at bottoms as well. That is the notion that this is truly different, and we're going to see something very different then what we've seen before is partly always true and partly never true. The process of trying to extrapolate from what when before to what will come now is of course enormously difficult and requires both an interesting combination of fact gathering analysis and insights. But this time through the size of this thing is just enormous.

I mean if you look a couple of weeks back, Lehman Brother's filed for Bankruptcy over a weekend. That was a company that held approximately 630 billion dollars worth of assets and had a balance sheet of approximately another 130. So call that three quarters of a trillion dollars. In the ensuing two or three weeks, markets have developed for 80 to 90% of all of those, of all of that merchandise. Rather I'd say large gaps in the Bid/Ask Spreads, which means it's a Broker's Market, not an Investor's Market. But here we are looking at things we've never seen before.

The AIG deal remarkable in terms of size is I think one that lots of folks in the business looked at and said, "Gee, if only we could knock out a zero." In other words, "If only this was going to be—if only this wasn't an eight and a half billion dollar deal, and not a 85 billion dollar deal. This might look very interesting for the private sector."

This brings me back to the theme that I think mostly answers your question. On the assumption that the country's investment bill goes the way I assume most folks in the room hope it goes. There will be an intermediary to some extent between the likes of me and the sellers. And to some extent there will be, as we saw in the RTC, something that's going to be set up in which simply because the amount of capital available in on the private side isn't big enough to take care of the problems government thinks it sees. The government will step in first.

To some extent, they'll be two market places going on. The private side buying from the private side. The government buying from the buying side. And the private side buying from the government. Those of you paying attention I said two, and I counted to three.

And how that works out I think is the part this time through that might be a little bit different then the last time.

MR. GRANT: Roger does Hank Paulson [phonetic] need 750 billion dollars?

MR. LOWENSTEIN: That's a very good question. 750 billion is something like, what \$2,000 for each American, \$6,000 for every family. So if you said that a tenth of the households in the US are going to default, and I'm sure they're not. But let's give them a big benefit of the doubt. At \$60,000

per defaulting mortgage, most of these mortgages were written at, you know, 180, something like that thousand dollars. 60 is a whole big number. It seems like more money, that seems like enough money to cure, you know, even more than this problem. And that's a lot of money. What do you think?

MALE VOICE: I haven't followed this very closely—

MR. LOWENSTEIN: Yeah, I've just—

MR. GRANT: [interposing] Ezra?

MR. MERKIN: Well I don't think Hank Paulson needs, Hank Paulson needs a credit market is what Hank Paulson needs. Hank Paulson is I think more than anything else interested in restoring some notion that contraparty risk is an acceptable form of risk in the debt market place.

At the end of the day, capital systems work on a remarkably simple premise, which is, "Somebody I have never met in my life, to whom I will lend money, whom I will never meet and whom I will never shake hands is going to pay me back." And if one can't reassure or reassert some since of, as I say the acceptability of contraparty risk this will all end up a lot messier than anybody would ever hope to see.

MR. GRANT: Well Roger you asked very cordially how I saw things and I'll give you my two, ten cents. To me what got us into these difficulties was very easy money, very low interest rates and somewhat malleable disclosure in accounting. And the items at the top of the Federal Quick Fix List would seem to be very low interest rates, very easy money and somewhat malleable standards of disclosure in accounting.

And it seems to me this is a little bit of the hair of the dog that bit you. And I wonder a little bit about the advisability of rushing in to prop up the prices of what must, in this cycle, be called the underlying, namely houses. So, if the Stock Market were going down and if this caused distress, and if the Fed doubled the size of its balance sheet within the space of a month as it is now about to do it seems. In order to finance the acquisition of common stocks to forestall the settling of equities at some clearing level, people would say, you know, "Is this a good," I think more people would say this is a good idea.

So I'm going to ask the man who's buying the mortgages whether there aren't too many houses. Whether we American's don't own too much house and whether it wouldn't not be, perhaps, a good thing for house price to settle quickly at a clearing level rather than to be suspended at a non-economic level. And for this contraction or mess, to use the technical term, so it doesn't drag on for a full Japanese decade.

MR. MERKIN: Sure.

MR. GRANT: Ezra, we have a half an hour to fill, you have to do better than that.

MR. MERKIN: Jim, I just ask you, you said better, better for whom?

MR. GRANT: Right. Better for society. I mean—

MR. MERKIN: [interposing] Absolutely.

MR. GRANT: —Japan stumbled for ten years in twilight kind of a low-level viral state, in which losses were denied. And then when confronted were not marked and banks were propped up. I mean to me, America has many strengths. America's economic resiliency is storied. Its enterprise is legendary.

What people, I think to infrequently remark upon is this country's spectacular capacity to fail. So, in not many places in this world can you file for Bankruptcy and come back without social stigma for life. Not many places can you fail in business and come back start something and then succeed and people don't recall, really, that you had failed. This an incredibly forgiving, it's an economic society almost as forgiving as it is enterprising. And it seems to me that when the authorities intervene so forcibly to forestall failure they are perhaps over reacting as a general proposition.

And so you have to ask also, "So how forceful and how potentially dangerous in second and third order affects is the intervention?"

So here are three deal points from this intervention. So the first thing they're going to do is, among three things. One is that there's a little thing in this bill that will allow the Fed to pay interest on reserve balances, banks deposit

with it. Now this seems innocuous and wonky, but the effect will be to allow the Fed to create massive amounts of new credit without losing control of the rate it fixes. So the Fed now is the price fixing business. It sets the funds rate. And any regulator can set either the price of the thing it regulates or the supply. It can't set both at once. The US Department of Agriculture could fix the corn price, but it couldn't then determine how bushels free farmers would supply at that price, at the official price.

So the Fed has been in the dilemma. It has fixed the funds rate at 2% and it also has recently, in the past two weeks, has expanded its balance sheet by hundreds of billions of dollars a week. This is unprecedented, it is epical. So the funds rate has, is wondered, it has crashed, it has veered. It's gone from as high as 7% to as little as 0%. The Fed wants to regain control of this regulatory rate it sets. And to do this it must be allowed to fix the rate in other ways. So it's going to paybacks to bring them funds at 2% and then it will be allowed to stick a penny in this fuse box. And then it can create all the credit it wants while holding the rate where it wants to hold it.

So that's one highlight of this transaction. This perspective, I guess imminent bail out bill.

The second is the lifting of the insured deposit rate, balances for \$100,000, \$250,000 dollars. Now when the FDIC came up for legislative approval in the 30's it was an old warhorse of an idea. The populist had advanced in the 1870's, 80's, 90's. The establishment had rejected because of the idea of moral hazard. Franklin D. Roosevelt, himself, was against it. Circumstances were as the Fed now says, "Exigent and this Bill was signed into Law." So the Fed Reserve, the FDIC came into being with \$2,500 dollar ceiling on deposit insurance. Over the years, it was raised. Inflation galloped, trotted and in any case, the ceiling was raised until finally in 1980 it went to \$100,000.

Now to look at the banking literature for ten years after that, people argued and was self evidently true that this increase in deposit insurance ceiling had been the starting pistol for the bank wrecking of the late 1980's. And the calamity of the S&L's, which gave rise to the fondly remembered RTC. So now, in response to the bank wrecking and

the credit destruction of the OTS, we are more than doubled the deposit ceiling.

So in the third leg, I take special interest in, is something that's not legislated, which is happening now. And we'll get another look at 4:30 today when the Fed's Balance Sheet appears again. The Fed's Balance Sheet is began this, you know, about six weeks at 900 billion dollars, and now it's going to be probably a trillion five or a trillion seven tonight.

This is a light show. So the question again, Panel, is are lower house prices, is you know, is the clear and present danger described by the Administration and by the Fed's so clear and present as to legitimize these truly radical interventions?

MR. LOWENSTEIN: I'll answer briefly that—the question I think is that clear and present day? Is that danger as clear and as present as the dangers of acting? And to separate the blanks of, you know, your position. They're raising the deposit insurance ceiling troubles me the least because we've lived with deposit insurance for 60 years with relatively few problems. And this in effect, you know, recognizing inflation. And even the RTC, which you know is fondly remembered, and I don't think you actually do remember with much fondness. I—that was a relatively painless fix to that problem.

The one that most troubles me and the one where I agree with you most strongly is that everything the Fed does to keep housing prices higher than they are, which is the same thing as keeping these mortgage securities than they would otherwise be, may suspend us in a sort of, you know, Japanese type stagnation. And the history of that was not good. So that one scares me the most.

MR. MERKIN: I don't doubt that some of the issues that you raise carry with them extraordinary consequences that may not get full and adequate consideration for the moment. But your question was, is the urgency as clear as perhaps the administration states it is. And from a very narrow perspective, I think the answer is most affirmatively, yes. Simply because some of the things that you're describing are being proposed to be undertaken for the purpose of restoring, again, a credit system.

But the reason that an RTC in some multiple of a 100 billion dollars needs to be created to permit the off loading of all these securities from various lenders balance sheets is to create lending. And at some point in this world, somebody needs to be able to take risk and restore the process of elementary lending, simply to avoid a spiraling down of something that might be as simple as a garden-variety recession, which the last thing I am is an economist seems to me the upside of the moment. To something that might really rival some of the things we've seen when there were still a Saturday Evening Post. And when markets behaved as poorly as they did in the decade that you described. Not necessarily for the purposes of putting a floor under the value of mortgages, although that's clearly a very, very possible outcome. But simply to make sure that someone can lend it to somebody.

I tell you this sort of by way of antidote and just because we shouldn't be sort of, you know, only sober. Just before, I guess the last time we had something of a bit of a government, wasn't a very long crisis. But the last time we had some sort of a significant crisis in New York State before these financial crises started was the last time we changed Governors. Which for those of you who remember was in February and March of what only seems like a decade ago, was 2007. And one of the oddities about Governor Spritzer's departure from office was that one of the things he seemed to have, and it was very easily examined was an account at something called an Escort Service at which he was keeping five or six thousand dollars under his own name. Which is an odd thing to do if you're the Governor of the State of New York.

The very week that Bare Sterns finally finished its spiral. But two or three days early or else I never would have said this to somebody as Senior at Bare Sterns as whom I said it to. I told him, "It's merely indicative of contraparty risk. The Governor didn't know where to keep his money, and not having a better place to put it." And not necessarily wanted to take Bare Sterns risk as contraparty risk. Later in the week that would have been an incredibly cruel comment, he left it at the escort service. We have a system that right now, and from a certain point of view, prefers escort

services as contraparty risks to normal banks and brokerage firms because you don't know where to keep money.

I can make it less funny and much more pointed and tell you that if you speak to folks who run capital and if you ask them whom prime Broker's are every single one of them will tell you a story about a wire that took three days to get out, or a wire that never got out, or a wire that got stuck. At some point, you don't want to start things that, you know, begin to run toward sort of levels of panic. But there are parts of the system that are generally broken in terms of the capital plumbing. And a lot of this bill is aimed at that in the first instance and will undoubtedly have absolutely fascinating, possibly wonderful and possibly awful outcomes along the way. But at some point, you need a credit system.

MR. GRANT: Well enough - - heard from the - - here. I would welcome—I know my fellow Panelists would welcome a question or two or three. And I, is there some—yes sir.

MALE VOICE: Well I've hear you talked about how Warren Buffett's detected the bubble of the early 1970's, maybe a year or two earlier, but basically in good time. Liquidate his Partnership. And then in 2004, I think it was his 2003 Annual Report he said, "There were a number of stocks I should have liquidated during the great bubble of the last '90's, I didn't and Shareholders are worse for that." Was there a reason that he did a better job of identifying the 1970 bubble than the 1990's bubble? And is it possible to identify such a bubble perhaps by the policy of Graham & Dodd Investments.

MR. LOWENSTEIN: You know I, yeah, I don't think actually he would normally speak of himself as having an identified a bubble so much as, he'll know when he just doesn't see anything that he wants to be in. Or he certainly wouldn't say that he could identify bubble tops. You know he was early in '68 before that bubble. He said he reduced his stated target from 10% to 5%, or something, but it was such a frothy year that he earned 57%. I mean it just, it almost didn't matter what, you know, what you earn.

And the bubble that he was referring to, that I referring to was late 1990's was TEX Stocks. You know he didn't own any of that stuff. Of course, in the '06's he was in a private Partnership so he had the liberty to do nothing. Berkshire

has held up to 40 billion in cash, but it can't, you know, at a certain point it's going to be owning something. So, he didn't fold up then as he did in '69.

MALE VOICE: Hi. Quick question. A lot of focus has been on mortgages, how cheap they've gotten and housing as an asset class. But a much smaller asset class is the automobile industry. Sales have plummeted last month, they've been drifting downward for some time. And the securities related to financing automobiles have also been hit quit hard. To the extent possible, would anybody on the Panel want to talk about those types of securities, and is that a potential opportunity for people to be looking at in this mess?

MR. GRANT: Ezra do you have any thoughts on the auto finance subs on their paper?

MR. MERKIN: It's certainly potential opportunity, but it's like any other subset of an opportunity. You don't necessarily get paid by being super early. That is—this goes back, I guess, to Jim's first question. At some point, if you're a Pilgrim and you get it right, you get paid a lot of money. It's very nice to be the number two or number three person in there. Look at a different set of risk rewards, and perhaps leave some money on the table and being to invest it in an area where it's received more definition. Where the downsize can be analysed with a little more care, a little more likelihood, something short of certainty. And the upsides considered on the basis.

The observation I make about the auto industry, broadly speaking, is that as political hot potatoes go, it's actually pretty hot. It is an election year, there are hundreds of thousands of employees in automobile manufactures and automobile finance companies and then generally live and work in states whose Electoral Votes are not small and are undecided. And that makes for an interesting process, both in terms of the bill that didn't get voted last Friday and a bill that did get voted last Friday. So it's just moving pretty quickly.

MR. GRANT: Ezra, pending the next question from the floor, I'd like to ask you about commercial mortgages in addition to residential. In New York City, in the day, which is not so long, I guess that's really 2007. One of our great real estate titans was able to borrow, I think, however billions

of dollars with, I think, 1% equity exposure on his part. And the cycle turned, as cycles will. And it's been wanted, to an extent, that some of these office properties in New York City. How do you think this is going to play out in the senior mortgage market for commercial real estate? Is there not a likelihood that one can at least to say in corporate debt, you know, was it not something to own, lend to own, is that it? Okay. So you go and buy the senior mortgage claim with the expectation that you will become the equity holder. Is that—do you see that happening in—

MR. MERKIN: [interposing] Well I mean in general one of the observations worth noting and perhaps linking this a little bit with some of things that were said on early Panels. There's this great, sort of, mystery shared by Graham & Dodd genuine scholars, such as to some extent the two of you and merely buffs like me, which is having completed a lot of analysis. Why come back to bonds at the end? At some point, it's because certain forms of obligations perhaps, it's because certain forms of obligations genuinely have more than one feature to them. There is a fixed income level to order, which your upside might be stopped. And then there is the ownership potential, particularly if you're going through an insolvency with your organization. Mindful of Bruce's comments earlier about perhaps the single least attractive - - class he could see today is commercial real estate. And applying that to New York City a lot depends on, to what extent some of these banks want to get out of these obligations.

I have the good fortune of working in a building, which is right down next to level land. I work in a building that stands next to some one that used to be the Drake Hotel on 56th Street and Park Avenue. The Drake Hotel is no longer, not because it wasn't a perfectly nice hotel and not a bad place to, you know, get a cup of coffee in the morning, but because up in some incredibly elevated structure somebody decided that they could knock the building down and put up, what was then thought to be a 72 story building. The thing has changed hands three times while it's just been a level—it could be a parking lot if somebody decided to park cars there. And these things go around and around and around. If you want to buy, if you want to set up debt at discounts to what ownership is as distinct from discounts to workouts, I'm

just going to try to keep this - - , then you're generally working very much—I'll take a stab at this.

It depends on how tiered the structure is. The combination of a very levered structure, sort of a waterfall structure with small changes in value with a residual asset, drives very different outcomes for different structures on the balance sheet. If what one is interested in is focusing ultimately on the control piece then you simply have to do enough work and analyze both what is financially doable and legally available to you to ultimately assert an ownership stake. And that is in every single debt piece.

MR. GRANT: Yes, sir.

MALE VOICE: Yes, we've talked a lot today about residential mortgages and commercial mortgages, among many other things. One thing that I haven't heard anyone mention is credit cards. And if I have my numbers right I think that's about a two or three trillion dollar asset class. And how, to anyone on the Panel, you know how might you think about credit cards as we think about our economy right now?

MALE VOICE: Credit, what was the question?

MR. GRANT: Our credit cards, well it's a great question for Learner Hall [phonetic]. We are here are on account of that industry.

MALE VOICE: Right.

MR. GRANT: - - a part from using them every once in awhile, do you have any thoughts on—

MALE VOICE: [interposing] I think the—my guess is that they'll be loss experiences severe, but probably not as severe. Credit card companies, I don't think were quit as forgiving and, you know, negative equity, and I mean the rates of interest were high enough so that I think they were perpetually flushing out the deadwood. So if I had to guess, they'll have bad experience, but not a sub-prime experience.

MR. GRANT: Ezra do you have thought on credit card receivable, opportunities—

MR. MERKIN: [interposing] So it's difficult for me to talk about credit cards knowing as it happens that my wife is here. But

I would have said a year ago, and been wrong, but let me make clear. I would have said a year ago that credit card debt would at some point experience really significant difficulties before some of the auto paper and after sub-prime, sequentially. And that hasn't been the case. And it goes back to something that Jim sort of asked at the beginning, which is there are a number of traditional - - that suggests, there isn't that much distressed paper out. Just depends, I guess, a little where you look.

Credit card paper is being to trade in secondary markets. I said beginning, it has always traded in secondary markets, but it's beginning to trade in size and it's extremely difficult to analyze other than in detail. Now that might be the way you're supposed to analyze, what I'm saying is it's very hard to generalize about it. The generalization is I think what Roger said. And that is, at some point I think the management of credit card debt has improved incredibly on the part of lenders. At some point, it's going to be the same thing. Banks have to be made whole. We need a credit system in the country and there may very be opportunities in credit cards, but if they are or and if they are they'll be because the work is put in to analyze the credits of an incredible number of people and saying that individual opportunities make since.

A little bit, it's the reserve of securitization. You de-engine, you reverse engineer what these securities look like to try to get a sense of what the underlying credits really are and where the opportunities are. That's what happens in mortgages, that's what happens in auto paper, that's what happens in credit cards. Credit cards are a little more difficult because it's a much larger number of smaller obligations. So just that much more work.

MR. GRANT: Roger, I get the last question. The last question is how in your dealings with Warren Buffett, how has he surprised you? What is it about him that this simply, you weren't expecting?

MR. LOWENSTEIN: He is very quick. You know journalists have all sorts of strategies for ingratiating, sneaking up upon, asking a casual seeming question that cloaks a, you know, I mean we—he never did sit down and interview with me, but for

the book although we've done it on other subjects when I wasn't reporting about him. He really sees it coming.

I just had a recent—I'm working on a piece on the oil business and I had heard that he'd given a chat about the oil business. But I called him up one day and he didn't know I was calling and I got a call back—actually his secretary said he was on the phone, was it all right if he called me back in 15 minutes. And of course, I wanted say, "Look he's the wealthiest guy on the planet, he can call me back in 15 years." You know, and I called, so he called back and I wanted to ask him about the oil market and was it a bubble, the price rise, all sorts of questions. He reeled off statistics going back to the big fine in East Texas in 1930, the rates of well allotment, production allotment that the Texas Railroad Commission had permitted in each decade in, subsequently. He had no foreknowledge that I was going to—

MR. GRANT: [interposing] So that's what he was doing those 15 minutes?

MR. MERKIN: He didn't know I was going to talk about that.

MR. GRANT: Right, okay. Thank you one all, thank you Ezra and thank you Roger.

MALE VOICE: Thank you, Jim.

[END TAPE SESSION 3]