Walter & Edwin Schloss Associates, L.P.

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COLUMBIA BUSINESS SCHOOL UPPER LEVEL SEMINAR IN VALUE INVESTING

Before I begin to talk about the subject at hand, I'd like to tell you a little about myself so that you can see where I am comng from and perhaps from this you will understand why I am doing what I and my son, Edwin are doing. I have been around a long time and Wall Street has changed a lot so here goes.

Back around 1918, my mother's best friend married a very attractive man with no money. (What else is new?). Shortly thereafter, he got a tip from his uncle about Mexican Petroleum (what else is new?). In those days, you could buy stocks on very little margin, perhaps 5%. He bought as much stock as he could and as it went up he kept buying it. As luck would have it or inside information would have it, Mexican Petroleum was purchased by Harry Sinclair who merged it with his Consolidated Oil. Sinclair was later involved in the Teapot Dome scandal. In any case mother's friends husband took the money he made and bought a seat on the N.Y.Stock Exchange. He and a friend purchased a lovely 160 acre farm in Ossining NY and he and his wife went to live in the Sherry Netherlands Hotel. Because their son was close to me in age, I used to visit them quite often in the country. As a boy of around 10-12 I liked their life style (remember this was around 1928) and Neville, the father had a great jois de vivre. Wall Street sounded interest ng and exciting but i instinctively didn't like the gambling part. About this time arpund 1930, there was a lottery at the Exchange. Only 2 chances at $500. each for a Chevrolet. Neville won it and I'm sure he got rid of it as he had a Cord car made by Auburn one of the high flyers of the day and a La Salle made by GM and didn't need another care.

I liked the results of the profits in the markets at that time but I didn't like the gambling and instinctively didn't like the way it

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was made. Then the Depression hit!

One of the things I've learned is to stay with what you like to do rather than do something you don't like but think you can make money out of it. Anyway, I got a job after graduating from high school in 1934 as a runner at Loeb Rhoades, now part of Lehman Bros. I don't know if they have any runners today but they were the men and boys who delivered securities by hand to the various brokers on the street. There was no Central Depository then and you worked half a day Saturday because the Exchange was open until 12 noon. About a month later I was promoted to the cashiers department, then called the cage because the stock were there during the day. About a year later, I went to Armand Erpf, a very bright man and the partner in charge of the statistical Department which is what it was called then and asked him if I could get into his department. Armand said no but he said there was a new book that recently had come out called "Security Analysis" by Graham & Dodd and if I studied the book and learned all that was in it, I wouldn't need to know anything else about securities. The N.Y.Stock Exchange ran a series of courses for the work on the stock exchange including accounting and finance and after taking them I was allowed to take a course in "Security Analysis" with Ben Graham. It was a great experience and I remember taking 2 different classes with him. The firm paid for the class which I think was $10 a semester but perhaps it was $20. In the class was a fellow named Bob Heilbrunn who is the man who created the Chair in value investing for Professor Greenwald some 50 odd years later. Ben was a very simple straightforward man with a brilliant quick mind. He would use current examples of undervalued stocks which made it profitable for some of the professionals on the street to take his class.

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Ben would like to take companies that appeared close in the alphabet and compare them statistically. I remember specifically Coca Cola and Colgate Palmolive where he showed statistically how much cheaper Colgate was than Coke and he compared Dow Chemical to Distillers Seagram (now Seagrams) in which Seagrams was much cheaper. There was no talk of franchises in those days. Ben didn't look for franchise value or managements. He felt that management showed up in the price of the stock. If management was good the stock sold at a higher P-E because its management was better. Basically Ben didn't want to lose money. He had had a rough time during the Depression and in 1938 to 1940 when I took his courses, he was looking for protection on the downside. Since I liked the way Ben thought and I liked the statistical side, I guess I still look at stocks with the idea of not losing money. The only problem with this kind of thinking is that you don't emphasize the profit potential enough. When a stock goes up to what appears a reasonable price, we sell because the growth in our portfolio is limited.

In thinking about how one should invest, it is important to look at your strengths and weaknesses. If you don't like to lose money and it affects your judgment, don't buy things that can go down a great deal. I must say, I NEVER have put in a stop loss order because if you like a stock and buy it and it goes down, then you should buy more if you can afford to. I find it very difficult to buy a stock that has gone up after we start buying it.

Basically, we try to buy value as expressed in the differential between its price and what we think its worth. What we think a company is worth may not be the correct one and this means we have to look at the risk on the downside.

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Ben Graham didn't visit managements because he thought the figures told the story. Peter Lynch visited literally thousands of companies and did a superb job in his picking. I never felt that we could do this kind of work and would either have to quit after a few years or I'd be dead. I didn't like the alternatives and therefore, went with a more passive approach to investing which may not be as profitable but if practiced long enough would allow the compounding to offset the fellow who was running around visiting managements. I also liked the idea of owning a number of stocks. Warren Buffett is happy with owning a few stocks and he is right if he's Warren but when you aren't, you have to do it the way that's comfortable for you and I like to sleep nights.

When you are managing the other fellow's money, it is important not to get sick over it.

When Ben was operating in the 1930s and 1940s, there were a lot of companies selling below their net working capital (NET NET). Ben liked these stocks because they were obviously selling for less than they were worth but in most cases, one couldn't get control of them and so, since they weren't very profitable, no one wanted them. Most of these companies were controlled by the founders or their relatives and since the 30s was a poor period for business, the stocks remained depressed. What would bring about a change?

1. If the largest controlling stockholder died, the Estate may want to sell control.
2. If business got better, then the company would make money. WW 2 was a good example of this. The large asset base let many secondary companies earn good money in the war years, the excess profits tax didn't apply to them and the stocks did well. I have given you a list of Graham-Newman's holdings in 194 . It was an Open-End investment co that did well in those years because the business in which those companies were in prospered.

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Graham-Newman didn't do too well after the war in that type of security but their stockholders got rich when G-N distributed GEICO stock to the stockholders in 1949 and GEICO became a growth stock.

I remember going to Chicago when I worked for Ben in the late 40's and talked to Mr. Bush the President of Diamond T Motors (no relation to George) a manufacturers of heavy duty trucks alongside Mack, White and Autocar. A Mr. Tilt owned 50.1% of the stock and wouldn't sell. The stock sold for 10 and had a working capital of $20. a share. I asked Mr. Bush why anyone would buy their trucks as they were quite expensive and he said there were people who liked to buy trucks that weren't made by the big companies. I guess that may also be true in our business. Anyway, when Mr. Tilt finally died at age 90, a few years later, the stock was sold at a premium over $20 to Mack or White. Easy Washing Machine and Thriftimart both on the Amer. Stock Exchange had an "A" voting and a "B" non voting stock. The companies were eventually sold but it took a long time for these things to occur with a law suit in the latter case. Unfortunately, these kinds of situations are hard to find which is why we don't publish our portfolio. If the stock goes down we may want to buy more. We certainly don't want to show the world our mistakes.

In running an open end fund, there are problems that a closed-end fund doesn't have. Each year starts January 2nd and ends on December 31st. This means that if you were fortunate enough to buy a stock at $10 and find it at $20. at the year end, you had a great year with a big unrealized profit but beginning on a new year, you are starting at $20. If at the end of the second year, the stock is at $15. you have lost 25% of the stockholders money THAT YEAR if that were your only holding. For the investor who bought in at the beginning of the second year, he will be very unhappy and may liquidate his holdings. If enough people do this, you

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won't have a company. This is and will be a big problemfor open-end funds. They want more investors but have to recognize the risk. This is why we like to own stocks that we think have downside protection. The trouble is that many might not have too much upside potential. It's a more passive way to invest but it's comfortable for us.

If you are investing for yourself, this can be most rewarding but assume you are investing for others as a portfolio manager. Your clients have to understand your approach to investments. If they don't agree with this approach, then they probably shouldn't invest with you

When Warren Buffett gave his Hermes talk about value in 1984, he talked about the innoculation to value investment. For some people it takes but others don't care for it. Let them go elsewhere for investment management. By setting up Berkshire Hathaway, Warren has done everything very rationally.

1. By having insurance companies, he is able to use stocks as well as bonds as reserves. By having large reserves he doesn't have to pay dividend If Berkshire was only a very profitable manufacturing company with no insurance companies it would have to pay out some dividends.

2. By keeping all the earnings, Berkshire can keep reinvesting their profits and compound their results. By owning growth stocks he is able to increase the value of the company. There has never been an investor in other companies who has been as brilliant or as successful as Warren. Since, it is in effect a closed-end investment company, Warren doesn't have to worry about investors redeeming their shares. For example, the market collapes and Berkshire goes down 30% which it has done several times before, no one can redeem their shares. Some investors have 90% of their net worth in Berkshire. I know a man, an outstanding bridge player, who told me he cashed in his Berkshire stock when it was liquidated in 1969-70 because he thought he could do better in the stock market.

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If you are a portfolio manager with a lot of clients and you own growth stocks such as GEICO or Coca Cola and you are up say 40% for the year, you worry that if the market goes down say 30% your clients are going to be very unhappy even if you write them what great cpmpanies they are. I remember having a woman client who was raving about A.W.Jones an early hedge fund. They had done brilliantly for a number of year and each year she put back more and more money until 1 year, I guess it was around 1962, A.W.Jones was down 50%. She panicked and liquidated her holdings at that time. That is one danger in an open-end fund or a private limited partnership. You can never rest on your success, While closed-end funds can keep on going even if they sell at large discounts from Net Asset Value which they used to do. My point is that one has to invest in ways that are comfortable for you. I like Ben's analogy that one should buy stocks the way you buy groceries not the way you buy perfume.
Some kinds of stocks are easier to analyze than others. I agree with Warren to keep it simple and not use higher mathematics in your analysis. I'm always amused when I see a stock go from say 25 to 20 in 1 day when the quarterly earnings come out because the company earned 31¢ instead of 35¢. I saw a recent headline in the Wall St Journal (8/23)"MORE INVESTORS TRY PLAYING COMMODITIES"

I've been down in Wall Street including midtown for some 56 years excluding the 4 years in World War 2. Actually the 4 years in the service were good training years in building confidence. In any case I find that we don't own stocks that we'd never sell. I guess we are kind of a store that buys goods for inventory (stocks) and we'd like to sell them at a profit within 4 years if possible. We receive some income while we wait which is more than a store does but,unfortunately, we have to wait for someone to come along and make our merchandise go up in price. We can't do this ourselves by running sales.

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We invest the way that makes us sleep nights. Not everyone likes to invest this way and we'd say to them, "Fine do it the way that you prefer".

It is hard to change the way you have been doing things and even though there may be better ways, I'm happy with our approach. Phil Carret is about 96 and has been investing for over 70 years . He has done very well but he is very patient. I'm not as patient as he is but I'd like to last as long.

INSERT ABOVE CARRET:

To summarize: Know what you want to do, know your strengths and weaknesses, don't kid yourself, enjoy your work and have high ethical standards. Despite all the insider stock market trading scandals of the 1980s, not one chartered financial analyst was involved.

I thought you might like to see what securities Graham-Newman held some 43 years ago, so I dug up an old report I kept had it Xeroxed and have enclosed it for your perusal,As of January 31,195

As you can see the numbers are tiny compared to today's markets. I find it interesting that of the 62 industrial common stocks ln the list .. valued at $3,288,000, only 2 stocks,Crowley Milner and Lukens Steel remain. Douglas Aircraft is part of McDonnell-Aircraft, Todd Shipyerds recently emerged from Chapter 11. Over 50% of the total market value is made up by Atlantic Gulf & West Indies which was a controlled company and was liquidated by Graham-Newman.

You might find it interesting after perusing the list to look up what happened to some of the items Graham-Newman owned.

Since numbers are much larger today and the working capital stocks (net net) have all but disappeared, I can understand why investors are looking elsewhere. You may find my discussion of a company I find undervalued not to your taste but it may offer some protection on the downside which I find interesting.
An awful lot of effort was put into finding these stocks and after finding them, you can see how little money was invested in them.

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WHat kind of stocks do we look at for investments?

We look for stocks that are depressed.
Why are they depressed?
Are they selling below book value?
Is good will in book value?
What has been the high low over the past 10 years?
Have they any cash flow?
Have they any net income?
How have they done over the past 10 years?
What is their debt level?
What kind of an industry are they in?
What are their profit margins?
How are their competitors doing?
Is this company doing poorly compared to its competitors?

We get their annual report,proxies and valueline and quarterlies.
What appears to be the risk on the downside vs. the upside potential?
How much stock do the insiders own?

Based on the above factors and perhaps a few other items, if the figures look satisfactory, we will take an initial position.
We will watch the action of the stock and decide how much more we may want. It will depend a good deal on price.
Generally, we are happy with a 5% holding but we can go up to 10-12% if we really like it a lot. Since we own some 60-75 stocks, we have small holdings in a number of securities. One reason for this is that while selling a stock, it goes down so that we end of holdings some of its shares. Sometimes when buying a stock it goes up and we don't want to follow it up so we stop buying it.
On the whole we are allergic to bonds.

Today, what has happened? Everyone is now looking for franchises. The key, in my opinion, to successful investing is to relate value to price today. Instead of present value many investment managers are relating future value to present price. Since I can't do that, I will let others do it and stick to what has worked for us.

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Since you undoubtedly like to hear about a current situation, we will use ASARCO as an example of a stock we have an interest in. The shares are currently selling at

ASARCO is the old American Smelting and Refining Company founded by the Guggenheims. Bernard Baruch was one of the early owners. Interestingly enough, during the 1940s, Ben Graham advised Baruch on several situations, notably Northern Pacific which Ben wrote up in the Intelligent Investor.

In any case, American Smelting was one of the Dow-Jones 30 stocks until it ran into a lot of financial trouble. Dow-Jones dropped it just like it dropped InternationAL Harvester and Loews before Larry Tisch made it such a success. At least these changes show the fluidity of the capitalist system.

Anyway ASARCO decided that they had to own some copper mines because the smelting business was no longer profitable. They bought the RAY mine from Kennecott after Kennecott was taken over and they also purchased the Mission Mine both in Arizona. To modernize these mines and other operations ASARCO between 1989 and 1992 spent some $20. a share and had a cash flow of $20. a share. They have reduced their dividend from $1.60 a share to .40¢ on about 42 million shares, to reduce their debt but so far haven't been too successful. They have some $873 million debt compared to a net worth of $1.3 billion Will copper prices recover? They have some silver but copper is their main natural resource. 25% of their stock is held by the M.I.M.Holding company of Australia but they own some 17% of MIM. ASARCO owns 52% of Southern Peru Copper which has a lot of copper but they are reinvesti their Peruvian earnings back into new mines there. Asarco has been trying to sell their Mexican Copper mine but haven't got a good offer.

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Since ASARCO'S copper costs are higher than Phelps Dodges, AR is adversely affected by the decline in the price of copper but since ASARCO sells below $20 with a $32. book and a .40¢ dividend compared to Phelps Dodge selling at with a book of $29., we prefer the discount from book. Cyprus Mines is involved in a takeover of AMAX and is also selling above book value.

Time will tell which of these companies will do the best over the years but we thought ASARCO offered us the most bang for the buck or as others might say the most promise at the price. It certainly is no growth stock but we aren't paying for growth.