Ruane, Cunniff & Goldfarb Investor Day

St. Regis Hotel, May 18, 2012 – New York City

Remarks have been edited for clarity and relevance.

Bob Goldfarb:

I would like to introduce our team of analysts. On the dais to my left is Rick Cunniff who, most of you know, is the co-founder of our firm. On my right is Greg Alexander and to Greg's right is Joe Quinones, who runs the operations of our firm as well as those of Sequoia. To Rick's left are David Poppe, President of our firm and co-manager of Sequoia, Jon Brandt, and Greg Steinmetz. Finally I would like to introduce the rest of our team who are seated in the front of the room. In alphabetical order, they are Girish Bhakoo, Jerry Feng, John Harris, Jake Hennemuth, Arman Kline, Trevor Magyar, Will Pan, Terence Paré, Rory Priday, Chase Sheridan — Stephan van der Mersch is traveling and cannot be with us today but hopefully we will see him next year. I would also like to introduce Jon Gross, who is our director of client services, and in the front row are four of the five outside directors of Sequoia: Roger Lowenstein, Bill Neuhauser, Sharon Osberg, and Bob Swiggett. We are going to follow the same format that we have in the last few years, which means that we are going to respond to your questions from now until 12:30. We have to vacate the room by one o'clock, but we will be around between 12:30 and 1:00 to meet you and respond to any questions you may still have for us. With that we are ready for the first question.

Question:

Why do you have so much invested with a pharmaceutical company?

Rory Priday:

Just to preface, when we first bought Valeant, it was a smaller position; it was probably a 6% to 7% position. The fund has grown quite a bit since then, but the stock has more than doubled. That is the reason it's closer to a 10% position in Sequoia and maybe 15% in some of the private accounts. More money has come into Sequoia than into the separate accounts. It's outsized to some degree just because the stock has gone up a lot.

The reason that we still like Valeant is the reason we liked it in the first place. It is a pharmaceutical company that does not really function like a traditional pharmaceutical company. By that I mean most pharma companies, if you look at how much they spend on research and development might spend 10%, 15% or in the high teens as a percentage of sales on research and development. Last year Valeant did about $2.3 billion in sales and it spent $66 million on R&D, which is about 3% of sales. So instead of spending money on R&D, it spends money acquiring whole companies and/or products and other assets. And what it does is restructure those assets. So we think of it as a value investor in other companies or in the assets of other companies which are available for purchase.

The reason that Valeant can do that is that it has a good team at the top led by Mike Pearson, who has been an extraordinary and very aggressive manager. The types of returns that Valeant can generate by acquiring another company and cutting costs can be in the 15% to 20% range. Just to give you an idea of that, when Valeant merged with Biovail, Biovail was doing a billion dollars in sales, and management cut out — the year-end synergy target this year is $300 million to $350 million. Valeant is eliminating costs that represent 35% of sales. Because of the company's tax structure, it pays taxes at very low rates. So a lot of that $350 million is going to flow through to the bottom line. You can generate huge returns if you do those kinds of deals. Last year Valeant acquired Ortho Dermatologics, Dermik, Sanitas, PharmaSwiss and a few other companies. In aggregate, these companies added another billion dollars in sales and the synergy target is $250 million. Again, a lot of that is going to fall through to the bottom line. So Valeant is generating really high returns by acquiring other businesses in the pharmaceutical industry.

One of the most attractive things about the company is that it is going to generate $1.3 billion in cash earnings this year and there are not many companies that can retain that amount of money and reinvest it at a rate of return of 15% to 20%, and we could potentially see Valeant doing that for a number of years. You can get a huge amount of growth if you can reinvest that amount of earnings at those rates of return. That is the main reason that we are excited about it.

Question:

I'm concerned about the banking system and the fact that the banks are going through a crisis now. I think banks have to take risks one way or another. But the government wants to intervene. Now we have this thing that is going on with JP Morgan. It lost $3 billion, which is nothing because it is such a rich company. So what is the future of the banking system in this country?

Bob Goldfarb:

The only bank we own directly is Goldman Sachs. Jonny, do you want to try to respond to that?

Jon Brandt:

I do not know that I have that much to say about the banking system in general. After the crisis the regulators required the US banks to raise a lot of equity capital and reduce leverage. If you just look at the numbers, the tier one capital ratios are as high as I think they have ever been, certainly since I have been following the industry. When I think of the concern about new regulations that are going to hurt the returns on equity in the business, most of the hits to earnings for the commercial banks have already flowed through. The things that people are thinking about with the implementation of the Volcker rule and what it does with derivatives, those are going to affect the investment banks more. But I see both types of banks as being fundamentally strong and healthy. The commercial banks are being hurt a lot by low interest rates right now. The earnings of investment banks are lower than usual because of a lack of activity in the markets. Is that a secular or cyclical change? Most of the investment banks think it is largely cyclical. However, we believe a lot of it is structural and secular.

I don't know whether I have any great insights into what JP Morgan did beyond what has been in the paper, and certainly we don't know everything that it was doing. But the company says that it was only hedging its risks. You could ask, "Do you really need to hedge your loans or just to take the losses?" Does a bank really need to buy credit default insurance? That is an issue that has been debated. Our only exposure to banks, other than Goldman Sachs, is indirectly through Berkshire's holdings in Wells Fargo, Bank of America, U.S. Bancorp, and M&T Bank. Berkshire also has warrants in Goldman Sachs. But I think the US banking system is pretty healthy. The real question is what kind of return on equity it's going to earn going forward with these regulations.

Bob Goldfarb:

I think the banks are a lot safer but to some extent it is at the expense of their profitability. So the industry going forward will probably be less profitable. But that isn't all bad.

Question:

In your opening remarks you mentioned that your results were hurt by some sloppiness in stock selection. I wondered if you would elaborate on what the problems were and how you addressed them.

Bob Goldfarb:

It's like every decision in life or in business. If you gain weight, you go on a diet. If a business is suffering from excess inventories and possible markdowns, it tightens up its inventories. There are costs to doing so, to tightening up, and it's possible to be overly disciplined. It is just a matter of trying to strike the right balance. But I don't think the source of the sloppiness was complacency or hubris. We have made a lot of mistakes over 42 years and the probability is we will make a lot over the next 42. We hope that those will not be a function of sloppiness.

Question:

I wonder if you could talk about the auto parts retailers. I believe you have owned AutoZone in the past. At 12/31 you owned O'Reilly and Advance Auto. Why do you like the industry? Two, I think Advance Auto recently reported earnings and had a weak outlook or something and the stock was down. Do you have any near term thoughts particularly on Advance Auto?

Rory Priday:

So the first question, why do we like the industry? On the do-it-yourself side, it's a good business when customers only go into the store once or twice a year and they don't know how much it costs to produce a part, and they don't know how much they should pay to buy a part. So you can charge more on the value-add than the cost of the product itself. On the commercial side, the auto parts retailers are selling to mechanics and garages, which repair automobiles. If a car is on a lift, the mechanic wants to get it repaired and off the lift ASAP. Parts availability rather than price is what matters. There are not that many big players; in most markets there are probably only two or three big players. They are pretty rational when it comes to pricing; so competition has not really hurt the industry too much. Those are some of the reasons why we like it.

In terms of Advance, yesterday it reported a 2% same store sales comp. I think the reason the stock was down a lot is if that if you compare its performance to the results of some of the competitors, O'Reilly had a 6% comp in the first quarter, and AutoZone had a 5.9% comp. The quarters don't exactly line up because the companies are on different fiscal years. But at any rate if you look over the last three years, Advance had a 5.3%

comp and an 8% comp. Then last year was a 2.2% comp. If you compare those to O'Reilly's, O'Reilly's were 4.6%, 8.8% and then 4.6%. So basically Advance was doing well through 2010. Then for the last four or five quarters, it has been under-comping the competition. In April, the last month of Advance's fiscal first quarter, comparable store sales were down a lot and the softness has continued into May. That is the primary reason the stock is down.

Longer term, we think that the team at Advance is very good. The CEO, Darren Jackson, and Kevin Freeland, the COO, are very bright. When they came into the company about five years ago, they brought a lot of changes to Advance. The most important was that Advance shifted its strategic focus to turning a DIY company into a hybrid with a goal of producing half its sales from the commercial business. We are comfortable with the stock, especially after yesterday's big drop in price.

Question:

Would you speak about First Solar or your investments in solar? I thought that Ruane, Cunniff & Goldfarb would shy away from any company or industry that is heavily based on subsidies, especially subsidies from foreign governments like Germany's.

David Poppe:

Can I say no? If you go back a year, we thought that First Solar was potentially a best-of-breed company that had a differentiated technology and a lower cost of manufacture. And you had Germany and Japan saying that they were going to eliminate nuclear power plants and accelerate the development of renewable energy. It looked like the subsidy programs might be in place for a long time. You had a pipeline of big projects that were on very, very lucrative terms. In California, the state was trying to incentivize development of a renewable industry, and the initial projects were really, really lucrative for the builders and the owners.

Fast forward — the Europeans, because of their own internal financial issues, have slashed subsidies. You have a Chinese manufacturing group of three big companies and a number of smaller companies that are state subsidized and don't have much discipline regarding return on capital and that have continued to expand production at a rapid rate even as demand has collapsed. The main problem is that we got it completely wrong that the European subsidy system would likely exist for four or five or six years; that, based on the comments from the governments, they were going to accelerate the development of renewable energy. The California pipeline also turned out to be less lucrative than we thought; so that is just bad analysis by us. There are four big plants under construction. I thought there might be $30 of earnings per share for them and it turns out it is maybe going to be more like $15. So that has also hurt.

Looking forward, there is absolutely no visibility of future demand because there are no big subsidy programs in place anywhere in the world. The cost to build solar is coming down really rapidly. But the cost of natural gas has come down even more. It makes much more economic sense if there are no subsidies involved to build a natural gas plant, especially in North America, than to build any kind of solar facility. First Solar has a pipeline that takes it out to 2015 or 2016 but you have no visibility on demand past that. Management acknowledged as much on its recent earnings call. It's scary. On one level it makes sense that the cost to produce the modules and the systems will come down and come down until it actually reaches something close to grid parity or even grid parity. But as long as natural gas is at the levels that it is trading at in North America, it will continue to make more sense to build natural gas plants. So First Solar has a very, very rocky path ahead and there is absolutely no visibility that demand will emerge. Even if demand does emerge, you have a competitive set based in China that is not focused on return on capital and that is also going to continue to be a problem as far into the future as the eye can see. There is just massive overprotection. From what I see today that does not figure to stop.

Question:

What concerns do you have about the growth of assets under management reducing your universe of investment possibilities and increasing the difficulty of outperformance?

Bob Goldfarb:

Our goal has been to maintain the amount of assets under management and that the growth in assets would ideally be a function of appreciation. Over time that has been the case. There is some lumpiness in those figures because there were a number of years when we had net withdrawals. The money that came in, particularly into Sequoia in the last year, has brought our level back to around where we want it to be. We did take steps to curb the inflow. Most of the cash was flowing into Sequoia and this cash was coming in faster than we could put it to work. This diluted the percentage of assets invested in equities. The logical thing was to try to cut off the source of most of that money, which was coming from intermediaries like Schwab and Ameritrade. Sequoia can now be purchased only directly through our transfer agent, DST. After that change, the inflows into Sequoia moderated very significantly. We are not a marketing machine, and I expect any net growth in assets will be due to capital appreciation.

David Poppe:

The assets under management now are only this year surpassing the peak in 1999. We were closed for so long that we had a normal attrition rate of 6% to 8% of assets because clients were getting older and we were not taking in any new business. Then if you look at a compound — I don't know exactly what it is — but from 2000 to 2012, of around 6% per year, again good compared to the S&P, but it has been a tough period. If you have 6% to 8% attrition you are not growing your assets. So we opened Sequoia in '08 not to try to get bigger but in fact to have a new generation of younger clients, younger investors.

Question:

I have two questions for the two companies that Rory mentioned. For Valeant I was wondering how much longer it can continue to make such accretive acquisitions, and what will allow the company to do that. Then for O'Reilly and the auto parts businesses, what is the risk of disintermediation by online websites such as Amazon?

Rory Priday:

I'll start with the Valeant question. The company can continue to grow for a long period of time. As you have seen in the last six months, Valeant has spent $600 million to $700 million on some companies in Russia that you have probably never heard of, a podiatry company in the US, a nutritional supplements company in Brazil and a branded generics pharmaceutical business in Mexico. Valeant currently has a market capitalization of $15 billion, which compares to a market value of over one trillion dollars in the industries that management has targeted. Valeant's addressable market is smaller than that, however, because many of the companies or assets which comprise a significant portion of that trillion dollars are in countries or product categories in which Valeant has no interest.

The question is can Valeant get the asset or the company at the right price. Companies that are for sale but do not want to see major changes after selling are not good candidates. Private equity firms whose interests are primarily financial are more likely sellers. More significantly, there are innumerable private businesses, a lot of which are smaller companies we have never heard of. The pathway to growth is there and the company has a plan. Not only does management want to create a lot of shareholder value, but it wants to do it quickly. Management seems to be in a hurry. So the prospects are fine for Valeant to continue to grow.

With regard to O'Reilly and the other auto parts retailers, the disintermediation threat from Amazon is one we don't spend a lot of time worrying about. In order to get the hard part to the customer ASAP, you have to have a lot of distribution points. Amazon's model has been to have a limited number of large warehouses spread out geographically. With that model, Amazon cannot cover the US with a dozen warehouses and be able to deliver hard parts to every single customer within 30 minutes. Unless Amazon changes its model, I don't think it's going to happen. O'Reilly has over 3,700 stores, which are distribution points. In addition, the company has 23 warehouses. It's going to be difficult for Amazon to match O'Reilly's speed of delivering that product. So that's the main reason why you will probably continue to see brick & mortar retailers prosper in the auto parts space.

Bob Goldfarb:

There is an internet company out there called RockAuto whose ads I see quite often. I know it is doing a lot of advertising, but I don't know how much revenue the company is generating and whether or not it is profitable.

Question:

You used to have a bigger position in Expeditors. Will you comment about that?

Greg Steinmetz:

Expeditors is a fantastically run company. It's all organic growth, very high margins, very consistent. It benefitted from the growth in global trade that we saw in the last decade. Now that is slowing down. You used to be able to count on global trade growing about 6% a year. That has not been happening for a while and Expeditors has slowed down with it. Some of the near term problems relate to the fact that what it pays to put loads onto an airplane has been going up at the same time that volumes have been going down. That is an unusual situation that will not be sustained. Normally if you have fewer loads, Expeditors can pay less and its yields go up. That is not happening now. And in ocean freight we are seeing a similar dynamic although not as pronounced. Carriers are losing a lot of money. They have to survive, and they are doing that by raising their rates. So Expeditors is suffering with its ocean yields too. We still think it is a fantastic company. Peter Rose is still there. We have all the respect in the world for him. But it's a valuation question. When we sold it, it looked like it was priced on the assumption that it would continue to grow 20% a year and we didn't think that was going to happen. So we cut the position. But we are still fans of the company and watch it closely.

Question:

Berkshire has always been a cornerstone holding of the firm. Obviously in the last couple of years you have reduced it. I would like to get your comments as to how you assess it now.

Jon Brandt:

Do you want to talk first about why we reduced it, Bob?

Bob Goldfarb:

No, I think we made that clear in the past.

Jon Brandt:

It is still a fantastic company. It has something close to a $200 billion market cap. It cannot grow as fast as it has in the past. It still has a good chance to grow intrinsic value 10% a year. The price is quite low compared to intrinsic value. So the downside seems very modest. If the company grows its intrinsic value at 10% a year it will produce an acceptable return even if the current wide discount persists.

Bob Goldfarb:

At the annual meeting a couple weeks ago, I thought there was some frustration both on the part of some shareholders and on the part of Warren Buffett about the stock price. For Warren's part, he has always wanted the stock to sell as close as possible to intrinsic value so that both buyers and sellers get a fair deal. It's clear from his comments over the last couple of years both in the annual reports and at the annual meetings that he thinks it's selling below intrinsic value by quite a bit. He did announce the stock buyback last year, saying he will buy stock back at no greater than 110% of book value. At this year's meeting he suggested that if he thought he could bring in a lot of stock he would pay 115% of book. The stock is quite cheap and we are very comfortable with the position.

Question:

Just wanted to see if you could talk a little bit about Precision Castparts. In light of the comment about valuation, it seems like there is a lot of growth potential in the build rates and in the energy business. As you think about the upside from here, how do you think about that in the context of valuation?

Greg Steinmetz:

As you point out, there should still be a lot of growth there. In a way it's a play on the growth in emerging markets and some of the newer markets in the world where people are buying a lot of airplanes. If you look at the backlogs at Boeing and Airbus, they stretch for seven years. Boeing and Airbus are increasing their production rates on the 737 and the A320. And now they are coming out with new planes. The 787 is really only getting going. Boeing is building maybe two or three a month now and it is going to take that up to ten. With that, Precision is going to get millions of dollars of revenue for each plane that Boeing builds. So what we think is we can just sit back and watch the aerospace cycle unfold and grow over the next few years, and we are going to be rewarded for that. The risk is that you could have the economy go down and we could get orders being cancelled. But we have been through that once before in the last recession and orders were not cancelled. The reason was that Boeing and Airbus have gotten smart about controlling the cyclicality and have taken so many orders that if customers cancel — or rather, they don't cancel, they just defer — the manufacturers can move them to the back of the line and put someone ahead of them who is more eager to get a plane. We think from time to time about the risks of people being able to finance these planes, and there is money still available because they are good assets and they last 30 years and leasing companies and banks are willing to put up money for aircraft. So we think aerospace is good. There is an aftermarket component for them too, where they are able to raise prices every year. That is a very good business.

Oil & gas is a newer business for Precision. And so far so good — it has been booking a lot of orders. What Precision has and what is key to this company is that it has some unique production capabilities. Precision is able to make things that no one else in the world can make. That applies to its new foray into pipe, which it could have done years ago — management just had other things to do. Now Precision is turning to this. It is able to build very high grade pipe for use in dangerous corrosive environments. If oil prices crash I think that business would take a hit. But the company is starting from such a low base and it offers a lot of value in its products that others cannot match. So Precision will not be hit as much as some other businesses in oil & gas.

The third major leg of the stool is industrial gas turbines. Those are doing well now too because as we talked about, natural gas prices are low. We think the management is outstanding and the company has a very strong balance sheet. Precision has a proven ability to take its cash flow, which is a lot, and buy assets that fit right into the company's sweet spot. Yes, the price has gone up a lot but so have the earnings and we are feeling good about it.

Question:

Would you be kind enough to share with us the philosophy of some of your adventures in corporate governance?

David Poppe:

I think as we said in the letter that we wrote to clients a few weeks ago, the goal is really to own best-of-breed world-class companies and to be positive and passive shareholders. Ideally for us we are going to spend a lot of time on research on the front end. We are going to identify a business that we love and a management team that we think is really strong. Then we are going to make an investment. Afterwards, I would not say we are going to go away, but we are going to be quiet. We are going to own it and if we get everything right, we are going to own it for a really long time. Where you have to get involved, you really need sharp elbows and you need a different kind of personality than we have. It's a different — I don't want to say effort level — but different relationship.

So hopefully we are not going to have a lot of adventures in corporate governance if we are doing our jobs really well. In the case of Goldman, Bob felt, and I totally agreed, that this was a case of a person who should not be on the board of a business that is fundamentally a risk manager. Goldman Sachs is fundamentally a risk manager, and Mr. Johnson has been a very poor risk manager throughout his career as a public company executive. We just felt that it was a simple call. We needed to vote against his being on the board of Goldman. A couple people have asked — you are pretty late to the party — he has been on the board for 12 years. Well, we have only been a shareholder for two years. We voted against him last year and we raised our voice a little bit louder this year. I have to say I'm not sure it is a position we like to be in very much or would want to be in very often. But every now and then it has to be said.

Question:

On a similar theme, I'm quite struck — this is the first time I've been at this meeting — I'm quite stuck by the lack of gender diversity that I'm seeing represented here. I'm also noticing that you have investments in an awful lot of macho kinds of things: cars, all that really macho stuff. How much does not representing the viewpoint of 50% of the population and 56% of the educated population of the world influence the kinds of choices you make?

Bob Goldfarb:

Actually, the person who is responsible for recruiting analysts is a woman.

Question:

Would you like to say a few words about what impact the current euro crisis is likely to have on our positions? And what the fallout is likely to be.

Bob Goldfarb:

We really do not know how it is going to play out. So it would be at best conjecture and probably speculation on our part to give you the response your question deserves. We are certainly aware of it as are you. But there are just so many scenarios out there and even if you gave me one scenario, it would still be difficult to answer your question. We are well aware of it, and it's certainly top of mind for the markets.

Question:

I've got a question. But before I do so, I want to respond to the question about gender diversity. One of the greatest analysts of all time at Ruane, Cunniff was Carley Cunniff. If you had been here, it was either at the 2000 or 2001 annual meeting, when everyone was saying "Why aren't you buying technology?" she stood up and she talked about Lucent Technology, how she had read the annual and that Lucent was doing vendor financing that was going to get the company in trouble. And she was absolutely right. I think we should all acknowledge that part of the record of this wonderful firm came from Carley Cunniff. So there is gender diversity in the history. That is for sure.

Bob Goldfarb:

Thank you.

Question:

My question is regarding Google. What do you perceive to be the biggest threats to Google's franchise?

Chase Sheridan:

That is a good question. If there is something that dislodges Google it will come sideways; it will be something we don't see. Bing has been around since 2009; Google has grown its share of search during that time. Facebook is in a different business. It competes with Google in display. I think they will both continue to do very well in display. But in terms of technologies that could unseat Google, there are no viable competitors in search at the moment.

I worry more about Amazon, frankly. Because Amazon is at the bottom of the purchase funnel, as it becomes a broader and broader vendor of everything we buy online, it can usurp search traffic. I certainly have every respect for Jeff Bezos as an entrepreneur and as a business manager. So Amazon is one that people don't bring up much as a direct competitor to Google but it's one that I worry about more than the ones that are usually in the press. But it may be someone else entirely.

I can say that I am comfortable with Google's position. It is one of the best businesses I have ever seen. It has one of the widest moats — I believe it's a very wide moat — in its core search business. In fact, I believe the core search business is even better than the financials would indicate. The reason is that Larry Page overinvests in Google's business, and that is how you get all these amazing ancillary products that Google spins out from Gmail to Google Earth to self-driving cars. There are good and bad aspects to that. I think if you asked Larry Page, he would say the biggest threat to Google is Google not performing at a high level. I actually think that it will continue to flourish.

The question that would go along with that is, "Why is Google trading for the price it's trading at, 14 times, give or take, 2012 earnings after you net out the cash?" This is for a company that is growing over 20% a year. Part of that is that there is so much investment and there is a certain level of trust you have to put in Google's management team. They trust themselves with the cash more than they trust their shareholders with the cash — unfortunately for us.

Question:

Can you talk about the lawsuit against Google that is going on right now?

Chase Sheridan:

I believe that is a tempest in a teapot. But someone else said that recently and it backfired on him. Oracle originally wanted $6 billion and Google's response was somewhere closer to a dollar in terms of what it was willing to pay. The controversy is over nine lines of Java code that Google has adopted in its Android operating system. I have looked at the lawsuit. Anything can happen. On a monetary basis the damages that Google faces from that lawsuit will be trivial to the company. I would not factor that in the valuation at all. But there is a competitive issue behind that. Most of us probably have seen what is happening with patent wars right now. A lot of companies are being purchased at very high valuations in order for companies like Google, Apple and Oracle to fortify themselves against various IP litigation cases that could come down the pike. Google paid — the headline was $13 billion for Motorola Mobility; Motorola Mobility had $3 billion of cash and a couple billion dollars of deferred tax assets; so the actual cost was somewhat lower than $13 billion. Google got a good patent portfolio in the handset space because of that. But it was not solely a purchase based on the patent portfolio. Larry Page has indicated pretty clearly that he wants to build a more integrated handset. Google has a little bit of Apple envy. There is probably only one company in the world that Google could envy and that is Apple. It's a broader issue, but referring specifically to Oracle I don't think that is going to be an issue at all.

Question:

With Warren Buffett's recent purchase of newspapers, the *Omaha World Herald*, and his commentary that he is going to buy more, I was interested to hear any takeaways you might have on that.

Jon Brandt:

In the context of Berkshire these are very small purchases. It is interesting to note that with the Media General purchase of the small newspapers yesterday, he is spending $142 million for the papers but he also lent them $400 million at 10.5% for ten years. So the larger allocation was to the loan. Then he got a quarter of the company basically for free. So he got a free lottery ticket. He seems to be interested in smaller or medium-sized towns, with Richmond and Omaha being the top tier. I think he believes that in a small or medium-sized town where the paper is still relevant, a newspaper can be a decent business; I don't think he would say it is a great business.

Question:

A question about the case for Corning?

Will Pan:

Corning is a 150-plus-year-old company based in Corning, New York, upstate. Over its long history you can think of it more as a material science research lab. It is a very impressive lab; there have been a lot of great technologies that have come out of it mostly focused on glass and ceramic. Over the years Corning has made things like the original machine to manufacture Edison's light bulbs, CorningWare, which people are familiar with, as well as fiber optics, which the company was very well known for in 1999 – 2000 and notorious for in 2001. These days the business is transformed again. Corning makes the glass that sandwiches the microelectronics for LCD TVs. It is a leader in this category, where it has a 50% share. There are only two other competitors; so it is a technical oligopoly. And this glass is incredibly difficult to make. Many have tried and failed. It's extremely thin; each piece is less than a millimeter. But there are also extremely large pieces, 100 feet square, and they have to be incredibly uniform. They have to have very specific compositions. So there is a lot of secret sauce that goes into these pieces of glass. That is where Corning derives most of its earnings.

The company also has another promising product, Gorilla Glass. Some of you who have smartphones might know that the piece of glass that you actually touch is called Gorilla Glass. It's a chemically strengthened piece of glass; again Corning invented this technology. The company has done a good job in turning it into a consumer brand; so now smartphone companies will advertise their handsets having Gorilla Glass the same way PC companies advertised having Intel Inside. Corning has very high market share of this business as well.

The issue with being a components supplier to the consumer electronics industry is that nobody has found a good way to sell more TVs except to lower the price. If you recall five years ago a 32'' LCD TV might have set you back easily $1,000. Today it's $200 to $300. It's sort of a law in consumer electronics that the prices come down over time. As a supplier Corning feels this pressure as well. Historically, glass prices had declined about 8% a year. But there are times when the oligopoly gets ahead of itself. Last year, it had more glass capacity than was necessary for the end retail demand and there was excess inventory in the channel. The glass makers got ahead of themselves and what you saw was that the customers had significant leverage on them. So the earnings have come down about 20% year over year.

That said, it's in this industry's interest to make sure that the capacity is aligned with demand and we are pretty comfortable that after having taken down roughly 30% of the industry's capacity over the last year, it has got a handle on it going forward. So we think of it as a low point from which Corning can build upward.

The other thing to note about Corning is that it is cheap and it is going to generate a lot of cash from this business. It has had to invest a lot over the years to build these extremely automated glass plants. These things take no people to run. Over the next five years the company has indicated that it is still going to be able to sell a lot of this glass but it is not going to have to build a lot of capacity. Corning is not going to have to put a lot of cash into the business. So it has a long runway to generate a lot of cash. The company has got net cash on the balance sheet. It has a buyback in place. We feel it's a cheap stock and it is a good bet.

Question:

We have an investment in MasterCard. I'm curious to know what your thoughts are on mobile payments and the future of that business and threats to MasterCard.

John Harris:

Mobile payments are a big change for that industry. Right now it seems like a fairly benign change, probably more benign than I would have expected a couple years ago. But as an investor you are well served to approach radical change, even if it looks benign for the moment, with a healthy degree of skepticism and humility. So I reserve judgment on how mobile turns out over the next five years. It's likely to continue pushing along the market share shift away from paper-based payments toward electronic payments, which is certainly a trend that goes in MasterCard's favor. Right now it seems like most mobile payment platforms are going to operate similarly to how PayPal operates today, which is basically as a mobile wallet where you can enter all of your plastic credit card information into the mobile wallet along with your bank account information and basically use PayPal the same way you use your wallet. You can choose which payment card you want to use for any given transaction. You can set one as the default, which most people do in their minds, even if they don't have a computer program in their wallet that does it for them.

So all that seems pretty benign. One of the big risks of mobile is that in any mobile wallet you are likely to enter your bank account information, which will enable the mobile wallet to pull money directly from your bank account and make an ACH — automatic clearinghouse-based — transfer of that money to whomever you are buying the goods from. That is a form of payment that escapes the MasterCard/Visa universe. There are some merchants online that offer that. If you go to Amazon.com you can give them your bank account information and pay that way. A lot of people, number one, they are reluctant to do that because it's a pain to enter information in every website you go to. Also there's a big trust issue involved; a lot of people don't want to have their bank account information sitting out there all across the Internet. Obviously ACH is something that you cannot do on the ground at a brick & mortar merchant — or you have not been able to do thus far, though that is changing now that PayPal signed up a deal with Home Depot that allows customers to use their PayPal accounts at the point of sale at Home Depot. That is another thing we will have to watch carefully because it brings the ACH modality to the point of sale. But for the moment, at least, your ability to pay that way is pretty constrained. If mobile wallets proliferate and if we see PayPal sign up a lot more offline deals like the one with Home Depot, then your ability to pay by ACH increases, and that is a negative for MasterCard. How all of that shakes out — I think anyone who tells you he knows is just putting you on.

The other curve ball that you are likely to see is that you have got people involved in mobile now like Apple and Google, who because of the way that universe has emerged, because of the fact that Apple essentially controls a mobile user base in the hundreds of millions of people — Google's may be over a billion now — may have the ability to start a new mode of payment that really no other participant in the payment's ecosystem has had heretofore. Traditionally one of the best aspects of MasterCard and Visa's businesses is that what they built is just very, very hard to build. There is a huge chicken and egg problem about trying to build out a global payments network. But they did it. They were the first to do it and it took them decades to do it. Other people who have tried going along the same road have largely failed. But Apple and Google, given that the paradigm has shifted, may be able to succeed where others have failed and that certainly would not be a good thing for the associations. So I definitely think about that. You can have very long debates about whether, given the prices that MasterCard and Visa trade for, you are well compensated to take that risk. I think for the moment, you are adequately compensated. But it is something that we watch and we have to pay a lot of attention to.

It sort of — just very quickly — reminds me a little bit of the question we got about Europe earlier. Just as with this, there is no way to know how Europe will unfold. But one little insight into our investment process that might be useful in answering your question is that Europe is a problem and I would say that, maybe a little bit unusually, around our shop, problems are our base case. There are lots of people who assume that the future will be okay, that the economy will continue growing, that the future will be like the past. There are a lot of lessons I have learned from Bob, but one of the most important is that things don't always revert to the mean. You cannot always line up all the data points from the past and extrapolate out into the future. The world is just riddled with a surprising number of points of inflection. The road you travel, it has curves — sharp ones — that you cannot anticipate. When we think about making an investment in a business, all of that is just assumed from day one. We don't assume that things are going to go swimmingly. We don't think about what happens to this investment if there is a recession. We think about what happens when there is a recession. The recession that we think about is probably a little deeper and darker than the ones most people think about when they make their decisions. It is a hard thing to verbalize because if you look at our results and you try to think about what risks we are taking to achieve the results, there are no fancy metrics we can show you to prove that the results we have achieved were achieved with a very modest, in our opinion, amount of risk-taking. But just objectively as someone who has been around the process inside Ruane, Cunniff for almost ten years now, I can tell you that the amount of risk we have taken to achieve the results that we have achieved is a point of pride amongst all of us.

Question:

About 36 years ago, shortly before Benjamin Graham passed away, he did an interview for the *Financial Analysts Journal*. I thought this was really interesting. This is before the explosion of information, ETFs, mutual funds. Asked if he advised "careful study of and selectivity among" individual stocks in constructing a portfolio, he answered, "In general, no. I am no longer an advocate of elaborate techniques of security analysis in order to find superior value opportunities. This was a rewarding activity, say, 40 years ago, when our textbook 'Graham and Dodd' was first published; but the situation has changed a good deal since then. In the old days any well-trained security analyst could do a good professional job of selecting undervalued issues through detailed studies; but in light of the enormous amount of research now being carried on," — 1976 we are talking about — "I doubt whether in most cases such extensive efforts will generate sufficiently superior selections to justify their cost. To that very limited extent, I'm on the side of the 'efficient market' school of thought now generally accepted by the professors.' I'm just wondering if you would comment on that and how the investment industry has changed over that period of time.

Bob Goldfarb:

I think that over that period of time, most actively managed portfolios have underperformed the benchmark indices; so that would be correct. But it's a big universe. It's gotten a lot bigger since he made those comments. There are certainly a number of firms that have demonstrated an outperformance over the 35 years since those comments were made. There is still an opportunity for active managers to outperform the indices, net of fees, but it will continue to be the minority that do so. And we want to be in that minority.

Greg Alexander:

Also I would add — that it is a funny thing — I have kids 14 and 11, and I think that the next generation will go about their decision making maybe differently than us. They have every expectation that they can go and spend an hour on the Internet and become semi-expert on anything that they are interested in, whether it is figuring out how to do a Rubik's cube, which I remember looking at and not having the least idea. But with all the information, the timeless human struggle remains judgment, the ability to think long term when there are problems that are short term, and whether we see something solid where everyone perceives uncertainty — many factors of that nature. Looking in new areas where people have not thought so much, there are many factors like that, that are timeless. I always tell people there will be men and women on the moon but we still will not understand the guy next door.

Question:

So the mysterious East — what effect would the fall, for example, of the euro have on those projects that you work on? Would that have a negative effect, a positive effect, or no effect?

Greg Alexander:

As Bob said, we don't have many deep thoughts on these kinds of issues. But on a personal basis I have always agreed with Margaret Thatcher, who said 20 years ago that the euro was never going to work because the countries were too different and there was not really labor mobility. People born in Greece do not really necessarily end up working in Germany or vice-versa, Spain, or whatever. Labor is not truly mobile. So I think they are going to give it their best shot, but I would not be surprised if we come back in 20 years and they have gone back to their local currencies again. For Asia, I have even less thought. I'm sorry.

Question:

It's been awhile since we have talked about Brown & Brown. I was wondering about perhaps two sides of the story. First, it seemed after a few years of tough conditions, things seem to be improving finally. Secondly, I wanted your thoughts about the management succession.

Jon Brandt:

Let me take the second part first. The current CEO is about 43 or 44. I don't think the board is going to need to replace him for a long time, if that is what you meant. I know Powell Brown reasonably well. I think very highly of him. In terms of ethics and the kind of person he is, you feel as if this guy could never do anything beyond a shadow of a doubt even slightly wrong. I have never met anyone as straight an arrow as Powell. You feel as if you are meeting someone from the 1950s. He is extremely hard-working and dedicated. He has good people skills; he is smart and he has a tremendous vested interest in doing well for the shareholders because he is a big shareholder and his family is a big shareholder. I think he feels the weight of his father's legacy very strongly and I do not think he wants to disappoint. This is not your roué son whom you sometimes see in other corporations — who gets the job but who does not deserve it. I do think Brown & Brown should probably have a number two. For many years Hyatt had a number two who was Jim Henderson. Powell might soon name a number two, and that would be helpful.

The company has been hurt by several things the last few years and there is no way of sugarcoating that the organic growth numbers have not been as good as those of the rest of the industry. But Brown & Brown's profit margins are still double if not more than double those of its peer group. The company has done a good job of controlling expenses. If you had told me six years ago that the organic growth was going to be what it has been, my estimate of current earnings would have been a lot worse than Brown & Brown's earning are turning out to be because management has been so good at managing expenses. Now that the cycle is turning in Brown & Brown's favor, and it has had these problems that the others haven't had, the concentration in Florida, which is one of the four or five states that has been hurt the worst in the recession, the competition from the state of Florida in property insurance, the fact that the company had significant exposure to small contractors — all these things should turn around in the next couple years. I would hope and, I would like to say, expect that the company's organic growth will be more like that of the industry, if not better. When it resumes growth, now that its costs are as tight as they have ever been, you could see a real improvement from already high levels of its EBITA margin, and I think it will prove to be a good investment even from here.

Question:

What do you think of Goldman Sachs moving forward?

Jon Brandt:

I still think of it mostly as a math problem. I can go a little deeper but the tangible book value excluding goodwill is 125. Since it went public its average return was something close to 20% on tangible equity. If you assume it could earn 10% on equity, you are looking at a $12.50 earnings per share number. The stock is below 100; so that is an eight multiple. The company is fighting so many different battles right now including public relations, greatly increased regulation, et cetera. But if you are young, smart and you want to make money, and you have got the kind of mind that is good for Wall Street, I still think that Goldman Sachs is one of the first places you are going to apply. Profits from trading with assets leveraged at the peak to 40 times equity drove the 20% returns. Earning currently are structurally and cyclically depressed. We don't expect the structural elements to improve, but we feel that the cyclical elements will. We will see what the next ten years brings, but I think it's still a tremendous franchise. Personally I'm still bullish on the company. It is not going to earn what it used to earn but it does not need to.

Question:

I'm wondering if you would comment on your assessment of TJX.

David Poppe:

We have owned TJX since 2000, so going on twelve years now. It's been an absolutely terrific performer, and the last four or five years in particular have been spectacular for it. TJX benefited over a long period of time from the continuing decline of the department store industry and the shrinkage in the number of department stores out there. The apparel vendors, the apparel industry, is particularly aware that the cost of production for the incremental item that you want to produce is usually very, very low. So just because ten department stores close does not mean the vendors want to produce less product. They are still incentivized to produce as much as or more than they used to but they need to find a market for it. So what has happened is the department stores have weakened. The amount of supply out there has not really shrunk and TJ has become more and more important to many apparel vendors. Management talks about having thousands of relationships. The reality is there are probably a hundred that are really important but twelve years ago there were probably 25 that were really important. There are just more big name, nationally known vendors who depend on TJX today than in the past. The shopper has proven that she is willing to — I do not want to say trade down — but go to TJX instead of a department store if TJ has the same products at lower prices. So it has been an extremely powerful model. You see how good the business model is in the fact that TJ has a competitor, Ross Stores, that does well, too. Both are spectacularly successful and profitable businesses.

The one issue I would have if I were initiating a position today is that TJ has had a wonderful run over a long period of years. The operating margins for the business have gone up to levels that I personally did not think were possible. I thought you had to keep the margins a little bit lower to maintain a value spread with a department store. I would worry a little bit going forward about the ability to raise the margins from here while maintaining the same level of value. I do not want to speak for management but I think the company might counter that as you become more important to the vendors, your economics get better all the time and it has not been an issue of shrinking the price gap with the department store. It has been more an issue of the vendors getting weaker all the time because the number of department store doors is shrinking on them.

Going forward, TJ has opportunity in Europe. It has done really well in the UK and increasingly better in Germany. Germany is a huge country and it could be a big market for TJ. Very few American retailers have been successful in Germany. Going forward you have a 3% to 4% square footage growth opportunity in its current business and geographical footprint. Plus, the company is always exploring and testing new formats and new geographies. And if management runs its business right, TJ should be able to grow same store sales at a decent rate per year. And you have very modest margin growth opportunity. Finally, the company will continue to allocate a significant percentage of its prodigious cash flow to aggressive share repurchase. Earnings may grow at a slower rate than the heady pace of the recent past, but earnings per share growth ought to be in the low double digits. And it is an extremely well-managed company. When I talk to apparel vendors, as much as they might hate admitting that they sell so much to off price, I never hear anybody say a negative word about Carol Meyrowitz, who is the CEO there. She is very, very well regarded in that industry.

Question:

On the subject of retailing, I wanted to ask David if you still own Walgreen, the pharmacy — if so, why — if not, why not in the context of the ExpressScripts Medco issue going forward. Then completely separate from that but on retailing, just your thoughts on Target and Wal-Mart in an era of the frugal consumer. Target, for example, has to offer a 5% discount to get people into the store.

David Poppe:

We owned Walgreen for a long time and we sold it a couple years ago. I think we sold it — two buckets of reasoning. One is management had struggled for awhile. The business had gotten really large and it was an interesting case where Walgreen went from 3,000 stores to 7,000 stores in a decade, maybe a little bit less than a decade. There started to emerge, as the company got larger and larger, management issues — a tougher company to run. Then the rise of the PBMs also made the drugstore business a more difficult business. The PBM — ExpressScripts just bought Medco, Caremark — really controls the reimbursement to the drugstore. The PBM is heavily incentivized to take as much of that spread between the wholesale price of the drug and the retail price of the drug as it can. The PBM controls the client, which pays for its employee benefits. The PBM has that relationship; Walgreen does not. We saw that it was becoming harder and harder for the drugstore to command fair reimbursement. And the PBM's position was getting stronger and stronger; so Walgreen did not make as much sense to us going forward as it had for the previous ten years.

Target and Wal-Mart — they have both run their businesses pretty well over the last few years. It definitely is a more frugal consumer. You definitely have the rise of Amazon, which is something that really needs to be paid attention to going forward. First of all, during the period that we have owned them, they have both generated mid-single digit returns including the dividend, and that is a little better than the market has done; so they have been okay. They have certainly not been home runs. But as that has happened, their P/E multiples have come way down and they are both — I don't know if I would say quite cheap — but quite reasonable. Very profitable. There is not a lot of real estate opportunity right now. As the investment in the business has slowed down, you see that both generate really huge amounts of free cash flow. They are both very disciplined about returning that to the owners. I think they are both fine. There are definitely issues with both and they are a little bit different for each. But certainly they are very, very strong companies. Yes, online will get stronger. Yes, the consumer is more frugal. But there are a lot of retailers who will be steamrolled before Wal-Mart has serious problems. There are many others I would worry about more than those two.

Question:

Last year you said that QinetiQ was a mistake. The good news is it may be less of a mistake now since the stock price is a little bit higher. I would appreciate it if you could comment on that.

Arman Kline:

QinetiQ was a mistake in that it was not a typical investment for us. The underlying business, a defense contractor over in the UK, is not hugely appealing. It is not a bad business, but it is not the type of business we typically invest in. But it was a situation where a CEO who is very talented and for whom we have a lot of respect went in to turn the business around. We knew it was going to be a tough fight for him. The good news is he has done an excellent job, better than we could have envisioned. That business had a lot of debt on it, had a lot of problems. In a year, he took debt down from almost four times EBITDA to less than one. The cash flow is in good shape; he does not have any debt coming due for another four years.

What has not changed is that the end market is still very tough and he is doing all the right things. I'm heading over to London next week to see him and the company is going to report its results. So we'll see how the last few months have gone. But he has a hard slog ahead of him. There is still some stuff to do internally and he will continue to do that and that will continue to reward us. But it is going to be tough going for him and for us unless those end markets start to get a little bit better.

Question:

You said last year that you were starting to pay a little more attention to the jockey and perhaps marginally less attention to the horse. I'm wondering whether and how you are devoting more resources to scrutinizing the leaders of the companies in which you might invest.

David Poppe:

It has always been an important focus for us. We spend a tremendous amount of time on qualitative aspects when we are looking at a business. What does that mean? What is the quality of the management team? What is the quality of the culture? Why do people work there? What is retention like? These kinds of issues are really important. One of the things John was talking about earlier was that we think about what the worst case scenario is. Also we look at how good the managers are at decision making. How cohesive is the culture at the top? One of the things that I have found over my years of doing this is that the really good management teams tend to make good decisions and navigate choppy water pretty well. The B-grade management teams, when inevitable surprises come up, they tend not to navigate it nearly as well. So I do believe the qualitative aspects of analyzing business are very important and that is why you cannot do it solely off a DCF model. Math only takes you so far. I am not sure that our rigor is any greater today than it used to be. I will tell you from my perspective that trying to follow what this group of people is doing has become a little bit harder because we own more stocks.

It was certainly easier to feel as if I knew, almost on a personal level, management teams really well when we owned 12 or 13 stocks. It is much harder at 40 or 45. So it means the bar has got to be very, very high. We have to continue to work at it because the natural inclination as you own 40 stocks instead of 15 stocks is to know a little bit less about the particulars. But a really good analyst goes to the point of diminishing returns, and then goes a little bit farther.

Bob Goldfarb:

The new issue of *Fortune* magazine features the Fortune 500. There are articles on Coca-Cola and Walt Disney, which are two of the world's great franchises. What is interesting is that as great as those franchises are, they were undermanaged. Even in the great franchises management makes an enormous difference as it has in these two cases.

Question:

Bob, last year was an extraordinarily difficult year in the markets. First of all I want to congratulate you and your team for producing 13% versus 2%, and even more importantly, longer term results. My question though is really about your sell discipline. How do you think about trimming your winners when you expect them to continue to grow? How do you think about selling the losers?

Bob Goldfarb:

It is going to be stock by stock. In every case it is an assessment of the current market price of that stock versus what we think the underlying value is and how we think that value will grow over time. So there is not a single strategy. It is one stock at a time. We buy them one stock at a time and we sell them one stock at a time.

David Poppe:

I think it is fair to say though, Bob, selling is harder than buying. When you do what we do, hopefully you own businesses that you really like that are managed by people whom you really respect and you own the businesses for a long time. You have the team over here that has invested countless hours in understanding a business, knowing it. It is like divorce; it is wrenching to have to sell it, to say, "You know what? The value is really not there." It is hard. So sometimes you can hold things too long. I do think the record shows — this is mostly to Bob's credit — we have been pretty good sellers over time. But selling is harder than buying.

Bob Goldfarb:

There was a period we went through with TJX when we did not feel very good about it and fortunately the board ultimately did not feel very good about it either. So it paid to be patient. So you go through an example like that; it is humbling.

Question:

The fund has such a large cash position, 21%. What do you plan to do with it?

Bob Goldfarb:

That position has been reduced. It is currently around 18%. We are not uncomfortable with 18% in cash. Given the kind of discipline I was referring to earlier, we would rather be disciplined in putting that cash to work than in a hurry to do so.

Question:

Could you comment on any trends that you are looking at now that are helping you find new ideas?

Bob Goldfarb:

We generally do not look for big trends, megatrends. Again, one company at a time, one stock at a time. So anybody have any trends?

David Poppe:

The only trend in the last few years — we talked about it last year or the year before — is we really tried to own through a period of a lot of financial uncertainty businesses that did not have any debt and were not reliant on the financial markets to grow. Bob, was it '09 — we sold some positions like Caterpillar that subsequently just did fantastic. But we were nervous about anything that relied on a healthy liquid financing market to be able to conduct business. We have also always — I do not think this is a new thing — we have always shied away from companies that are using a lot of leverage to try to grow. Because we do not use leverage, we prefer companies that generate so much cash flow that they can self-finance their growth, and maybe there is even more of that element. But I would also say for every rule there is an exception. Valeant is a company that we think can grow fast using a lot of leverage and we think we are making the right decision there. So there is an exception to every rule. But in general we have tried to avoid highly leveraged situations.

Greg Alexander:

I would add, there is one trend within the firm, which is with all this excellent talent, there are more new things that we are looking at. I do not think some of the things we bought in the last couple of years we would have even thought of years back. There is more ferment around the firm.

Bob Goldfarb:

That's true. But if you look at the last five things we bought, it would be hard to see a trend.

Greg Alexander:

Right. Just that there's newness.

Bob Goldfarb:

Yes, that's valid.

Question:

Can you speak to some of the research you have done on Apple and why it is not in the portfolio alongside Google? It seems to have many of the elements that you guys praise — management, culture, financials and innovation.

David Poppe:

I agree with everything you said. But we typically do not talk about companies that are not in the portfolio. I think that is just smart. It is an excellent company, but we do not own it and I do not think we have anything important to say about it.

Question:

I'd like to get your views on Canadian Natural Resources, your only energy holding.

David Poppe:

It is a very small position in Sequoia. We bought it in the spring of '09 or maybe it was '08 when oil was $44 — it got so cheap. We like the company; we think it is a great management team. They are all owners. I like the balance of assets among heavy oil, the oil sands and natural gas. Natural gas right now is a terrible place to be but CNQ has got a tremendous position long term. You could own Exxon or you could own something like CNQ — it would not have to be CNQ. Exxon is a best-of-breed world-class company, but it has a really difficult time growing its production. It is spending a lot of money just to maintain production every year.

In CNQ we were somewhat taken by the fact that it has a really clear line of sight on growing production 6% to 7% to 8% for a decade, primarily of oil sands, and that is because of high cost oil. CNQ is one of the few oil companies you could look at and say, "Wow, it has very nice production growth for a really long time based on just assets in the ground today that we know are exploitable." It is one that we thought you could look at and see very good production growth for a long time at $70 to $80 a barrel for oil. You do not need $140 or $120 oil to make it work.

Question:

Share price is not always reflective of a company's performance. So on that I would like to get your thoughts on Becton, Dickinson and how you gauge how the company has done, and whether it has increased its competitive advantage in the last couple of years.

Will Pan:

Becton, Dickinson is a medical device company and it is the world leader in a couple different products. If you looked across its whole product set, it probably has half the market in aggregate of what it sells. Becton is in three areas. One is in medical surgical products. BD sells a lot of syringes, many of which are safety syringes — they prevent needle sticks — and also prefilled syringes and needles for things like diabetes pen injectors. The second would be equipment for life science research, and the third would be medical diagnostics.

I guess the question hinted at is, "Why is a pretty good franchise selling at a pretty low P/E?" Over time, when we first looked at it, it had gone on a really long growth streak. It compounded in the teens. A lot of it was driven by safety adoption. It had this great product that prevented needle sticks. There was legislation in the United States passed in the '90s that enforced the use of these products, the uptake of these products. It grew tremendously through that because safety products were much more expensive than just very simple syringes. The US is the largest market and that has been largely penetrated. There is still a safety adoption cycle in Europe. It is a smaller market. There is also a lot of safety adoption in the rest of the world, though, again, that is a smaller market. So in aggregate, it just has not grown as quickly over the last few years as it did previously.

The other thing is that since the recession, utilization generally in healthcare is down and additionally you have some austerity in Europe that is causing a little bit more price pressure. So it has got some challenging things to go through.

But at the same time we do feel that it is widening its moat in important areas. It has a program to reduce costs to make sure that BD is the low cost leader. We like low cost leaders and we like that the company is proactively addressing this. So we think the management team is doing a pretty good job. It is a tough environment; growth is not as high as it used to be. Maybe the company is not getting as much credit as it used to in its stock price, but we think BD is taking the right steps.

Question:

You got into IBM before Warren Buffett did. Now the price has gone up so much, do you still like it? Do you still have the same feelings for the prospects of the company?

Will Pan:

I would think of the prospects as independent of the price, unless you are asking is it as a good buy now as it was back then — no, it is obviously at a higher price now. I think we feel great about the prospects. IBM is in the middle of a five-year plan up to 2015 according to which management has said that it is going to deliver $20 a share in EPS, in earnings per share. There are very few companies that we know of that can commit credibly to something like that. It is important not just in the sense that we as investors want a cheat sheet. Management explained that it is also very important for the company as a management tool. It is very useful for a company to have something like this to organize around. Every person in the company, you go up to them and you ask them what is your place in the 2015 road map? They will be able to tell you what the goals are and that is very rare in a company. It shows that A) IBM has tremendous planning capacity. The company has the systems in place to know all the pieces of the business and how they are doing. Management also has tremendous execution capability; so it is able to get everybody on the right page and moving in the same direction.

The company is now a year into the roadmap. It has exceeded expectations. IBM grew EPS 15% last year and now for the next four years it is only going to have to grow at 10%. It is ahead of objectives in a number of other areas. Most importantly, IBM is doing very well in software. So some people ask, "After five years will it be able to continue doing well? What is in the next five year roadmap?"

Software can be a much bigger part of the portfolio and that carries 80% gross margins. We just don't see what is going to stop the company.

Question:

Can we have a comment on World Fuel Services?

Rory Priday:

World Fuel Services is a position we have owned for a over a year now. World Fuel Services is the largest independent marketer, seller and distributor of fuel. It operates in three markets: The marine bunker fuel market, the aviation jet fuel market, and the land segment, which would be gasoline or diesel. Basically it functions as an intermediary between the big oil companies and customers on the other side. In the marine market it would be the shipping industry or cruise lines. It would be airlines in the aviation industry and gas stations or jobbers in the land segment. About 30% of its business is marine, 50% would be aviation. The other 20% would be in the land segment and that is by the income they generate, not the revenue. The key thing to focus on is just how much money the company makes on each gallon or each ton of bunker fuel that is moving through the system. That will tell you how much gross profit it is making in each segment. Management has done a good job over the last 10 to 15 years because the big oil companies have been moving out of the downstream part of the business and by that I mean they have been selling off assets like terminals and gas stations. If you went to the airport in the past, you would have seen an Exxon Mobil truck or a Chevron truck that was delivering gasoline to the airplane. And the same at ports around the world — the big oil companies may have had bunker fuel ships that would go out and deliver fuel to a larger ship so they may have had terminals at the port.

The big oil companies have moved out of these businesses and sold off a lot of those assets and World Fuel has moved in. It serves as an aggregator. World Fuel goes to the big oil company and says, "We want this amount of fuel." Then on the other side it will deliver it to the customer. It is an interesting business because to some degree there is a little bit of a network effect there. World Fuel has no assets like the big oil companies used to; it is asset-light for the most part. So it would be really difficult for someone else to come in who is not already in the business doing huge volumes to say to Chevron, give me a lot of fuel to sell to the customers. Because the newcomer would not have the customers — and it would have to go get the customers in order to deliver fuel to them. So it's a chicken and egg problem to some degree, and it depends on the market. But it would be really hard to go at them in an asset-light model. You may have to buy the assets to compete with them. We are enthusiastic about the company because big oil continues to move out of these downstream segments. That will allow World Fuel to grow organically.

Question:

Just quickly can you give some insight — I hate to go back to retail — but with TJX, Target and Amazon — Amazon has the new scanner allowing you to go into any retailer. You scan the product. Amazon will guarantee a lower price on that item if you order online. How is that going to affect the base business of some of these retailers like TJX?

David Poppe:

Definitely it's a headwind and Amazon has been a headwind for a couple of years. It is part of the reason why Target trades for such a low multiple. There is a lot of pessimism about its ability to grow. TJX is less affected because of what it sells. TJX sells surplus that vendors would like to produce and quietly dispose of. For the vendor it is a real negative to have that surplus price be visible online. If you go into TJ Maxx stores, there is no advertising of the brands; you have got to pick through the racks to find what you want. In fact, all the major name brands that we all know are in that store but they are not highlighted, they are not called out. If you put that on the Internet it is immediately visible to everyone including Amazon that has got the price scanner and becomes the reference price then. The last thing, whether it is Ralph Lauren or Tommy Hilfiger or any big brand wants is for the surplus price, the TJ price to be the reference price.

For Target Amazon will be a headwind going forward. For perspective, the first four months of the year online sales grew 15% and offline retail sales grew about 6%. So the physical store is not in decline. The physical store in most categories is not in danger of going to zero any time soon. But the online store is going to grow faster. Online sales are also still less than 10% of total retail sales. So even as it is growing faster, online is a small percentage. But that is something that has to be watched, and over the next five to ten years I do expect online sales will become a larger and larger percentage of the total. The last thing on price and lowest price — the fact is people still do go out and they buy groceries, they go to the store on Saturday because they have many things to buy. Whether Amazon is 50 cents cheaper on a widget than Target — if you are already in Target for some other reason the 50 cents actually is not much. There is still something to be said for being able to buy 20 or 30 things on one trip and there is still a portion of those 20 or 30 that has to be picked up at a physical store like bananas, whatever. And you are going to buy other things while you are out. So I don't think the physical store is disappearing. We will have fewer in the future and we will have Wal-Mart and Target surviving and other companies not surviving.

Question:

I was curious about your comments on Fastenal.

Chase Sheridan:

It used to be when we talked about Fastenal, the conversation would focus on store saturation. Fastenal has over 2,600 locations. Just for background for everyone, it is an industrial distributor with a focus on nuts & bolts distribution to manufacturers and other customers. One of the things it has done over the past five years is address this issue of saturation very well. I stood up here probably five years ago and talked about its share of the overall distribution market, which is on the order of 2% and in fasteners on the order of 10%, and said that we think Fastenal has a long runway. It is nice to have management prove your thesis out. What Fastenal has done is slow store growth from an annual rate of around 15% traditionally to just about 4% to 6% today under a five-year program management calls, "Pathway to Profit." But the company has managed to maintain its top line growth rate — I'm going to put the recession aside for just a moment — it has managed to retain its top line growth rate, absent cyclical effects, by investing in outside salespeople, by investing more in its stores, by letting stores mature. More mature stores are more profitable stores. So it is absolutely bringing the company's operating margin up as well. Management's goal was 100 basis points a year of operating margin gains. It has been meeting that goal despite the economic headwinds it faced in 2009.

But to talk about Fastenal's future I have to bring up the topic of vending machines as well. It actually goes all the way back to the founder, Bob Kierlin. He had a concept for a nuts & bolts vending machine, back before Fastenal opened its very first store. It only took 40-some years to realize it but Fastenal is actually selling industrial supplies through these vending machines. I think originally the goal was to place 10,000 machines and management thought it could do at least that many. Over just the last year that goal has really, really changed. For 2012 Fastenal wanted to place 10,000 machines just for the year and it is going to blow that goal away. It may place as many 15,000. It is a wonderful thing because vending changes the game between Fastenal and its competitors. There is no competitive response of any import to Fastenal's vending program. What happens when you put a vending machine on your customer's site is that when your Fastenal representative goes in, he stocks the machine for the customer and he sells to the customer. He has an excuse to be there a couple times a week. So the program gets the Fastenal salesman's foot in the door of his current customers more frequently and opens a lot of new doors as well.

The CEO, Will Oberton, thinks that the company can place at least 100,000 machines. I actually believe that, which may be a little bit optimistic. But we think that Fastenal management has a lot of credibility because it tends to follow through on its predictions. But getting back to your question, top and bottom line volatility — if you look at the growth of Fastenal over the last five years, ex-cyclical effects, it has actually accelerated. This is despite the fact that the store growth has decelerated to 4% to 6% a year. I think that is responsible for a lot of the run-up in the stock that we saw. The worry over saturation has been answered.

Question:

Would you please comment on Mohawk?

Terence Paré:

Mohawk is an interesting test case. If I were to revisit long term expectations for the company that we might have had six or seven years ago, I would say that it is probably not going to do as well in the US over the cycle. On the other hand — and this is a tribute to the jockey — Mohawk has expanded outside the US in very interesting ways. So you get compensation for the disappointment, let's say, at the rate of growth in the US because Mohawk will get some good growth in Russia, where it has been expanding in both laminate and vinyl flooring. It has a joint venture in China, which can sell to the Chinese market, but at the same time export from China to the US with low cost ceramic tile if Mohawk needs additional product here. The company also has moved into Mexico in a more significant way. The CEO has done a very good job of internationalizing the business at the same time that the US business was contracting. It is going to take awhile for the US to get back to normal and that normal will probably be a little less exciting going forward than certainly I expected before the housing crash. But given the expansion overseas and the CEO's proven ability to find good businesses to go into outside the US, we will do pretty well with it.

Question:

Do you invest your own personal wealth alongside us in all these investments? Do you eat your own cooking?

David Poppe:

We are entirely in commodities. Yes, we do, we invest alongside you. We do allow the analysts to trade in their own accounts; they do have personal accounts. They can buy things that we do not own in Sequoia, but I do not think they do so often. The only time that really comes up is when Bob and I reject something for Sequoia and the analyst strongly believes that it was a great idea, and he did a lot of work on it and feels good about it. We think that is an appropriate outlet for frustration. We have a pretty strong compliance program in place. Everything has got to be authorized; everything has got to be okayed before you can own something personally. The analysts never own anything that we are working on until Bob or I make a call on whether we are going to own it for Sequoia or not. So there is no ability to front run and say Bob and David are going to buy two million shares of X so I want to get some first. The compliance program is really strong, run by Joe. That does not happen. But occasionally after we are complete on Sequoia and all the separately managed accounts, the analyst can trade personally.

Question:

To the gentleman who made the comments about Mohawk, I would like to ask a little further about the housing situation and what your expectations are in the US and perhaps, Mr. Goldfarb, you would comment as well. Mr. Buffett famously said a year ago — maybe a little more than a year ago — that he expected that to turn in the last quarter of 2011. He has now said obviously that he missed that. But I would not think he will miss it hopefully by too much. What are your expectations let's say in the next year or the next 18 months for housing in the United States?

Terence Paré:

I do not think any prediction that I were to make about housing over the short term would have very much value. Just about everybody's predictions have been wrong on this over the last three or four years. So I would just be making a public mistake. However, maybe I was a little misleading. I still think that the basic economics of the housing market in the US are good. I am saying that in a relative sense it is going to take longer for the recovery to occur than I expected after the crash. I don't think that single-family home ownership rates will return to the levels that they reached during the bubble. But our population is still growing. We have a huge demographic bulge coming up of young people who sooner or later are going to move out of the house. It is a matter of timing and some of the cause of that is things that I really do not think you could have foreseen, for instance, the rate of foreclosure. If you just look at the states where the banks are allowed to act more freely, the rate of foreclosures has come down more rapidly because banks were able to get the excess stock or the dead stock through the system faster. But I do not think anybody really understood how complicated and how messy the paperwork on these things became during the boom and that has been one of the rocks in the machine that has slowed down flushing out the stock and getting things back to normal. That is going to take awhile to fix.

There were some non-economic events that occurred in the US housing market that were very hard to predict, and they are slowing down the recovery. Money has a time value. If it takes longer to get back to normal you cannot expect to do as well as when it gets back to normal quickly. So that is really what I mean by the disappointment in the housing market, not that any of the fundamental drivers of housing demand have changed.

Bob Goldfarb:

We do not have any precise prediction. I just think over the next few years it will get better. And Mohawk will benefit.

Question:

Having been on a trip overseas with Rick, my question has to do with the foreign earnings of the portfolio. For those of us who look at Sequoia as a stock substitute, have you roughly calculated the size of your foreign earnings and foreign earnings growth? The way I look at your portfolio, it seems to me well over half of earnings are foreign.

Jon Brandt:

We did that for a client a couple years ago. I do not remember the number we came up with but it was definitely less than half. If you contact me, I will get it to you. It will be a stale number but it might give you a rough idea of where we are.

Question:

Would you mind commenting on Ritchie Brothers?

David Poppe:

Ritchie Brothers, for those who don't know, is an auctioneer of industrial equipment — Caterpillar, Komatsu, construction & mining equipment. As it gets older, as the contractor needs to sell that piece of equipment, traditionally he might use a broker, might try to sell it himself, might sell it through a Caterpillar dealer. Ritchie Brothers emerged as an alternative channel. A lot of the existing channels, the handicap that they have, just to use the example of Caterpillar — the dealers all own territories. While they can sell a machine outside of their territory, it is not easy for them to do and they are not really supposed to do that. Ritchie Brothers, by running an auction, can tap a global marketplace. So if Ritchie Brothers holds an auction in Orlando, Florida, it can take equipment from anybody and can sell it to anybody. In recent years you had in a lot of cases 25%, 30%, 40% of the equipment that Richie Brothers sold at auctions going outside the United States, for example. We think that is a great model. You tap a global audience for the seller, which means you are probably going to realize a higher price.

For the buyer, though, it can be a great market too. Depending on the strength of the dollar versus a foreign currency, it might be very cheap for them to buy goods in the United States. Or if the construction market in Brazil is hot and it is not hot somewhere else, Brazilians might not care about the premium that they are paying because it is very important to them to get their hands on equipment now. So Ritchie grew like wildfire for a long time. We think that auction model is just deceptively brilliant. Another thing about it that is subtle and very tricky, almost impossibly so, to replicate is that these are unreserved auctions. Everything that goes into the auction gets sold. You cannot pull your item out of an auction once you put it in. So for the seller, that creates a lot of risk. You could sell a bulldozer for one dollar, theoretically. But for the buyer it also creates a lot of interest. There is a reason to go because you might actually get a bulldozer for one dollar. It never happens but the fact is for the buyer it is clean and it is honest is the point.

In a lot of other auction models that have sprung up — because they do not have the same scale that Ritchie has — the auctioneer has to make a side promise to this guy — "Look, if the price is too terrible, we'll let you pull it out." Then for the buyer it becomes a fool's errand to show up. If I am willing to pay too much I can get it but if I am not willing to overpay they will pull it out of the auction on me. So Ritchie has built a model that is terrific.

The thing that we got a little bit wrong — and that surprised management too — is that the used equipment market turns out to be more cyclical than any of us thought. We thought that the equipment market was so huge and Ritchie Brothers had so much market share to get that we thought it could grow, and grow, and grow. But post 2008 there has been almost no new equipment built and purchased in the United States. There was mining equipment, mostly, which tends not to ever get sold. It goes into a mine and it never comes out until it dies.

So there has not been a lot of late-model, low-hours equipment in the marketplace to sell. There has not been much construction activity; so the contractors are not moving around. Contractors tend to go from job to job. They might build a shopping center and sell all the equipment for cash flow reasons. When they get the next bid, they buy other used equipment. That is a better way for them to do their business than to park a machine for two months or something like that. But there has been less of that activity in general; so it has been slow for Ritchie. We still think the model is a terrific one. We still think that the company has scale in North America that is unrivaled. The company is growing scale in Europe. We see buyers — Arman and I have been to a number of auctions over the years — if you go to the big one in Orlando, the big auction in February, there are buyers from all over the world. Every language is being spoken. The model really resonates; people get it. It is a better way to exchange equipment. But we thought it was a secular grower for a long time and it turns out there is some cyclicality in that business that makes it harder for Ritchie to grow in an economy where construction activity has really stalled out.

Bob Goldfarb:

We have time for one more question. Who would like to ask the last question?

Question:

The pharmaceutical and healthcare divisions — I came in a little bit late so you may have touched on this — what about Johnson & Johnson and a number of the other companies that are out there, do you think there is a platform to go forward or are they pretty much stagnant during the next few years?

Bob Goldfarb:

I would just say we are more comfortable with the Valeant model where you spend very little on R&D. The big pharma model where you spend a lot of money on R&D has not been productive over a number of years in aggregate. It is like wildcatting. We are more comfortable with the R&D-light model that Valeant has. That does not mean that J&J won't be successful.

With that, we will call the meeting to a close. We want to thank you for attending and look forward to seeing you next year.