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The Other Warren Buffett: Meet Walter Schloss

Recently, NewsMax Editor Christopher Ruddy met with Walter Schloss. Mr. Ruddy has provided this account exclusively to readers of Financial Intelligence Report.

Meet the other Warren Buffett.

His name is Walter Schloss, one of Warren Buffett's oldest friends.

Like Buffett, he is one of the greatest stock investors of our times.

You don't hear much about Schloss. He has flown under the radar screen for a long time and has little interest in publicity.

Of course, there has been the occasional article about him, such as the 1995 Fortune magazine article about how he and Buffett consistently beat the market in both good years and bad.

Both Buffett and Schloss had the requisite training for investment success.

During the early 1950s, they shared offices as analysts for the famous stock analyst Benjamin Graham. They have been friends since.

Like Buffett, Schloss had an illustrious career as a stock market investor.

But unlike Buffett, Schloss kept quite a low profile, quietly investing his money through the years.

Recently, I visited with Schloss in his offices at Tweedy Brown, an old-line investment-banking firm on New York's Park Avenue.

I met Schloss several years ago at an awards dinner in Washington for Accuracy in Media in which Justice Clarence Thomas was the guest of honor.

We sat at the main table with Justice Thomas and his lovely wife, and Schloss discussed how he had helped Accuracy in Media build an endowment fund then worth more than \$5 million.

Reed Irvine, chairman of Accuracy in Media at the time, then explained to us that in the mid-1970s Schloss had decided to donate \$200,000 to Accuracy in Media.

So much did Schloss like Reed Irvine's work in seeking "fair and balanced" media, he not only donated the sizable amount of money, he also invested it for Reed's group to create an endowment.



Irvine and AIM became part of Schloss's partnership investment firm, Walter and Edwin Schloss Associates.

Not three decades later, that \$200,000 grew into more than \$5 million in endowment money, just one example of how Schloss and his son Edwin helped to create terrific wealth for others.

But surprisingly, father and son decided to get out of the stock market altogether.

In May of 2001, the Schlosses decided to pull the plug on their stock investments and began liquidating their more than four-decade-old investment partnership firm.

Schloss explains to me the simple reason: The market is extremely overpriced.

Schloss argues that this is due partly to the huge amount of money now being put into equities. "There aren't enough companies" to absorb this capital, he tells me, creating what he says is an "inflation of big company share prices."

Today, Schloss believes, only about 100 large public companies can handle the liquidity needs of major pension funds, investment firms and mutual funds, so the big investment dollars are crowding into these companies. The effect is to raise the value of all other listed companies.

Schloss grabs the latest edition of Barron's to show me the current overall P/E ratio for the Standard & Poor's 500. The S&P is selling at 43 times earnings, Schloss notes.

Schloss believes it should be closer to 6-8 times earnings, based on current economic conditions. If prices were to meet what Schloss believes is the real value of the market, there would be a catastrophic market fall-off of 1929 proportions.

The realization that the market was overvalued brought Walter and his son to a crossroad.

As Schloss recalls, one day Edwin, who sits at the desk across from him, said to him, "Dad, I really can't find any more cheap stocks."

Schloss said the discussion didn't last long. He simply looked at his son and said, "At my age, let's call it a day." Schloss was then 85.

Since that fateful day in 2001, Schloss says, they've been liquidating their assets and are now down to two companies they continue to hold shares in. He would not reveal the names of the stocks because he has a rule of never sharing the names of companies that he invests in.

In fact, he tells me, he rarely, if ever, discloses his portfolio picks to his own investment partners. He has good reason not to share his portfolio picks, he says.

For one thing, he does not like to tout stocks and cause the stock price to go up based on his recommendation.

He actually wants to have his stocks fall in price so that he can buy more shares.

One of his golden rules is advice that he received from Benjamin Graham, who told him that "an intelligent investor should buy stocks like you buy groceries, not like you buy perfume."

Schloss's approach has been much like Warren Buffett's in its simplicity. It might be summed up this way:

1. Buy companies as their stock prices are falling, and sell them as their prices increase.
2. Buy secondary companies, i.e., "the struggling firms that most investors overlook." As Schloss notes, great companies are generally "not cheap enough." He thinks it takes a "strong stomach" to buy a company that's having problems. But that is the best way to find a value.
3. Once you sell a stock, forget about it.
4. Never disclose to your partners what you own.

The advice has worked well.

His partnership began in 1955 with \$100,000 and ended 47 years later with \$130 million.

Over 47 years, Walter and Edwin Schloss Associates averaged 21 percent compounded return per year.

Warren Buffett noted in a letter to his friends who had been Ben Graham analysts: "Of Walter's partnership, however, there is much to be said. Over its lifetime, it had a gross return of 21 percent compounded annually (before the general partner share) and achieved this return using only minor leverage and without ever running any risk of permanent loss of capital. The S&P delivered 11.2 percent. It's an astounding record."

At the end of such a successful stock career, Schloss has one lesson that he wants to share with his children, grandchildren and great-grandchildren: "Know that the only thing harder than making money is making it back once it's lost."

Perhaps that sums up one reason why Schloss is getting out of the market now.

In an interesting aside he made to me in his office, he said that he and his son did not wish "to have to wait 20 years for stock prices to go up again." The comment implied that he sees a big market fall-off coming, with a long bear market.

Schloss's thoughts mirror those of Sir John Templeton, who sees the coming bear market as a long one.

Another important lesson that he learned from Graham was to keep focus on a company's financials and avoid discussing the company with its management. Schloss warns not to let emotion crowd your investment judgment.

Schloss's advice sometimes differs from Warren Buffett's strategy.

For instance, Buffett tends to be a buy-and-hold investor.

Schloss does not agree with that philosophy, noting that stock prices can rise and then stagnate for a long time. Meanwhile, the investment money could have been used more profitably in finding better-valued stocks with more room for growth.

Secondly, Buffett took an active role in purchasing and managing companies, something that both Graham and Schloss would have detested.

Graham's idea of value analysis was simple: "to find companies that were selling before working capital."

As Schloss explains, this meant finding companies "whose market values were less than its current assets: cash, inventory, and receivables. To calculate this, we would determine the company's liabilities and subtract them from its current assets, and then divide by what was left by the number of shares outstanding."

Schloss and son Edwin consistently made fortunes following the principles of value investing. They do not believe the current market is the place for reliable returns. Their wisdom should be noted by every investor. ■

Finding Values in REITs

With real estate prices soaring throughout the U.S., investing in real estate has become a national past-time.

Despite significant declines in the real estate sector and

REITs in April (see below), long-term real estate will undoubtedly remain "a golden path to wealth" — as it has throughout history.

In this issue of FIR, we will examine one popular way to "invest in real estate without owning any" — Real Estate Investment Trusts (REITs).

History of REITs

REITs were first created in the 1880s. They enabled investors to avoid double taxation since trusts were then not taxed at the corporate rate so long as income was distributed to beneficiaries.

In the 1930s, this tax advantage was removed, subjecting REIT income to corporate and then individual income tax. However, corporate tax on REIT income was removed in 1960 by new legislation signed by President Eisenhower.

REITs obtained additional freedom with the passage of the Tax Reform Act of 1986 which allowed REITs to directly manage properties, and additional legislation enacted in 1993, which allowed pension funds to invest in REITs.

Today there are over 300 publicly-traded REITs with some \$350 billion in assets. Shares of about 70% can be purchased on the national stock exchanges.

Interest in REITs has been growing fast during the past few years. In 2003, \$4.5 billion in new investment went into real estate mutual funds, surpassing the previous record of \$4.1 billion in 1997. (Source: AMG Data Services.)

Soaring Returns

Returns from REITs are also soaring. According to www.InvestInReits.com, between 1972 and 2002, REITs outperformed the major index stocks. Here are comparative figures:

Compound Annual Returns in Percent 1972-2002

| | |
|-----------------------------------|--------|
| Dow Jones Industrials | 7.26% |
| Nasdaq Composite | 7.97% |
| S&P 500 | 10.68% |
| Equity REITs (publicly-traded) | 12.35% |

All data is derived from, and applies only to, publicly traded REITs

In 2003, REITs did even better, rising 17% PLUS pay-