Ruane, Cunniff & Goldfarb Investor Day[1]

May 18, 2007 – New York, New York

Bob Goldfarb:

Good morning and welcome to our investor day. We are going to follow the same format as we did last year, and we're going to try to adhere to the same ground rules. Those are, first, we're going to do just Q&A, no speeches, no talks. And we'll try to answer your questions until 12:30. We'll stay around for about half an hour afterward, but we need to vacate the room by one o'clock.

Second, if you look at our 13F filings with the SEC, you'll see that we own by my count stock in at least 222 companies. That means that there's a chance that any one person in this room might have a question about any one of those 222 companies or their stocks. In order to keep this meeting focused on the stocks that comprise the greatest percentage of most of your portfolios, we intend today, as we did last year, to answer only questions about the core stocks we hold, which are the stocks that are in Sequoia Fund. Because we know some clients with privately managed portfolios won't know which stocks are in Sequoia, we've made available to everyone here today the most recent annual report of Sequoia, which lists all of its holdings as of December 31st of last year. If a stock is not listed in the Sequoia annual report, we won't comment on it today. We ask that you respect that ground rule.

Third, as always, if there are any journalists or Internet bloggers in attendance, we ask that this meeting be off the record. We prepare a transcript of the meeting for our clients and shareholders, and we prefer that all of our shareholders and clients receive the transcript of our comments at the same time and in full. We don't want to inhibit your questions, and we encourage you to ask about any non-stock specific issues you feel are important. But we must repeat that we won't comment on any stocks that are not listed in the Sequoia report with the exception of stocks that have been sold out of Sequoia in the last year.

Before we start, I'd like to introduce our team. On the left is Greg Steinmetz. Next to him is Jon Brandt, then David Poppe who is the president of our firm and co-manager of Sequoia. Next to David is Rick Cunniff, whom I think most of you recognize and who is our co-founder. To my right is Greg Alexander, and to Greg's right is Joe Quinones, who runs the operations side of our firm as well as that of Sequoia.

Finally, I would like to introduce the rest of our team that's seated in the front of the room. First is John Harris; next are Jake Hennemuth, Arman Kline, Tom Mialkos, Scott O'Connell, Terence Paré, and Chase Sheridan. Not with us today is Girish Bhakoo, who is traveling on research business. I'm looking at the transcript of last year's meeting, and Girish was also traveling on research business a year ago. But one of these third Fridays in May, you will have the pleasure of meeting him and listening to him. Finally, I would like to introduce Jon Gross, who is our director of client services. With that, we're ready for your questions.

Question:

A couple years ago, Mr. Ruane thought that Mr. Buffett was still at the top of his game. Do you still feel that way?

Bob Goldfarb:

Gosh, I just saw him at the Berkshire meeting a couple of weeks ago, and he's absolutely at the top of his game. Charlie Munger contends, and I wouldn't argue, that his game has actually improved and that he is at an even higher level. Johnny, do you have anything to add?

Jon Brandt:

I would echo Bob's thoughts. I wish I could think that clearly. His ability to put things into analogies and distill thoughts is tremendous. I don't think the issue is whether he is or isn't at the top of his game. It's just running such a large company with so much money to invest makes it hard to compound at a high rate. But his talents, I wouldn't ... I think he's as great as ever.

Question:

At the Berkshire meeting, a question was asked of Buffett and Munger that related to their investment in the railroad industry. They talked about the relative competitive advantages today in that industry vis-a-vis trucking. I saw that Sequoia purchased Knight Transportation, and I'm just wondering in light

[1] Remarks have been edited for clarity.

of those comments on the railroad versus the trucking industry, what your views are on Knight as an investment.

Greg Steinmetz:

First, let me address the railroad question. Knight competes in what they call the regional haul market. Railroads are really most efficient when you are traveling cross-country. The savings for railroads versus trucks comes in the fuel. It costs a lot more to ship goods by truck than by rail. But the advantage diminishes as the distances decrease because you have to worry about getting from the railroad depot to the last point and unloading the boxes and transferring them to something else and all the rest.

Talking about Knight … trucking is on the face of it a pretty bad business. Anyone can go out and buy a truck and advertise their services. What we like about Knight is that Knight does it better. Average trucking companies don't earn much money. It's so competitive on pricing that they are lucky to make about a nickel for every dollar of revenue they generate. Knight finds a way to make 20 cents for every dollar of revenue it takes in. It's able to do that because its people just work a lot harder.

They are very productive and they are very discriminating about which business they accept. You can do that if you're not a very large player. It's a $160 billion market out there, and Knight's revenues are about $500 million or so. It's very tiny. It can be discriminating in deciding which freight it takes. Knight has at last count 26 little terminals all over the country. And the folks in those terminals are aggressively looking for freight that meets their criteria. So far, they've been able to find it and we think they will continue to find it in the years ahead. So it should grow nicely.

Bob Goldfarb:

I'd add one thing. As Greg said, the truckers that compete with the railroads have longer hauls than Knight does. But there has been a second-order effect, which is that a number of those trucks that were running those long hauls across the country have been diverted to the shorter lanes. So they compete with Knight in that regard. How effectively they will compete is the question.

Question:

You mentioned Bed, Bath & Beyond last year. Aside from the great management and their great decentralized operations, there are a few things, as I've looked at them, that I would like to ask about. One is their inventory turns are low — 2.5 — but they've always been that. If you compare that to some of your other retailers, that's a lot fewer. I think Costco might have over ten.

The other question I have is they just bought for $86 million somewhere between 300,000 and 400,000 square feet of stores total — that's eight of them — from their founder's sons. Would you comment on that? And do you think they are at all possibly showing good numbers because of aggressiveness, potential aggressiveness in their accounting?

John Harris:

There are a few questions there. One is Bed, Bath's inventory turns; I suppose they are lower than those of most other retailers we own. But I'd say a couple of things. First of all, the company earns an extraordinarily high return on capital, among the highest we've ever seen in retail. And part of that is because it uses a very small amount of working capital. So the inventory may not turn all that quickly, but it's in good part financed by the vendors. Not all the inventory, but a decent portion of the inventory, is not that perishable. If you've got a plain down comforter, a plain down comforter is sort of a plain down comforter. The working capital situation at Bed, Bath & Beyond is not something that keeps us up at night.

You also asked about the purchase of buybuy BABY. Yes, they bought it from the founder's sons, and I think it's an example of something we were aware of when we made the investment, which is that they are an insular group. I think that there are benefits and drawbacks to that. I think that, by and large, the insularity of the organization has been to the better and not the worse. But they do run it in some respects like a private business.

Bob has remarked in the past, and I think probably correctly, that it's a company that did not have to go public. But setting that aside for a second, I don't think they made a dumb acquisition. The business of buybuy BABY is very much related to, adjacent to, Bed, Bath's business. The size of the stores and the nature of the stores that those guys were operating are similar in many ways to the stores that Bed, Bath & Beyond runs.

I think frankly we're still learning about buybuy BABY. But I would say that these fellows who founded it come from pretty good retail stock. So I am inclined to give them the benefit of the doubt until we learn more. They didn't spend a lot on it and if it works out, there's potentially very large upside for them. If it doesn't, there's not a lot of downside. I think that is a theme that you see recurring with these guys … they are quite conservative and while they have made acquisitions in the past and they may continue to make acquisitions, they don't spend a lot of money and they seem both from their actions and their words to be very aware of the downside in anything that they do and try to protect themselves appropriately.

As far as the accounting goes, they did have the options back-dating issue which we're aware of and which we weren't thrilled about, but which did not in the end change our view of the investment. Aside from that, I am not really aware of any other accounting there that would be concerning. I would just say again that by and large they have run the business in what I would say is a very conservative way. I'm not all that worried about the accounting. The business generates a very large amount of free cash every year, and that would seem to suggest that the earnings are what the earnings are.

Question:

In some portfolios this year, you've been reducing the position in Berkshire. Why?

Bob Goldfarb:

I think that was more of a 2006 event than a 2007. We just think that it's more right-sized at its present level, than it was, say, at the percentage of the portfolio that it accounted for at the end of 2005. When you have 25 percent of your money in something, that's a pretty big holding. And it's one we're very comfortable with. Also, in some cases, we needed funds to pay for stocks we bought in 2006 such as Bed, Bath & Beyond, and we used Berkshire as a source of funds.

Question:

A follow-up question to that. Knowing what you know about the investment industry, and in that I reluctantly include the hedge funds and private equity funds, how might you think that Warren Buffett would meet the challenge of creating some sort of compensation system for the people he's bringing on? He's looking, as we know, for an investment czar of sorts. What is he going to have to think about in terms of creating a compensation arrangement, given the competitive environment currently in your industry?

Jon Brandt:

I think he's kind of outlined how he would pay that person or persons, and I think it's going to be a similar deal to that which Plaza Investments, which runs the Geico portfolio, has. I don't know the exact terms but I think it's something like ten percent of incentive above the S&P. You are absolutely right, if you're implying that that's less than somebody can make by starting and running a hedge fund with a two-and-twenty-type of compensation system. He's not going to get somebody who is looking to maximize his or her wealth.

I think he's gotten about a thousand applications, which suggests that there is a market. Some of them are jokes, obviously. But not everybody in the world who runs money is looking to maximize their wealth. There are some people for whom the prestige of working for Berkshire and the insularity from the quarterly pressure to perform might be quite appealing. So I would say there's a certain segment of the market that his compensation plan will not appeal to. And I think there's a certain segment of the market to which it will appeal. I think even if it were three people, it's a $100 billion portfolio, and if you run $30 billion and you make three or four points more than the S&P, or even two points more than the S&P, I think you can earn a pretty good living.

Greg Alexander:

Also, it might be fun working with Warren. And for some people the idea that they are making a lot of money for ultimately a charity, the Gates Foundation, might be satisfying too. I don't know what percent of capable investment managers that would be, but I would hope there's some out there.

Bob Goldfarb:

Some of you may have seen the article in the *Wall Street Journal* in which he was talking about the kind of person he'd like to hire. He mentioned Bill Ruane as that kind of person. My thought was that, number one, he was thinking about someone with the same analytical capabilities that Bill had, which were terrific. But beyond that, I think one quality in Bill, among many that Warren admired, that he found unusual for this business was the total absence of greed. I think someone who wants to make billions of dollars is probably not well suited for that job.

Question:

I'd like to talk about Walgreen and how you believe the model has evolved in 2006 first on the generic side with the $4 program at Wal-Mart. Secondly, the merger between CVS and Caremark … is there any threat there to Walgreen's business?

David Poppe:

The $4 generic issue was obviously pretty alarming when it came out. But the interesting early result is that there has been basically no impact on either Walgreen or CVS, or anybody else in the marketplace. Wal-Mart and, to a lesser extent, Target make certain claims about what it's done for their business. But if you are in the Wal-Mart stores, the pharmacy is not very busy. So that's part of it; that's just anecdotal. But you walk into the pharmacy at two o'clock in the afternoon in pretty much any Wal-Mart anywhere, and you walk into a Walgreen pretty much anywhere, and there's a difference in how busy it really is.

So I question a little bit how wonderful the impact has been for them. While the $4 generics are important, they cover a small slice of the total number of prescriptions that a typical family or consumer would need to use in a year. I think for people with insurance who are paying $5 co-pays on those same drugs, there's also a very limited benefit to changing your shopping patterns to go to a new store.

So one, there's been no discernable impact so far. It's hard for me to tell that it's done much for Wal-Mart because it really hasn't lifted Wal-Mart's front store comps at all. And part of the original idea behind doing the plan is you would create more traffic in your store. You would lose money, perhaps, on these generics. But you would have more front end traffic. Well, the front end comp at Wal-Mart, unfortunately, has done zero in the nine months since they brought the program out.

So it's hard to see a real impact. I think what people worry about is if Wal-Mart and others tried to extend these loss leader prices to all the generic drugs that they sell. But that gets very tricky because not all generics cost $1 or $2 to buy. Some of them are more expensive, and it would be very difficult to extend it without losing hundreds of millions of dollars of gross profit, which I'm not sure Wal-Mart is in a position to want to do. So I think the impact from $4 generics has been pretty minimal. You see Walgreen's prescription units per store going up. The five-year trend has been about a six percent increase in units filled every year, and that continues to be six percent. So it's difficult to see an impact.

CVS/Caremark I think probably is more worrisome if you are a Walgreen's shareholder because I think CVS/Caremark has an excellent opportunity to essentially have a closed loop system: if you are a Caremark PBM patient, you will be incentivized to fill all your prescriptions either through Caremark by mail or at CVS stores. CVS is in a very good position to reward people for doing that with front end coupons, coupons for cosmetics and other merchandise, and possibly even discounts on what you pay for the drugs. So that is definitely something to watch.

I can say that over a long period of years of talking with them and dealing with them, Walgreen is a pretty straightforward company, and they think there are as many negatives as positives to this. I'm not sure how that's all going to shake out.

But I would say Caremark has something like a 15 percent market share of PBM customers and CVS has a 15 percent share of the prescriptions that they fill at retail. If you think about the overlap there, that's probably two to three percent of people who are Caremark customers who also fill their prescriptions at CVS. You can overstate the potential impact a little bit by worrying about this. It's not a closed loop that serves half the US population. It's a closed loop that serves two or three percent of the US population.

So we're watching it closely. I think it's potentially negative for all the other companies that fill prescriptions if one PBM and drugstore combination can offer you a very lucrative incentive to stay in their system. But closed systems that other people have tried as joint venture-type operations haven't worked. So that's another thing that I think will be a challenge for CVS … to make that work. There is no guarantee that they will be able to make that work. Walgreen continues to perform very, very well both in the front end — which tells you the traffic is very good — and in the pharmacy. The pace of growth has accelerated this year, not decelerated, which we feel positive about.

Question:

I just wanted to know what attracted you to make your investment in MasterCard and whether that implies that you think it's a superior business to American Express.

John Harris:

I'm going to let Tom do most of the talking here because he knows more about it than I do. But very briefly, we made our investment in MasterCard because we thought it was an exceptional and unusual franchise. Because of concerns about litigation — which were valid concerns, but potentially overblown at the time of the offering — it was available at a very reasonable price.

Now, having said that, I think we all wish we had bought more. Although it's easy to say that with the stock up, I don't know, three, three and a half times from where we bought it. But we do think it's a very good business. As to whether it is a better business than American Express or not, I think you could have an argument about that. But I don't really know that it's relevant. I think it is just enough to say that they are both extremely good businesses for different reasons. But I am going to pass it over to the expert.

Tom Mialkos:

Overall, electronic payments are growing extremely fast both in the US and worldwide. In the US, electronic payments account for 60 percent of the transactions and are taking share from cash and checks. Worldwide, electronic payments have a lower share, but they are growing faster. It's fair to say that MasterCard is like a royalty on worldwide consumption. It's actually geared because electronic payments are also taking share from cash and checks.

MasterCard is a slightly different business from American Express. American Express is in the issuing business, which means that they physically issue the card to the customer. Also they acquire cardholders and merchants, and they are the payment network in the middle, whereas MasterCard is only the payment network in the middle. In effect, MasterCard's customers are the banks.

With these customers, MasterCard is literally in a duopoly position in most markets with Visa. There's some competition from American Express in this market in the US, Australia, and a few other markets. But it's fair to say that the traditional decision for most banks is whether to pick MasterCard or Visa. So in that respect, MasterCard is in a very good position, having only one main competitor. There are very few substitutes for the banks. There's no third payment association that's viable, especially no third payment association that has an international network. If you have a MasterCard or Visa, you can make transactions all over the world, and that's a very appealing aspect for consumers.

The economics of the business are tremendous. As the network in the middle, there's very little capital employed in the business. I would say most of the capital is really sitting in a data center in St. Louis. Most of the transactions actually go through the data center in St. Louis. It's also fair to say that an incremental transaction that goes over the MasterCard network has basically no marginal cost. Most of the incremental cost that comes from increasing the volumes springs from the decision on the part of MasterCard of how much to increase advertising and how much to increase staffing expenses.

We made the investment because the electronic payments through MasterCard are growing very quickly. We also thought that there's tremendous operating leverage in the business because an incremental transaction costs so little. Also, MasterCard spends a tremendous amount on advertising and marketing, over $1 billion. That advertising spending is not growing at the same rate as revenues, which means that there's operating leverage and the margins are expanding. At the time of the investment, we were quite optimistic about how much the margins could expand. But we didn't quite expect the margins to expand as quickly as they have.

One of the reasons why we thought about a certain rate of margin expansion was because MasterCard cannot price their transactions too much higher than Visa. So in a sense in their pricing and in the amount that they spend also on advertising, they are somewhat related to Visa. This was our initial concern — that they might be limited in terms of the expansion of the operating margin by Visa.

As it turns out, they managed to do it very quickly. So as payments, as volumes grew considerably over the past year, there was very little incremental increase in terms of advertising. Also, we were quite optimistic about the pricing power because it's a duopoly situation. There are certain pockets where MasterCard is able to raise prices, and as it turned out MasterCard raised prices tremendously in terms of the international transactions. International transactions are basically at this point the most profitable part of the business, operating at a higher margin than the domestic transactions.

Also, the business is global, as I mentioned. Right now roughly half of the transactions are outside the US. Transactions outside the US are growing at a rate that is faster than that in the United States. So it's a global business that's basically recession proof because even if there's a dip in global growth, the share of payments is still growing. So the runway is tremendous and it just so happens that the management of MasterCard executed really well. They managed to increase the operating leverage much quicker than we had expected. And we got it at a very good price.

Bob Goldfarb:

I'd just say that I've been to a lot of road shows in more than 30 years. But I've never been to a better attended road show than MasterCard's. And what strikes me in retrospect is that here you have a company and a stock that thousands of investors were looking at and valuing. Within less than a year, they revalued it at a level that's three times the valuation that they thought it warranted at the time of the initial offering. It's somewhat like Google in that sense. Google had lots of people valuing it at a price on the offering and revaluing it at a much, much higher price within a fairly short period of time. That said, we should have followed John and Tom's advice and been much more aggressive at prices in the forties, subsequent to the initial offering.

Greg Alexander:

I'll just say, it's amazing what happens when you have ... it's not really a mutual company, but a company that was not necessarily run to maximize profits. It goes public, and suddenly they have a ton of interested investors and the managers have stock options. It's amazing how that works. Secondly, in answer directly to the question — American Express versus MasterCard — we do actually own ... Jon, how many billion dollars of American Express does Berkshire own?

Jon Brandt:

It's about ten.

Greg Alexander:

It's about ten. So that would be about six percent of 25, a point and a half ... so we might actually have about a point and a half of each of them; so we might actually have three percent. So it's not an either/or.

Then lastly I just would add, it's one of the oddest pieces of accounting I've seen in a public company. I probably shouldn't say this because it's obviously GAAP. But MasterCard does the strangest thing. Their customers are banks and MasterCard's pricing is such that if you do a certain amount of volume with it every year, you hit a break-point and they give you a slightly lower fee. So every year until this last fourth quarter, they lost money in the fourth quarter because they would accrue at the higher fee during the year. And then sometime in the fourth quarter, the banks' retailers and customers would get the charges to the level where they hit the break-point. Then in the fourth quarter, MasterCard's revenue would plummet because they had ... I guess … are they giving a discount on the prior nine months worth of sales? It must catch up somehow.

So it baffles me because they know the approximate volume of the transactions moving through the banks. The charges don't go down every year so how can they not predict that they are going to hit the break-point in the fourth quarter? I don't understand it, but anyway if anyone knows the answer to that, please raise your hand.

Question:

Over the last four years, Costco has gone from $28 to $54, and our position is pretty minute. As a shopper, originally from the Seattle area, Costco is a great company and I'm wondering why you don't own more of it.

Bob Goldfarb:

We should.

David Poppe:

We made a conscious decision. Costco was $27-$28 a few years ago. I think I've spoken to this in other meetings — we were very discouraged that they never got margin improvement. It's really the only retailer I can think of — there's not many out there that comp the way Costco comps — but every year the same store sales go up five, six, seven, eight percent. It's really an amazing store. The shopper loves Costco. The sales per store go up by really fairly enormous levels every year.

The margins in the store are flat or go down every year. So that's also unusual. Most stores, if they are getting same store sales increases of five or six percent, the margins are going up just because you're getting leverage on your fixed costs. Costco doesn't do that — they tend to give pretty much everything back to the consumer and/or the employees.

We made a decision that we didn't think they would improve margins. Obviously, implicit in our decision is we weren't sure they could continue to do these comp store sales at six, seven percent forever. In fact, they did. They've comped at an amazing level and we just got that wrong. And we weren't sure that there was room for as many additional successful clubs as turned out to be the case.

Question:

Do you count the increase in the membership fees as a margin increase?

David Poppe:

I think even if you include those, the margins stay ... if you take those out, the margins in the store are actually going down. The margin in the store is maybe one percent and the increase in the membership fees is what keeps the margins at more like three percent. Costco also made a commitment that they were going to raise margins to four percent over time, and there just doesn't seem to be any real progress towards meeting that goal, so far.

That used to bother me, and I thought that mattered a lot, but again, if you're increasing your sales per store by seven percent per year, you can do what you want, and we should leave them alone. That's the story, that's what happened. That was the decision-making process, and that's why there's so little Costco in the fund.

Question:

I guess my question is not just because of the great share price, but if you've got people that love working there, and you've got people that love shopping there, something good is going to happen long term, more often than not.

David Poppe:

I agree with that; you're right.

Question:

Would you please discuss Progressive and your decision to reduce the position there?

Bob Goldfarb:

I would refer you to the discussion in the annual report. Have you read that? We did our best to explain it in the annual report. If after reading that you still have questions, please ask me.

Question:

Porsche seems to be one of the few international companies that you own. I'm curious about a business that we read a lot of bad news about. It's capital intensive and there are probably high labor rates in Germany. What's the future of that? What about the international currency position, the hedge?

Arman Kline:

Porsche has done quite well. It's not really like a typical car company in our mind. If you look at it, it has a different structure. Most of its cars are built by subcontractors. Now, the Volkswagen investment has proven that this model may not work long term. We think of it as essentially an investment in production.

However, even taking that into account, Porsche's returns are quite high. It's still 20 percent plus return on assets. I would say in terms of the currency question for Porsche, obviously if you are producing in euros and you are selling in dollars, and a little over a third of sales are in dollars, that's a problem. The company has solved that issue with hedging, so far. Hedging only works so long. If you buy hedges today at $1.30 and you are at $1.50 in three years, and your hedges run out, that stops helping. And that's definitely an issue with Porsche.

That said, if they keep growing their business like they have, the US is becoming a little smaller portion of that business as emerging markets grow — sales in China and Russia, though small, are doubling or tripling each year. And we feel comfortable that this business should continue to grow. They have some new models coming out, and they have refreshed some models, and we feel pretty good about that.

David Poppe:

You can go back and look at the Porsche financial statements, and it's a mid-teens operating margin business with the dollar and the euro closer to one-for-one. The core profitability of making automobiles for them is much higher than it is for Toyota or BMW or other auto makers. The margins come because of premium pricing for these cars. I think 15 to 17 percent margins are normalized margins with the currencies at parity.

So I think the reason we got to buy it in 2005 and 2006 is because there was a lot of fear that the profitability was all hedging. But to me it was a fairly simple thing to look at the years where the currencies are at parity and see that the inherent profitability of the business is terrific compared to any other car company. It's a luxury brand. The world is creating a lot of millionaires and billionaires right now in developing markets, and millionaires and billionaires like to own Porsches, Rolexes, and Tiffany and Cartier. Those should all be pretty decent businesses, as long as we're creating so much wealth in developing markets.

I think one of your questions was how much of it relies on emerging markets. I think that some of Porsche's growth going forward does rely on emerging markets, but they are getting that. There's tremendous demand for these cars in the Middle East and the Far East.

Question:

With the changing markets today, how are you going to protect or how are you thinking of protecting Sequoia Fund? With the advantages of the hedge funds, derivatives trading and so on?

Bob Goldfarb:

I'm not sure what the direct impact of derivatives trading would be on Sequoia. If you could elaborate on it, I'll respond to that. In terms of the hedge funds, I would say that hedge funds come in many, many forms and a number of them invest in instruments that we don't invest in; so those don't affect us.

To the extent that you're talking about long-only hedge funds or even long-short hedge funds whose primary investment is in publicly traded equities, that is additional competition that has a very different fee structure from ours. I think the question becomes to what extent does that fee structure attract additional equity buyers with unusual talent and expertise? My guess is that if hedge funds didn't exist, hypothetically, most of those people would probably still be investing in equities. A lot of them were running mutual funds, and now they are running hedge funds.

So in the end, I don't know how much incremental capacity or demand for publicly traded common equities has been added by hedge funds. Without knowing to what extent they are substitutes for other structures that invest in publicly traded equities, it's hard to answer that question.

Greg Alexander:

I agree with you on that one. It's the same universe of people that would be there anyway. I actually worry more about what you didn't ask about, private equity firms. I feel like they are actually in some ways more serious competition. Because to the extent that our business is buying wonderful companies whose prices are less than their present value, literally we hear … half the CEOs whom we've talked to in the last few months tell us that they are constantly getting phone calls from private equity people. I sometimes worry they are going to take away the stock market — I mean that as a joke. Obviously they will take companies public again, and they sell them to each other and so forth. But to the extent that we have the private equity firms keeping the stocks of companies from going down to irrationally low levels and to the extent to which when they take them public again the companies have been run at the very maximum margins that they can be and their capital structure is levered as maximally — or optimally as they might say it — as they can be, that actually worries me more. Actually, that would worry me equally if I were a hedge fund.

David Poppe:

I think the only thing I would say about that, getting to your question about derivatives, is if you are trying to own really high quality companies run by good people with fairly clean accounting, you should do okay during times when people get anxious and reassess how much risk they are willing to tolerate in their portfolios. I think over time, we've tended to do pretty well in periods of turbulence.

So if you ask what we are doing to insulate Sequoia from turbulence, I think it's trying to buy the best quality companies with the cleanest accounting that you can find.

Question:

Is it fair to say that our portfolio is not leveraged towards international growth? It would seem that most investment firms are increasing their percentage of international holdings to an extent greater than we are.

Bob Goldfarb:

It's very fair to say that. It's not the byproduct of a conscious decision on our part to invest or not invest in companies that derive a fair percentage of their profits from abroad. It's more the byproduct of a decision to buy stocks on a micro basis, company by company, stock by stock. But we're certainly not averse to having a lot more companies that would be positioned in the way you describe.

Question:

Do you think that Brown & Brown still has a lot of room to grow?

Jon Brandt:

Yes. They are a relatively small company in the context of their industry. They aren't growing right now for several reasons. Brown & Brown is an insurance broker, and their commissions are largely determined by the size of the subject premiums, which they are writing both on behalf of their customers and on behalf of insurance companies.

Right now, premium rates are going down because insurance companies are earning record-wide underwriting margins. So rates are dropping in a lot of the key areas in which they broker insurance — worker's comp, general liability — all the kinds of insurance that a small business would buy. So that's pressuring their growth.

Secondly, their growth is being pressured by changes that are going on in the Florida insurance market. We've had a massive state intervention led by a Republican governor down there, newly-elected Governor Crist. And he is responding to public disaffection with skyrocketing homeowners rates and also some rates on commercial businesses, property rates. He is trying to suppress rates, and he is basically giving a state subsidy.

In the long run, I don't know if that is a sustainable plan. I don't think those rates should have been going down. But they are going down because of government intervention. And that hurts Brown & Brown's revenues and profits and growth. Also, they are in a couple of businesses where they act as managing general agents, which means that even though they aren't taking the underwriting risk, their volume is more dependent on being able to meet a price.

Whereas in general liability or worker's comp, if the state were selling the policy, Brown & Brown could still get the business. They might get a lower commission on a slightly lower premium but in one of their biggest business units, which is called Florida Intercoastal Underwriters, they are writing on behalf of a British insurance company which is providing the coverage. If the state undercuts the British insurance company, they don't get to write any of the business.

There are a couple businesses like that, where they are being dis-intermediated. I would like to think it's a virtual certainty that the state intervention is going to end in tears for the state, and Brown & Brown would get the business back and the premiums would go up.

Thirdly, private equity has impacted their growth by acquisition. Brown & Brown has had a lot of success buying brokers at reasonable prices, but in 2006 there was more competition for these acquisitions. Nevertheless, they are definitely a very small part of an industry that is still in the early stages of consolidation. So they should be able to grow. They are in a rough patch right now. I think there will be other times when the external environment is more propitious for them to grow.

Bob Goldfarb:

I would just say that most of their growth over the years has come from acquisitions. And the risk for any enterprise that depends on acquisitions for growth is that if the going rate for acquisitions increases, then that's going to change the economics. Brown & Brown has had remarkable economics heretofore, when you think about all the goodwill that they have acquired. The kinds of returns on equity that they have ... you very rarely see in businesses that are largely the result of dozens of acquisitions.

Question:

I'd like to ask a question about the Sequoia Fund and Ruane, Cunniff, and Goldfarb 30 years from now. In the past 20 years, we've seen a number of management firms be sold. A lot of us in this room are planning in terms of our children and our grandchildren. You have this incredible culture. So would you speak to what your expectation would be about the firm and the fund in generations to come? Do you think you will still be able to retain that culture as you go through some of these succession issues?

Bob Goldfarb:

Thank you. I absolutely believe that we will. We're fortunate to have a good number of people whom you see here today who are a lot younger than Rick and me, and they buy into the culture. And I believe they love the culture. What reason would we have to alter it?

Question:

As I have understood it, with some management firms, there's this question of the capitalization and how the younger people are able to buy in. So in terms of that, would you see any concerns over the next 10 or 15 years?

Bob Goldfarb:

Zero. Bill and Rick were good enough to set up a structure that is designed to facilitate the transfer of ownership. And that favors the perpetuation of the firm as an independent entity. So it's not something I worry about at all.

Greg Alexander:

In response to your question about other management firms selling out, there's no way we would ever sell out. Frankly, even if we wanted to, which we do not, there's no price that any irrational, or even semi-irrational, buyer would be willing to pay that we would ever consider worth selling out for. Am I stating that correctly, Bob?

Bob Goldfarb:

There's no price. It's not a question for us.

Question:

You talk in your annual report about the impact of the housing mess on Mohawk. I was wondering if you could talk about the impact of the subprime market on some of your other portfolio companies, and the housing market on the retail side, for example.

Bob Goldfarb:

It's clearly impacted Mohawk the most because it's far and away the largest holding that's primarily housing-related. For Mohawk itself, the builder market is not a big part of their business. They clearly saw the downturn coming in new construction, and we were expecting that part of their business to suffer, as it has. What they weren't expecting, and maybe they should have, was that the sale of replacement carpet in the residential market would decline as much as it has.

Some of that is directly tied to housing. Some of it may be indirectly tied in the sense that a lot of big ticket consumer durable purchasing has been extremely weak whether housing-related or not. Boats have been weak, everything it seems except big screen TVs. Other than that, Lowe's is clearly affected. When we bought the stock last year, we knew it. The stocks of retailers in general were depressed at that time, and that's why we bought several of them. But for Lowe's, there were two factors: one was concerns about consumer spending in general and two, the impact from the building and remodeling slowdown.

Terence Paré:

I would echo everything that Bob said, as far as Mohawk is concerned. One thing I'd add, though, is that clearly the management there was expecting historical patterns to repeat themselves and it just didn't work out that way this time partly because the replacement business, which is so important to them, depends on the confidence that consumers have in the economic outlook. So when people got worried about housing and what was happening to the prices of their houses, the working hypothesis is that they lost the will to fix up the house that they were going to keep rather than sell.

So it was kind of a secondary effect from the subprime lending problem and the slowdown in housing sales overall. In the context of the history of the company, usually when housing sales slowed down or housing turnover went down, replacement business held up. And that just didn't happen. Nobody really — at least at Mohawk — was expecting that strong of a secondary effect.

But Mohawk has done pretty well despite the slowdown in housing because of the acquisitions the company has done in the laminate business, for instance. So it would have been nice if people were replacing carpets a little bit more. But so far, I think we're doing okay.

Bob Goldfarb:

Given what we said, there's somewhat of a disconnect between how we're talking about Mohawk and the numbers they've been reporting, which have been just fine. Some of it has come from terrific profits from the Unilin acquisition. They have also done a very good job with costs so that if you looked just at the earnings per share that Mohawk's been reporting, I'm not sure that you would think that there was much of downturn in housing at all.

Jon Brandt:

Berkshire has some building products businesses and its majority-owned subsidiary, Mid-American, has a real estate brokerage outfit. So there's some exposure there, but I would estimate that the total exposure may be around ten percent of Berkshire's earnings. There's some ... within Berkshire's building products piece, some of those revenues and earnings are derived from residential as opposed to non-residential construction.

Bob Goldfarb:

Johnny mentioned Berkshire, and I would just add that Mohawk's principal competitor is owned by Berkshire. Shaw's earnings were down significantly in the first quarter, and we'd expect more of the same as the year progresses.

Question:

Back in the late nineties, Sequoia studiously avoided investment in technology, for which we are very thankful. How about energy? Berkshire's taken some steps in energy, and I don't see that Sequoia has. What are your thoughts about some investment in the broad field of energy?

David Poppe:

We've looked at a few. We don't have expertise in the area. You could argue that in the 2004 time period when some of these were really quite cheap in hindsight, we didn't have a view on long term $60-a-barrel of oil. We just didn't think about it one way or the other. Then we've turned out to have, at least medium term, $60-a-barrel oil. It's hurt us in terms of having the wrong macro view.

We looked at a few things that I guess I probably shouldn't talk about because we could look at them again one day. We didn't feel we had great expertise differentiating one oil company from another. It's extremely important to be able to figure out who is going to have the lowest finding and development costs over time. We just didn't feel we had expertise there.

Since we didn't have a strong view on expensive oil long term, we felt we didn't need to make those investments. And hindsight is 20/20. I suppose you could argue that this was a mistake. But I think everybody in the room knows that we make no effort to be diversified.

We're trying to find great companies that we can understand. In this particular instance, we ended up missing out on what's been an extremely profitable, three, three and a half years for energy companies.

Greg Alexander:

I would just add, I think we probably do know which are the really good ones and less good. But as a firm, we just don't like guessing. I remember when I first joined, Ruane, Cunniff, which was 22 years ago, if that's possible, it seems like yesterday. But I remember I was very enthusiastic about this one company that had just gone public. I was very excited by it.

I went into Rick Cunniff's office. He was pleased that I was that excited about something. He read it and he came back the next day and said, "Well, from what I can tell you, the revenues are pretty much of an estimate. The expenses are an estimate. The loss reserves are an estimate. And the balance sheet and book value are an estimate." It actually was quite a good stock for a number of years before it suddenly went bankrupt.

So let's say that we do know or have a pretty good guess as to which are the good oil and gas companies, but when it comes to deciding whether we are going to buy them, the thing that's the guess is the revenue. We don't know what the revenue is going to be. As a firm, you know that our culture is such that we're not going to guess that oil and gas prices are as high as other people who are more comfortable making guesses. So we're never going to win the competition to end up owning things like that, probably.

Question:

I'm speaking of a profit-sharing plan that has more securities in it than Sequoia and that you managed for us extremely well over the years. I've noticed in the last couple, three years that the number of stocks, not necessarily by valuation, that are in retail has increased a lot. Excluding Berkshire, I think it's something like a little bit more than a third of the stocks in the portfolio are retail stocks. I wondered if you could just comment on the thinking that's driven you towards a greater number of retail investments than you've had historically.

David Poppe:

I'll talk about it for a minute and I'll let Bob address the larger philosophical issue. You're right that a third of the companies are retailers, but they represent just over twenty percent of the assets. Part of it is, to the extent I'm involved in it, I have a preference for a tactile business that I can see and feel and understand what the competitive advantages are. I feel pretty comfortable in several industries, and retail would be one of them.

I think there have been times in the past when the firm was heavily biased towards financials. But I think the reason was because they were cheaper. In some cases in the last few years, it has seemed to us that really top flight retailers have traded at very, very reasonable valuations. So since we feel comfortable that we understand what the competitive advantages are, we feel we have some ... I don't know if we ourselves have a competitive advantage, but we have some expertise in the area. There's just a comfort level. I think the retailers have mostly done pretty well.

I don't think there's a big macro view on the consumer, nearly as much as we think we understand how well run these businesses are and what a reasonable growth rate is for the next three to five years. And they have seemed to be very reasonably priced. It's as simple as that. There's not a macro view on the consumer.

Jon Brandt:

It's kind of the other side of the coin of our answer on energy. It's an industry which we're more familiar with and feel more comfortable making decisions about who the winners are. Like David said, I don't think it's a macro bet on the industry, that we think it's the best industry out there. It's just that we can do the analysis better.

Bob Goldfarb:

I'd also say that it's an enormous industry. So that means there are a lot of companies out there. It's also an industry where there are a lot of niches. And because there are so many niches, you have many best-of-breed companies. That's not true of a lot of other industries. So I think the size of the pool is a factor together with our comfort level.

If you go back historically, we've had much larger concentrations in a given area. In the mid-seventies it was media. In the early eighties it was consumer goods manufacturers. You could argue that it was financials in the nineties. And retail is certainly a significant part of the portfolio in the current decade. But if we found a terrific retailer at the right price, the fact that we have 20-some-odd percent in retail already would not constrain us from making a significant investment.

Question:

I was just wondering in light of that energy question, what your thoughts were on the ethical issues raised at the Berkshire meeting around PetroChina.

Jon Brandt:

I'll just briefly describe the issue[2], and I think I'll get it right. Berkshire Hathaway owns a fair amount of stock in PetroChina. I'm going to get this wrong ... I believe that an arm of the government of China, which is the 88 percent-owner of PetroChina, also owns some oil wells or they buy oil from the Sudan. There was a proposal that Berkshire divest its position in PetroChina on the basis that it would send a message to the Chinese government to try to use its influence to, I guess, tell the government of Sudan to stop the slaughter. The question is what everybody's responsibility is in their personal life or their business lives to do that and to help effect change.

Question:

I guess my question really is how you reconcile investing in certain things. Do you think about the influence that you have, or are the ethical issues sort of separate? Do you just focus on the investments and hope to do good deeds with the returns?

Bob Goldfarb:

We really don't have much influence on the companies we invest in. But there are certainly a few businesses or industries that we wouldn't invest in because of ... it might be the nature of their product. It could be that they are just such tough businesses that they might rely on labor practices we're uncomfortable with.

Jon Brandt:

There are definitely companies we haven't invested in because we felt uncomfortable with the management's ethics. I would say it's largely revolved around how they treat shareholders as opposed to how they treat the world at large. But sometimes the two go together. People who are going to cheat their shareholders are probably going to cheat the environment and their employees as well. So it's something we try to pay some attention to, perhaps not as much as you might. But it's on our radar screen and it's a good question to ask.

Investor:

I attended the discussion on Darfur. They made an impassioned plea with a number of people speaking in favor of Berkshire Hathaway's divesting. There were two very clear take-aways for me. One was that Warren Buffett made it very, very clear that A) Berkshire Hathaway would have absolutely no influence on the Chinese government. And the second, which was really quite striking for me, was that he made it very clear that he doesn't want Berkshire Hathaway involved in issues of foreign policy. That issue is much better left to the American government. I think many people ... the feeling in the meeting was that was something that hadn't come out in the proxy.

But I have another question regarding management behavior in a company that I just noticed is in your report. Apollo is a company that has a share class that doesn't allow people to vote. While it's a phenomenal business, I'm wondering if you could comment on that.

Bob Goldfarb:

Over the years, we've owned a number of companies with dual classes of stock. Berkshire itself is one. And the fact that Berkshire has two classes of stock has certainly not inhibited us from buying the B-shares.

David Poppe:

I think in general I would say it's a bad idea, and it's a demerit when you are doing your scorecard about whether you want to make the investment. But it's not a deal-killing proposition. It depends on the people in charge. But I would agree with you that the dual class voting structure, generally we would view it as a negative. And it's a negative for Apollo.

[2] For the text of the proposal and Berkshire's written response, see www.berkshirehathaway.com/sudan.pdf.

In the case of Porsche, where you have an exceptionally strong management in place and a family that seems largely willing to let management run the business, it's probably less of a negative than it might be in another place. The family has all the votes and you have no votes. In every way possible, you have no votes. But the management that runs the company is really exceptional. They are just extraordinary people and the family seems to give them very wide latitude to run the business as they see fit. It's certainly hard to argue with the returns.

Bob Goldfarb:

When I look at our list, I don't see a single company where we would own fewer shares if there were two classes of stock instead of one or where we would own more shares if there were one class instead of two.

Greg Alexander:

I'd just say, I mean, I can't stand that, frankly. But a lot of the companies we own …. we couldn't outvote them if we owned most of the remaining shares anyway. So it sort of becomes part of the analysis.

Bob Goldfarb:

We're very passive shareholders. We don't exert a lot of influence even in cases where we have significant percentages of ownership. Our concern is that if we did, we may not be that welcome as shareholders going forward in other companies in which we would invest. It's just not been a factor for us. I think the quality of people is. If you invest with very high quality people, the structure of the voting is much less important.

Question:

I've been fortunate enough to be a shareholder for the past 30 years. Hopefully, I will be a shareholder for the next 30 years. What criteria do you use, or are you looking into learning how to use, to assess the importance of responsible social and ethical practices on the part of management in deciding whether you want to invest in a particular company?

David Poppe:

I think Johnny said it best just a second ago. Primarily we are focused on their fiduciary responsibilities to owners. I do think there's some link between managements that are good fiduciaries for the owners and managements that are likely to be honorable fiduciaries to the other stakeholders in the company. We have owned gambling companies and other kinds of companies, where, depending on your perspective, you could question why you would want to own this kind of business.

But I think Warren's oft-stated theory on that is if it's a legal business acting legally in all ways, it's not necessarily for us to decide whether we do or do not want to own it because of issues not related to the way they treat owners. I don't know if that's right or wrong but I guess it just seems like it's the fairest for the clients of our firm. If it's a legal business, we don't tend to make a lot of moral judgements.

Jon Brandt:

Bob has on more than one occasion cut short or advised against a project because he viewed it as a rip-off business. And rip-off is in the eyes of the beholder. As David was saying, you could argue about gambling or lottery. But we have had ideas that we haven't pursued not just because the company wasn't friendly to shareholders, but because we felt some stakeholder was getting ripped off, and perhaps we didn't think that was sustainable. Or even if it was a sustainable situation, it wasn't something we were comfortable with.

Question:

I noted that you have made investments in financial stocks before. But as of December 31st you didn't have any investments in either US bank stocks or other international banks. Could you run us through the logic for your decision not to hold any bank stocks?

Bob Goldfarb:

There's been no decision not to buy bank stocks. And there's no bias against bank stocks. From the fact that the portfolio currently doesn't own any, you shouldn't infer anything about our attitude toward banks.

Jon Brandt:

If we found a bank we liked, we'd buy it tomorrow.

Question:

Are you worried about the large payout option packages and their dilutive effects? I'm thinking, for example, of Danaher. It strikes me that the CEO, Culp I guess is his name, has made an enormous amount of money in a short amount of time. Maybe it's having dilutive effects on what we would have gained as shareholders.

Bob Goldfarb:

I'd say in the specific case of Danaher that you have a very interested party that has approved those compensation schemes, namely the Rales brothers. They have been terrific businessmen. They've created a company with enormous value. They've decided to offer those incentives to George Sherman, the previous CEO, and Larry Culp, and we don't have a problem with that.

Again, I think it's consistent with what was said at the Berkshire annual meeting. We'd have a much greater problem with George Sherman or Larry Culp's compensation if Danaher were a poorly performing company. But it's not by any stretch.

Question:

From a non-operational standpoint, would a few of you and maybe specifically — I'm sorry to single out Jonathan — mention what your typical day might be? Only in regards to business and ultimately finding companies.

Jon Brandt:

It's a combination of reading published financials of the companies we follow; reading transcripts of conference calls. I think that is one of the more amazing changes in the business over the last 15 years. You don't have to be on the call to know what a company has said, a company CEO has said. Plus, you can go back.

There's a company I'm looking at now, and we got a transcript of a 2005 analyst day, which was six or seven hours long. The slides were on the company's website. I think there were 209 slides. I read the transcript, and I inserted the slides, and it was like you were there.

The other thing we do is we interview people on the phone. We go out and visit them. We do a lot of field research. I've been in Nebraska, California and Ohio in the last three weeks. I think Greg Steinmetz probably spends more nights on the road doing field research than he does at home. We build models. That would be something else we would do. Not necessarily to project the next ten years of cash flows and margins, but to understand what's driving the business, what the returns on capital of the business are, both including acquisition premiums and the returns on the tangible capital.

We don't have a lot of meetings within the firm. We had one yesterday. I think it's been seven or eight months since the last one. But if you are a fly on the wall of our e-mail system — and Todd Ruoff is here — he's our fabulous tech guy and he does a lot more than that; he's fabulous all around. But one of the things he makes sure of is that people cannot eavesdrop on our e-mail conversations. I would say it's almost a 24/7 meeting going on discussing ideas. When I check my e-mail over the weekend, if there are not ten e-mails on a Saturday and ten on a Sunday ... I mean, Tom here is at work not 24/7 but I would say 18/7, if not 365 days a year, maybe 349. And Girish is writing us from the other side of the continent or the globe or wherever he may be. It's almost like he is in the next office. Sometimes you don't even know where he is, and he finds the time to comment on an idea we're looking at in the office even if he's trying to bone up on the ten companies he's seeing in wherever he might be.

Question:

Do you think Wal-Mart went into the drug business to make money or to make them more like Costco? They always emphasize that they are profiting from this business, that they aren't selling anything under cost. Looking out a year or two, what effect do you think universal health care will have on Walgreen? And then whether big pharma is right in adamantly opposing vastly increased health service in view of the fact that so many people aren't covered at all.

David Poppe:

Wal-Mart does say that they aren't losing money on any business. We're a Wal-Mart shareholder, and it's a very good company, but I think you have to have a particular view of accounting to think that they aren't losing money. The generics cost $2 to buy. They are filling them for $4, on average. A pharmacist makes about $50 an hour, I think, if I'm not mistaken. About $2,000 a week or $100,000 a year. So $50 an hour, and it takes five minutes to fill a script, for a pharmacist, five to seven minutes to fill a prescription. If someone asks you a question, it can take more. But that's just the economics.

So if you think $50 an hour in five minutes, that's $4 right there just for the pharmacist's time alone. Then there's rent, then there's utilities. Then there's the pharma tech. Then there's the store and the inventory and the distributing. They are just not making money.

Wal-Mart would argue with you, "Well, our pharmacies were not busy before and we have to pay this guy or gal $50 an hour whether they are reading a book or filling a prescription. So we might as well have them fill incremental prescriptions basically for free. We're not losing money because they were there anyway." But you're losing money. That's the way it is.

When you decide to go to $4, you've also foregone all your opportunities to fill prescriptions at an economic rate in the future. That is, if your business goes up 25 percent because of this and you have to hire a new guy or gal, then you are really up a creek because now you've hired another $50 an hour person to be sitting there filling prescriptions that are not economic. So I question it. They argue with me. They believe in their methodology.

The larger issue is they believed that by doing this, they would create more loyalty and more traffic and that would create more grocery store sales and front end general merchandise sales. They claim that this is happening. If it is happening, it's almost doubly alarming because you know the traffic was minus three last month. So if they didn't have this program, would the traffic be minus five, would it be minus seven, what would it be? So I'm not a big believer in the way they account for it, the way they think about it. So that's part one on Wal-Mart.

I also think that this is partly what makes it very tough for Wal-Mart to expand the program a whole lot. In fact it's good to add incremental prescriptions for a pharmacist who is otherwise standing around, but you can't add too many because then you have to hire another pharmacist, and then it really becomes a disaster for you. So they can only take these guys up so much in terms of how much they produce per day. A pharmacist cannot — despite whatever you might read — they cannot fill endless numbers of prescriptions. The pharmacist can do 10 to 12 per hour, and that is really about all you can do in a retail environment.

Universal health care, I don't have a big thesis on that. But I will tell you that obviously the Congress in their wisdom cut the funding for Medicaid last year. And they are going through the process right now of renegotiating all the reimbursement on Medicaid prescription plans. What we're finding is that because it does cost $7, $8, $9 to fill a prescription, the drugstores cannot accept less than that as reimbursement. They can't fill scripts for cost and they won't fill them for cost.

So I think whether you have universal health care or whether you have Medicare and Medicaid trying to dramatically reduce reimbursement, at a certain point you can't fill the prescriptions. Maybe Wal-Mart or someone else will step in at some point and say that they can fill the prescription or they are willing to do it on a loss leader basis because of the front end traffic that it generates. But unless and until that happens, I think there's a limit to how low reimbursement can go. Put it that way.

I have never seen any kind of economic study — and there's not a lot of studies out there — but I've never seen anybody serious talk about it costing less than $7 to fill a prescription. You hear numbers of around $7 to $10. I think Grant Thornton just did a study that said $10 — $10 is probably high, and $7 is probably low. But whether you have universal health care or any other kind of system, you have to have $7 to $10 of reimbursement.

Then to bring that back to Walgreen, Walgreen is the low cost provider of this service in the United States. Nobody is as good as they are in terms of the cost to fill the script. So whatever the reimbursement is, they make more money than anybody else. If it gets too low, it's bad for everybody. But if it gets too low, I can tell you there are a lot of pharmacists who are probably at higher than $10 to fill a prescription, and at some point they have to go away.

That concentrates more market power in the hands of Walgreen and CVS, and the drugstores that are really efficient. So I think universal health care is something to worry about. But I would be more worried about universal health care if I were United Healthcare or Pfizer or Merck than I would be if I were Walgreen or CVS. And then big pharma — I don't mean it to be a cop-out — I just don't have a take on what they're doing.

Question:

I have a question about the sale of International Game Technology since last year's meeting. Was the primary reason that the price of the stock got too high? Was it something about the company itself? And to what extent does technology play an issue? It seems like Sequoia's most comfortable in things that aren't technological. Did that have any impact? If you could also comment on technology, in general — investing in it — I would appreciate it.

David Poppe:

I am a big fan of IGT. I think it is a wonderful company, a wonderful business with probably a sustainable competitive moat despite the technology issues. The price got to a point where it seemed more than reasonable. If you follow this industry, the other issue is that at some point the slot machines are moving to a server-based system where they will all be run out of one server and it will be much better for the casinos and should generate excellent savings for the casino and increased profitability for IGT in the form of a big replacement cycle. All the current slot machines are going to come out of these casinos at some point and be replaced by computer networks. All the slots will be run from a central terminal or a central server.

We bought the stock with an idea of what the peak earnings during that cycle might be and when they might come. As time went by, it's not so much that we thought our peak changed as we thought it was going to take longer to reach it, and that made a difference in how we valued the company. Time is money. It was as simple as that. It's really a terrific business.

Question:

You've mentioned big pharma and energy are two areas that you didn't have a big strength in. How do you determine when to go out and hire people with that strength? When do you say we're just going to stick to the areas that we know? Can you talk a little bit about that trade-off, please?

Bob Goldfarb:

I would say that our hires — and there have been quite a few of them, including recently a couple of people you will meet next year — we've never hired a person to fill a void or a gap in our knowledge base. We've just always hired individuals based on who we thought would be great analysts.

David Poppe:

We have hired two people who will start in coming weeks and months and who have expertise around health care. But that doesn't mean you're going to see health care stocks in here at any point. It really is a company by company process that we go through. I think we've gotten broader over the last seven or eight years. But I'm not sure breadth matters as much as depth, at the end of the day. It is really knowing the individual position and making good decisions at the time you purchase or sell that matters.

To put it another way, I think you could have a pretty limited circle of competence, if you will, and still do very, very well as an investor if you were very good in your circle.

Question:

I had similar concerns with Wal-Mart to the ones that David mentioned. I'm wondering if you might be able to expand on your analysis and knowledge of Wal-Mart for us going forward. I noticed that Gotham Capital — Joel Greenblatt — has put a substantial amount of his portfolio in Wal-Mart. Of course I wouldn't ask you to comment on what's going through Joel's mind. But I am wondering if you could talk to us briefly about what type of valuation you put on Wal-Mart.

Last year, you talked about buying it under $45 a share. What's going on with that company in international markets and perhaps how you feel about it as an investment now? Would you buy it going forward?

David Poppe:

First of all, I don't know Joel Greenblatt, but I know he's very very smart. Wal-Mart has done a lot of things wrong over the last few years. Probably most of the international investments could be questioned, as we sit here some years after they've begun the process. But I would say this — the interesting thing about

Wal-Mart is it continues to earn more money every year than it earned the year before. The earnings continue to go up at a pretty good rate.

It continues to have a pricing advantage, to be the most efficient player in its industry, to have a pricing advantage over its competitors. I think at some point, to be critical for a second, if you're senior management you have to hire somebody to do the PR who's really good at PR because these are real issues that they have. But you have to run your business. I see some reasons for optimism that they have finally done this. They've hired some people who are really good. Hopefully that means that management will be more focused on running the business. Because we do see stores that don't look as good as they should and initiatives that haven't worked as well as they should have. And the number of people who have left alarms me a little bit. I don't know how Terence feels about that. I'm going to let Terence answer that.

But I would come back to the point that Wal-Mart's competitive advantages still exist and are still pretty powerful. Wal-Mart as a stock at this point is really not very expensive at all. I think it is trading for 15 times this year's earnings. There's a good amount of free cash flow there. They do invest a lot for growth, but basically there's a lot of free cash flow in that business. You know the earnings will be ten percent higher next year than they were this year. At some point, the earnings matter, and it's got to trade with earnings.

But I would say there's a lot of frustration for me around Wal-Mart because just talking about walking through stores and feeling like you have a competitive advantage, if you walk through Wal-Marts today, I think they are very inconsistent and they don't look as good as they should look. And that's bothersome. I don't know if Terence has anything to add.

Terence Paré:

Just a couple things. As David pointed out, I think when you look at how Wal-Mart has done internationally, I'd say basically those companies that they've acquired have continued to do okay, if they were doing okay when they bought them. They certainly had trouble in Germany. They had trouble in South Korea because the culture of the company doesn't necessarily translate very easily.

But to the company's credit, they do want to grow. It's a growth-oriented company and they are looking for ways to get bigger. When you are a retailer, and you are as big as they are in the US, sooner or later you either have to just stop and start buying back stock or go across the border and look for more horizons. I'm not so sure that we would be upset if they decided to pursue the former strategy. But they are bound and determined to keep on growing.

As far as the stores themselves are concerned, I think it's true that they've had some issues with staffing and maintaining the stores. But in the stores that I've been walking in recently, I'm starting to see some very positive signs. I'm one of those people who believe that Wal-Mart's value proposition is selling stuff for low prices and as long as they do that, I think they will do just fine.

I'm more skeptical about the ability to go up market when you are a retailer like that. So when I see the smiley faces back and the pallet drops in the aisles with a DVD player I saw the other day for $29, or when I was walking around touring stores around Christmas, you could buy a bicycle for what it would cost you to take your kid to the movies and buy him popcorn — you could buy him a bicycle for Christmas — that's just a tremendous value that the company brings to the consumer.

As long as they keep doing that, and they can continue to expand their retail floor space productively, they are going to make more money. What multiple the market puts on that, I don't think we have too much control over. But over the long run, the price of the stock will converge to the earning power of the company, and I think it will be okay.

Question:

I wonder if you could comment on two companies. One, Apollo Group… they have had a lot of problems: management turnover, I think there was some back-dating or insider trading problems, some questions about the student enrollment growth — a lot of questions around that company. Do you still feel comfortable with the company? The second is the growth prospects for O'Reilly.

Jake Hennemuth:

Just for anyone who doesn't know Apollo, it operates the largest university in the country. They have about 292,000 students in the University of Phoenix, and a subsidiary of the University of Phoenix called Axia. Those are students in class. If you count the students on the bench, meaning not taking a class in any given quarter or semester — their classes are actually five to seven weeks long — there are about 600,000 students.

So to one of your points about growth slowdown, yes, they are encountering the law of large numbers; they've talked about that. I think there are about 17 or 18 million higher ed students in the country. So what's 600,000 as a percentage of that? You can actually express it as an integer, and it is kind of amazing that you can do that in a country as big as the US.

At the same time, I would point out that the stats are overwhelming in the other direction, which is that only 34 percent of adults in this country have a bachelor's degree or better. The largest percentage of those who don't have degrees do have some college credits, meaning they gave it a shot. That's really Apollo's bread and butter, going after working adults who have some college background. So the runway is still a long one.

Secondly, I'd say education is a darned good business. The returns on invested capital for Apollo for the last two years, both of which haven't been super for them, are north of 50 percent. We just don't find a lot of companies like that.

Then as it relates to Apollo in particular, I would say that they've been at this for three decades. In my opinion, they are the best at what they do, especially in their niche. People may know the University of Phoenix, the name, because it's all over the place. If you drive along the highway, you see it. You see it in your Yahoo account, you see it on billboards, it's everywhere.

Not that many people know what it is. If you actually take the time to find out what it is, I like to say they have a pretty big engine under the hood. Meaning I really do think they are the best at what they do — at developing curriculums, at training teachers, at communicating with teachers, at hiring teachers.

One of the ways we got comfortable with Apollo — and there's been a lot of negative press about this company — was talking to teachers. A lot of these teachers teach at other schools too. They basically make a career out of moonlighting. They will teach online at three or four different schools. The other three are schools that we would know; they aren't for-profit schools. They are state schools; they are community colleges; they are name brand private schools.

So in summary, it's a good business. The runway should be a long one, even if it looks like the law of large numbers should be staring them in the face, and we really do think they are the best at what they do. To the extent that anyone has a brand in this business, in the for-profit business, Apollo is that company. So the money they have to spend each year to get new students, the trend has not been a great one but it could reverse itself, if they astutely spend that money.

David Poppe:

A couple of your specific points — on management turnover — sometimes management turnover is a good thing. I think Apollo benefited a little bit from some turnover. I think that is probably a net plus for that company. Certainly in any one of these situations, good people leave as well. But I think it is a company that probably benefited a little from turnover. And the back-dating, while in no way excusable, was primarily done by the management team that's gone. The team that's in place today, while some of them were there, they were not involved in those back-dating decisions — I think the team today probably has a stronger sense of fiduciary responsibility than the prior managers.

So I do think back-dating is an issue for them. But the current president didn't have anything to do with it, and the current CFO who is new to the company didn't have anything to do with it. So I think in that regard, hopefully they are cleaning house. I would just repeat Jake's points — it's a very, very strong free cash flow generator. Because they have had troubles over the last year or so they haven't been buying back stock and the cash has been accumulating. You do have an opportunity, if they allocate capital intelligently, to do pretty well. The enrollment growth people are worried about — enrollment still grows. I don't think you need the enrollment growth to be 15 percent going forward, or 10 percent even, to have a very successful business.

John Harris:

O'Reilly operates something on the order of 1,500 stores right now. You could certainly say that there's a lot of room for growth just by virtue of the fact that their closest competitors on the commercial side, NAPA and CARQUEST, each have between 5,000 and 6,000 stores in the United States. Even their competitors on the retail side of that business, which is selling parts to people who repair their own cars as opposed to selling parts to garages that repair cars for other people, even on the retail side of the business, I think AutoZone is getting close to 4,000 stores in the United States.

So if you just compare the relative sizes of the store bases, I think you'd have to say that there's room for growth. I think at the same time there is some danger in making those comparisons without looking under the covers a little bit. As Bob is quick to point out and right to point out, competition is really the bane of retail. There is a point at which trade areas can get over-stored. I think that was a risk that we were aware of from the beginning with O'Reilly because it is painted by some as a fragmented industry.

But I think the real fact of the matter is that it's actually much more consolidated. I think that's particularly true on the retail side of the business. We were — and still are, frankly — a little bit concerned about their ability to grow the retail side of the business.

But I have to say that if there are two things that I think we all have been pleasantly surprised by with O'Reilly, one of them would have to be the strength of the comp that they've generated on the retail side of the store. The comps have exceeded our expectations since we bought the stock. And I really have been pleased to see that they have been strong on both sides of the store. We expected the commercial comps to stay strong, and they have. But quarter in and quarter out, they tell you that either the retail comp has been similar to or just slightly lower than the commercial comp. I think that is a very positive thing.

The other thing that gives me some confidence that they will be able to build those incremental stores and succeed in them is the management and how impressed we've been with Greg Henslee, the new CEO — not new to the company in any way, but new as the head of the company. Another lesson I think I've learned in my days at Ruane, Cunniff & Goldfarb is that in spite of all the research that we might do, you can spend three months, six months, nine months, a year looking at a company — there are always going to be unknowns. You can't know everything.

There always will be surprises. I think that we as a firm have found from experience that if you invest with managers of the highest quality and the highest ability, the surprises over time tend to be good ones rather than bad ones. It's not always the case, but more likely than not. We all think very highly of Greg, and I suspect that he will — I hope that he will continue to surprise us positively in the future.

Greg Alexander:

I'll just make one comment on Apollo, which is that it's so fascinating to watch. When I joined Ruane, Cunniff, someone would recommend some stock, and Bob would say they had a bad inventory problem in 1973 or something like that — this being in the mid/late eighties or whatever. This long term perspective, it's fascinating to think of Apollo, which was really the first online school. For a long time they really ran circles around the state schools, which are cheaper, much cheaper. What is the difference, Jake?

Jake Hennemuth

It's state by state. In an expensive state like Pennsylvania, I would guess Apollo is probably 30-40 percent more expensive, all in.

Greg Alexander:

It's gotten closer because the state schools have been raising tuitions. But in the olden days, if you were a student and you wanted to hold down a job, the state schools just gave you no flexibility. Whereas Apollo planned around trying to let you actually hold a job while you were in school. So they ran circles around the state schools.

Then the internet came along, and Apollo really pioneered online education. Then for a long time, they ran double circles around the state schools. Now the state schools can buy software that lets them go online much more easily than would have been the case five years ago. It's just sort of fascinating — someone asked about hedge funds before — people who sometimes have different perspectives, less long term perspectives. But it's fascinating to watch these industries evolve over long periods of time and observe all the competitive changes.

Question:

There seems to be an older population of Sequoia Fund investors — no offense. My question is if those folks have a good portion of their portfolios in Sequoia Fund or 401Ks or Roth IRAs. If in the next five to ten years, those folks want to take those monies out of the fund, what impact will that have on Sequoia?

Bob Goldfarb:

That's an excellent question. The analogy I use is that if you had a restaurant in 1982, and you said that the only people who can dine there going forward are people that have dined there in the past — or their children or grandchildren — in 2007, you are going to have quite a few empty tables. So your observation is absolutely spot-on. If we continue the policy of keeping the fund closed, its assets could well decline.

Jon Brandt:

But I can't think of a reason why it would hurt the Sequoia shareholders for the assets to go down over time.

Question:

A couple of different questions, and I'll make it really quick. First, could you comment on Fastenal and specifically comment on what you see as the point of saturation for that company within the marketplace that they address? Secondly, looking at the broader portfolio from an opportunity cost perspective, where do you make the judgment to say "What is the long term compounding that we're going to get on this holding relative to our other alternatives?" Obviously there's a tax consequence, which leads to the third question related to what the other lady just asked. Does it make sense at some point to re-open the fund? Potentially there are a couple reasons. One of them might be instead of having to sell down holdings to buy other things, if you have an inflow of cash, you can re-deploy that into maybe more interesting situations, benefiting everybody, without having tax consequences adverse to the current holders.

Chase Sheridan:

Fastenal just spent a considerable amount of effort to identify their truly addressable market, what they consider their addressable market. They came up with a number of $66 billion. Sales in the last 12 months were $1.87 billion. So obviously, there's a very long runway.

When you talk about branches outstanding, they currently have a little less than 2,100. They've conservatively estimated that 3,500 might be the number where they reach saturation in the US. If they roll out their stores at their planned rate and they grow their sales at their planned rate, they should reach that number by about 2013, at which point they will still only have eight or nine percent of the existing addressable market.

So in terms of runway, it's just tremendous. We've seen instances where Fastenal has rolled out a high density of stores in certain metropolitan areas, but we don't see the cannibalization that you might expect. Part of that is there's not a lot of on-premise sales. A lot of the sales come from outside salesmen and store managers making trips, knocking on doors.

When you get smaller territories, these salesmen will spend less time behind the windshield. They will make more efforts to knock on doors of customers they might have driven by previously. So the runway is very, very long, in our opinion.

Bob Goldfarb:

With regard to your second question, I can't remember ever passing up an opportunity that we were looking at because we didn't have investable funds. So the longer term holdings have had zero impact on ... have imposed no constraint on our ability to buy new stocks or add to positions of companies in the portfolio.

Question:

What if you have a company that is only going to compound at ten percent, but you have others that might ... probably with high certainty do so at 15 to 20? Then logic would say we should set the portfolio in that direction.

Bob Goldfarb:

What about the prices of the respective holdings?

Question:

I'm going to make it really difficult by saying that all other things being equal.

Bob Goldfarb:

That's the problem. Generally they aren't. And generally, the faster-growing company — the company with the faster-growing future earnings — is going to be selling at a significantly higher P/E than the company whose growth prospects going forward are lesser.

Jon Brandt:

I think you heard Bob say earlier with respect to Bed, Bath & Beyond that some of the funds realized from the Berkshire sales were used to buy Bed, Bath & Beyond. So maybe there's an implicit answer in that activity.

Bob Goldfarb:

With regard to your third question on re-opening Sequoia ... I think one of the issues, for me at least, has been that for taxable entities for quite a number of years, Sequoia has effectively been a load fund, even though we are classified as a no-load. And that load has been the tax liability for all the unrealized appreciation that we've accumulated in the past. We've always been proud of being a no-load fund. We'd be reluctant to offer it as a load fund, if you will, to taxable investors. Now, as we realize those gains and the unrealized appreciation declines and the load declines, then it's something that we would reconsider.

I'd say the second issue we've had — or I have, at least — with regard to re-opening it, is that when I look at other funds, I'm bothered by the inflows and the outflows and the impact that those have on the portfolios of the funds. But we don't want to put a constraint on new investors. We don't want to say if you join us, you've got to keep your money in the fund for three years, which is one way of addressing the issue of inflows and outflows, or of outflows in particular. I'm not sure a mutual fund is the optimal vehicle for managing money on a very long term basis.

Question:

Would you please comment on Tiffany, its competitive advantages and growth prospects?

David Poppe:

I would, but we sold it. Tiffany is a terrific company with significant competitive advantages. It's a great brand today, I think it will be a great brand in 20 years. We made a very good return in five-plus years of ownership of Tiffany. We felt the stock price got to a level that was fairly high, given the deterioration of the return on capital, really, over our entire ownership period.

I think I've mentioned this in a previous meeting — when we bought Tiffany it had about a 22 to 23 percent return on equity. When we sold Tiffany, the return on equity was 14 percent. They had continued to grow through the last five years at a reasonable rate, but at the expense of having to invest great amounts of money into the business to generate the growth that they were getting, including a series of initiatives undertaken in good faith, but they really didn't work — such as diversifying into other kinds of stores — they just haven't worked.

Then the price went up, I guess because of Nelson Peltz and some of the things that he's arguing for. But when it happened, I have to say, it comes out that Peltz owns five percent, and he wants to make various changes, and he's advocating for different things, and the stock is going up. I say to Bob — because management is saying, "We'll consider it all, we think it's a good idea," — I say to Bob, "This is so irritating to me. These are all the things that we've been saying to them for five years." Bob was reminded of a Buffett quote of Al Capone: "You can get much further with a kind word and a gun than you can with a kind word alone."

I think if they make the changes, it will be good, and it could be a good return for people even from these levels. But we felt good about it, we had a very good ownership experience. It's a great brand, but there's a price for everything.

Bob Goldfarb:

I've just been told that it's 12:30. So we're going to end the formal session. We thank you for attending and look forward to seeing you next year.