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PERSPECTIVES AND ACTIVITIES OF THE NATION'S MOST SUCCESSFUL MONEY MANAGERS.

Volume XIX Numbers 1 & 2 April 30, 2004

Investors featured in this Edition:

Other Investors in this Edition:

Companies & Investments in this Edition:

OID POTPOURRI: CHRIS STAVROU, SETH KLARMAN, MARTY WHITMAN & BILL NYGREN

We're pleased to bring you the following assortment of perspectives from *OID* contributors. First, Chris Stavrou parts the clouds hanging around a couple of *OID* favorites. Then Seth Klarman discusses how quickly investors have forgotten the lessons of the still very recent bear market and the case for holding cash today. Third, Marty Whitman (after whom Syracuse University recently renamed its business school the Martin J. Whitman School of Mgm't),

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CENTURY MANAGEMENT'S ARNOLD VAN DEN BERG
"IF PAST BUBBLES ARE ANY INDICATION, THIS ONE'S AFTERMATH WILL BE A DOOZY."

Since founding Century Management back in 1974, Arnie Van Den Berg has handily beaten all of the indices. Through March 31, 2004, he's managed to earn returns of 17.6% per year before fees versus 13.9% and 12.8% per year for the S&P 500 and the NASDAQ, respectively. And interestingly, he's done far better still the last five years — actually managing a return of more than 25% per year versus declines of 1.2% and 4.1% per year for the S&P 500

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CLIPPER FUND'S JAMES GIPSON & MICHAEL SANDLER
"THIS IS NOT A GOOD TIME TO OWN LONG-TERM ASSETS. IT'S UNCOMMONLY HARD TODAY TO FIND CHEAP STOCKS."

Jim Gipson has often pointed out that in a world of increasingly high turnover among mutual fund managers, Clipper Fund — which he and Michael Sandler have managed since 1984 — is an anomaly. No less anomalous have been its returns. For the three, five, ten and 20-year periods ended March 31st, it has outperformed the S&P 500 by 6.6%, 12.3%, 4.5% and 3.35% per year, respectively. And its returns relative to its peers have been no less impressive.

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WESCO FINANCIAL'S CHARLIE MUNGER
"THE BEST WAY TO *GET* SUCCESS? IT'S VERY SIMPLE — JUST *DESERVE* IT."

In the foreward to Janet Lowe's excellent biography — *Damn Right! Behind the Scenes with Billionaire Charlie Munger* — long-time partner Buffett says Charlie's mind is "breathtaking" and that "[h]e's as bright as any person that I've ever met and, at 76, still has a memory I would kill for." Lowe goes on to add that Buffett's eldest son, Howard, says his father is the *second* smartest man he knows — that

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and the NASDAQ and a gain of 8.2% per year for the Russell 2000. Besides encompassing the bursting of the tech bubble and the most recent bear market, Van Den Berg points out that this period also corresponds with the period when Century's Director of Research, Jim Brilliant, assumed a greater role in the firm's investment selection.

We're pleased to bring you the following excerpts from a client presentation given January 24th in Austin, Texas. We always find Arnie's insights and perspectives to be particularly sharp and colorful, and believe you will, too.

YOU CAN TAKE LESSONS FROM HISTORY OR YOU CAN REPEAT THE SAME MISTAKES.

We prefer to learn from history rather than repeat it.

Scott Van Den Berg: ...Now I'd like to introduce to you Arnold Van Den Berg — our company president and founder. I always like to introduce Arnold as not only my father, but as a wonderful mentor to myself and our entire staff — and also as my best friend.

So for the next 40 minutes or so he's going to share with all of us what we call the unwinding of a bubble — where he will show us how other manias and bubbles have occurred over history and in various marketplaces so that we can take lessons from history so that we don't have to repeat the same mistakes....

Only in investing does conventional wisdom change so fast.

Arnold Van Den Berg: Probably the biggest question we're getting this year is why we're holding so much cash as the market is going up. That's a very fair question. And it needs to be answered in an historical sense.... You truly cannot appreciate the times you are living in unless you put it into a historical perspective — because we are living in very, very unusual times.

There have only been three times in the last 80 years that all of the elements of the stock market, the economy and the debt structure have come together like they have today. The first period was 1922-1929. The second period was the 1949-'66 bull market. And the third period was the period that we witnessed from 1982 to the top of the tech bubble in March of 2000. These were extraordinary times during which the investment thought process changed completely.

It seems to me that this is the only field in the world where conventional wisdom changes so frequently. For example, in mathematics, 100 years ago, two and two equaled four. And 100 years from now, I feel confident that it'll probably *still* be that way.

But that's not how it works in investment thinking. I'm going to demonstrate to you that whatever you believe — whatever the current conventional wisdom is today — it was completely different 20 years ago. And I daresay that it'll be completely different a few years from now. So that's the first thing we want to explain.

Where there are great risks, there are great opportunities.

A. Van Den Berg: Then, the second thing we want to show you is how this develops, how it's created, what our strategy is, and how we intend to profit from it — because where there are great risks, there are enormous opportunities if you know how to take advantage of them. And none of us would know how to do that if we hadn't either experienced it personally or looked back in history and seen what happened during those times.

We're going to talk about bear markets. Of course, bear markets are periods during which stocks decline. Bull markets are periods during which stocks appreciate. And while everybody thinks they're short term, they last somewhere between 15 and 20 years once they get going.

There are no mistakes, just lessons.

A. Van Den Berg: And then we're going to talk about bubbles. You've got bull markets, you've got bear markets, and you've got bubbles. Bubbles only happen once every 25 or 30 years — because the pain and the suffering and the lessons that are learned are so deeply embedded in those people who experience one.... Therefore, it takes a whole new generation to start a new cycle again.

So we want to learn from this. There's a Hindu saying that there are no mistakes, just lessons. Well, there are a lot of lessons to be learned....

BUBBLES CAN ONLY ARRIVE WHEN ALL THE STARS ALIGN.

Only when the stars align do you get bubbles....

A. Van Den Berg: I want to mention one thing about bull markets. Bull markets always peak out when the whole society is involved in a period of prosperity that is unparalleled. You never get a bubble until the public, the brokerage community, the financial institutions, the pension funds and even the universities are all involved. Working together, they all create this chorus of prosperity.

And it's only in times like this — when you just can't stand to be out of the party — that bubbles develop. Bubbles just completely leave reality. It's just like you're on another planet. And then eventually they fall by their own weight.

So the first thing you need to understand is that bubbles can only come when all the stars align: The economy's got to be good; the outlook has got to be good. New technological changes are going on. As far as the eye can see, there's only prosperity. Only in that kind of an environment are you going to get everybody to just throw caution to the wind and say, "I want to be part of it."

In 1929, it looked like a new era unlike any other....

A. Van Den Berg: That was the kind of thing that happened in the '29 bubble. The '29 bubble started in 1922 when both commodity and stock prices collapsed, and interest rates and inflation went down. It was a perfect climate for equities to appreciate in a big way. And that's exactly what they did. (**See CHART 1.**)

While our chart only shows you to 1924, it actually started in 1922 with the Dow Jones Industrial Average at

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60. From the Dow's 1922 low of 60, stocks went straight up to 380 — or nearly 6-1/2 times.

Let me read you what the thinking was at that time: President Calvin Coolidge in a speech in November, 1927 — two years before the bubble burst — said "America is entering a 'new era' of prosperity." That's where that term was developed. It was a new era unlike any other era that America had ever experienced.

[Editor's note: President Coolidge was apparently no less optimistic a year later. As Vanguard Founder and Chairman Emeritus John Bogle pointed out in our 1997 *Patient Subscriber's Bonus Edition*, on December 4, 1928, President Coolidge said: "No Congress ever assembled on surveying the state of the union has met with a more pleasing prospect than that which appears at present."]

A. Van Den Berg: Yale University's Irving Fisher — one of the most noted economists at the time — said on October 15, 1929 that: "Stocks have reached what looks like a permanently high plateau."

Nine days later, the Dow began a long, steep plunge that stripped the market of 40% of its value in three weeks — and continued with few interruptions until the bottom of 1932 at 41.

Some interesting similarities between 1929 and 1999....

A. Van Den Berg: Here's what was happening in '29: The economy was strong. Corporate profits were up 20% over what they were in '28. Real wages had been increasing rapidly. And productivity had soared by 7% annually since '22. The public had reason to be optimistic.

In '99, we were excited about the internet because we knew that it would revolutionize the future. And it will. It just depends on what *price* you want to pay for it.

Well, in '29, look what they had going: They had the telephone, the automobile industry, aviation, and radio. Radio Corporation of America was the darling of that time. And it ended up the same way Cisco did. It was a tremendous company with a bright future. The public was hysterically bullish. And the media... If you read the media during this time, you'd think that America was just never going to have any economic problem in the world.

There's one bad thing about debt — it has to be repaid.

A. Van Den Berg: At the same time in 1929, the debt levels had reached 200% of GNP. Now think about that: the economy was roaring — and yet it had twice as much debt. People forgot about these kinds of things. But one thing you know about debt is that it has to be repaid. And so the economy started down on its sickening slide that wiped out all of the gains from that period.

Incidentally, that stock market was on steroids. And

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the reason it was on steroids is during that time, you could borrow stocks on 90% margin. In other words, you could put down 10% and borrow 90%. Imagine: you could buy $100,000 worth of stocks for $10,000. But there's only one problem — if it goes down 10%, you're wiped out. And that's what happened. People got wiped out.

DON'T WORRY ABOUT MISSING A BULL MARKET.
IF YOU JUST FOCUS ON PRICE, YOU'LL BE ALRIGHT.

Not only can bubbles kill, but so can bear market rallies....

A. Van Den Berg: Then, in the middle of this decline, the markets mounted a sharp rally. Note in your chart that it went from 380 to 199 to 294. So it went down 50% — and then immediately it moved up 50%. And everybody thought that was the beginning of a new bull market. And if you look a little bit down the chart, you see it wasn't. It was probably the biggest rally in a bear market. But people got back in. And as soon as they got back in, the markets went back down....

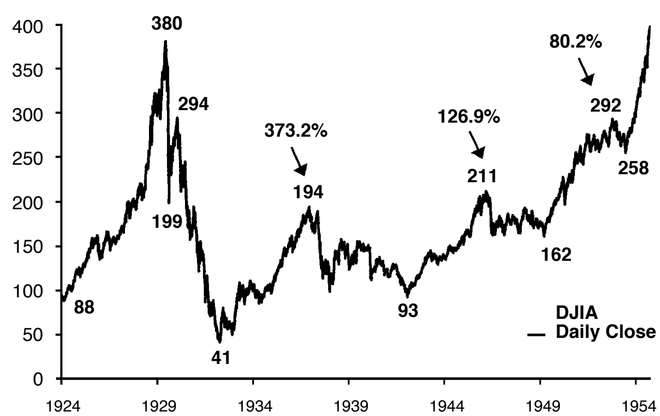
What can we learn from that? First of all, when you have an era of total participation — an era in which people suspend all logic, become part of the crowd and buy things just because they're going up — you've got a bubble. And there's only one way a bubble goes down — the only way you let air out of a balloon — it either pops, or you just slowly let it out. However, one way or another, the air has to come out of the bubble.

[Editor's note: In a subsequent client review in Houston, he added: "[Here's] the dictionary definition of a bubble: 'Something insubstantial, groundless, or an impractical idea or belief' — in short, an illusion. In other words, stock market bubbles create illusions.

"But Sigmund Freud had about the best definition of an illusion as to how it affects the stock market.... 'Illusions commend themselves to us because they save us the pain and allow us to enjoy pleasure instead. We must therefore accept it without complaint when they sometimes

CHART 1

DJIA Daily Close 1924-1954
25 Years Until New High



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collide with a bit of reality, against which they are dashed to pieces.' In other words, bull markets create bubbles, and bubbles create illusions, and illusions eventually lead you astray."]

You have plenty of time, after a bubble has burst, to get in.

A. Van Den Berg: Now here's the interesting thing about this market. People are always worried about missing the bull market. But once a major bear market has made its bottom, you don't need to worry about missing it. Take a look at that. In 1935, you could've bought the Dow at 100 — two years, three years after the bottom. And if you would've bought it at 100, you could've still gone to 194 and made 100% on your money.

If you didn't buy it during that time, you could have bought it again in 1938 — six years after the bottom — at 100. And five or six years later, you could've sold it for 200. And even if you missed it at that time, 15 years later, you could've bought it at 162. And as the markets moved up, you could've made a good profit then. So you have plenty of time in the stock market, once a bubble has been burst, to buy stocks. There should never be this compulsion to buy things just because they're going up.

Overpaying one time could have set you back 25 years....

A. Van Den Berg: For those who bought at the top range, I want you to look at this 380 level, or the 294 level. Look across the years and see how many years it took you to get to breakeven. Let me do the math for you: the answer is 25 years. It took *25* years after a bubble burst to break even. That's the important thing to understand about bubbles.

What protected you from folly and ensured profit was price.

A. Van Den Berg: Now, here's the other thing you should learn. Draw a line through the bottom of that chart — around the 150-200 level. And no matter when you bought it, your stocks might have gone down for a while, but you would've made money. But again, by contrast, if you bought it at the 295-300 level and up, it would've taken you 25 years to get even. By contrast, if you bought it anytime between 100 and 150, you'd have made a profit almost no matter when you bought it.

So the lesson is very simple: Once a bubble has burst, you wait for stocks to get into a fundamentally cheap zone before buying. There's plenty of time to find stocks in the value zone.

Incidentally, we buy stocks on an individual basis. We're just using the market as a proxy. There are many times when the market's way up there and yet we can find an inordinate amount of stocks. And there are times when it's fairly valued, but we can't find much. That's because of the different industries that are circulating. But generally speaking, it's safe to say the lower the market is, the more bargains we're going to find.

So the lesson that you should learn from 1929 is that no matter how great the prosperity is, no matter how great the future is, there is a price that you cannot afford to pay — because if you do, it could take you most of the rest of your life to get even. And by contrast, if you buy in at the right price, it doesn't matter how long it takes — you're going to make money. And this is one of the great lessons that comes out of this '29 era.

By the way, why did it take so long? It took so long because the debt had to be liquidated and paid off. And the companies had to be restored. And the excess capacity that was built up — that had stayed idle for years — had to be used up. So it takes *many* years, when you have an extraordinary bubble, to bring things back.

THE BUBBLE IN THE NIKKEI WAS A CLASSIC.
JAPAN HASN'T RECOVERED 15 YEARS LATER.

The Nikkei bubble made the '29 Dow look like a piker.

A. Van Den Berg: Next, I would like to review the Nikkei stock market in Japan. I would list this as one of the greatest bubbles next to our stock market in '29.

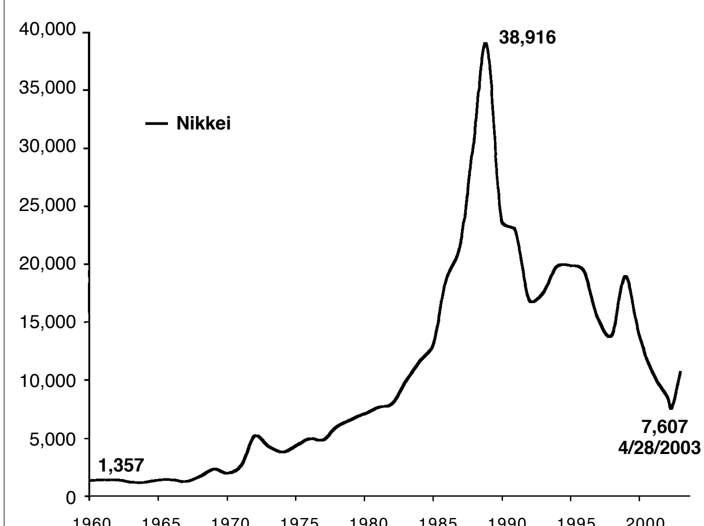
An interesting thing happened to Japan. Of course, Japan lost World War II. Their factories got bombed — and they rebuilt them. They started healing the country. The Japanese people are a very intelligent, industrious people. And they finally built some of the most modern, progressive factories and companies in the world.

As their economy started to move, their stock market started to move, too — and optimism took over. As a result, people started buying stocks and making money. The bull market in the Nikkei started in the '60s — at 1,357. And it just went straight up to 38,916 in 1989 — to nearly 29 times the original amount.

Again, at the top of the bubble in the U.S. in 1929, the Dow only went up about 6 times. The Nikkei went up almost *29* times. (**See CHART 2.**)

CHART 2

Nikkei 225 Monthly Close 1960-2003
14 Years After 1989 Peak to Hit New Bottom



Source: Global Financial Data

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So you can see why the Japanese people were just jubilant, overly optimistic and just hysterically bullish. And they bought stocks like you have never seen people buy stocks — up to their eyeballs.

Not only that, every Japanese company had all of its cash in stocks. People everywhere couldn't get enough Japanese stocks. And the Japanese made so much money that they came over here and bought our golf courses and half of Hawaii. They were just spreading that money around like it wasn't going to stop.

People destroyed by a bubble bursting don't soon forget it.

A. Van Den Berg: But all of a sudden, in the midst of this prosperity — at the height of this hysteria — the market started on a sickening slide that only last year made a bottom. Think about it. For those who jumped into the Japanese market at those insane prices, 14 years later, their stocks had still not even hit a bottom. Now that is what you call a *bubble*.

As a result, there is not a Japanese person alive who was involved in this bubble who is ever going to believe in or buy stocks again. Those people are cured *forever*. [Attendees laugh.]

It's just like those people who bought stocks in '29. Some of you have dads and moms and cousins and so on who lived during that time. And as you know, they've never felt the same way about stocks since — and they never will as long as they live.

I've got a client — he's one of my oldest clients — who's been with us since the beginning of the company. And he has had a very good return. Still, he always has that little shakiness in his voice when he talks about the stock market. No matter how much money we've made him, he's never quite felt secure — because it's a subconscious thing. It's a little voice back there saying: "I've seen this before. I've *lived* this before." No matter what the numbers are, he's going to think about that.

CHART 3

Daily Gold Price
1970-2003

Source: Global Financial Data,
Gold Bullion Price — New York (US$/Ounce)

Low interest rates aren't enough....

A. Van Den Berg: So Japan has been sliding down for 14 years. Their country has been in a semi-depression — call it a recession, if you will. There's not a lot of economic activity. Interest rates are at 1%. And you'd think that with 1% interest rates, stocks would be skyrocketing, right? You keep on hearing that if interest rates go down, stocks have got to go up.

Well, if Japanese interest rates are 1%, why aren't Japanese stocks going up? The reason why they're not going up is that in order for a high price earnings ratio to help you, you need earnings — and there *aren't* any.

Low interest rates alone won't do it. You need the other part of the equation. And when an economy is down, you don't get much of that. So a low interest rate alone isn't always going to save a market. It certainly hasn't saved the Nikkei.

ANY ASSET BECOMES RESPECTABLE
IF ITS PRICE GOES HIGH ENOUGH.

Until 1971, U.S. dollars were convertible into gold.

A. Van Den Berg: The next bubble I'd like to look at with you is gold. They say there is no fever like gold fever. And if you look at your chart, you can see that's true. **(See CHART 3.)**

What started the gold bull market in this country? During the '50s and '60s, low inflation and low interest rates created the stock bull market of 1949-1966. And as the economy was expanding and the government was creating more and more money, foreigners got a little concerned because they were holding a lot of dollars.

At that time, dollars could be converted into gold. As a matter of fact, the legal definition of the dollar was: "payable to the bearer on demand 13.71 grains of gold." So you could walk into the Treasury if you were a foreigner and get 13.71 grains — or 1/35th of an ounce — of gold. That was the legal definition of the dollar.

And if they'd kept that promise, your dollars would now be worth $12 — because gold is selling for around $420 an ounce, and 1/35th of that would be about $12.

You can still turn in your dollars today — just not for gold.

A. Van Den Berg: However, when foreigners started demanding gold and they started a run on the dollar, President Nixon knew that if they kept on turning in their money for gold, we would run out of gold. So he disconnected the dollar from gold. As they say, he "slammed the gold window down". As a result, there would be no more dollars exchanged for gold — just dollars trading out in the marketplace.

Therefore, if you look at your dollar bill now, it says "Federal Reserve Note".... Basically, what that means is if you go to the Federal Reserve and you turn in your note,

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you get *another* note [attendees laugh] — but you don't get any gold.

So long as the price is going up, you'll get a consensus.

A. Van Den Berg: Well, the foreigners realized, through their history of monetization, that gold was a little better than the dollar. So they started buying gold. And they had so many dollars around that they drove the price of gold up.

And any investment can be respectable if it goes up high enough. I am convinced it doesn't matter what it is — if it goes up high enough, university professors will write papers explaining why you should buy it. The pension funds will change their laws just in time to be able to get into it at the very top. The public won't *care* what it is as long as its price is going up. And the brokerage houses will shovel out these research reports that'll tell you by buying it, you're doing the right thing. So if its price is going up, you're going to get a consensus.

THE MEDIA IS A VALUABLE INVESTOR RESOURCE — BUT ONLY AS A CONTRARY INDICATOR.

Rising price turns barbaric relic into investment of choice.

A. Van Den Berg: At the bottom of its bear market, gold was referred to as a barbaric relic. But at the top, it was one of the most universal investments of choice. I'm going to read you some excerpts from an article that was written in 1979. And as I read it, I want you to focus on the date — 1979 — because unless you do, you're going to think it must have been written when the price of gold was at the bottom. But it wasn't. It was written when the price of gold was very near its top.

Here's what's happened: After the stock market was in the doldrums during the late '60s and early '70s and it went nowhere, *Business Week* came out with a startling research report. And when was this timely and scholarly piece of work presented to the world? Right at the top of the gold market and the bottom of the stock market. What was the title? "The Death of Equities". After the stock market had declined 40%, after it had gone nowhere for 13 years and was trading at 8 times earnings, *Business Week* came out with their "Death of Equities" issue. And we're going to talk about what they said about stocks, but let me tell you what they said about gold at that time.

On July 23, 1979, they wrote: "Institutions that manage pension funds began operating under a new and far more liberal interpretation of the labor department law. Pension fund money can now go in not only listed stocks and high-grade bonds, but also into small companies, real estate, commodity futures, gold and diamonds."

After they watched this market go straight up from $35 to $850, they decided it was time to get in.

When everybody gets involved in the act, it's too late.

A. Van Den Berg: Continuing from that same article, "At least 20 banks now include hard assets in their pension accounts. Just last May, for example, First Citizens Bank & Trust began accepting diamonds in their self-directed trust accounts because of increased demand from customers."

This is one of the things you learn in this business — when the customers start demanding things, you know it's going to start topping out. This is the only business where the customer could be wrong. [Attendees laugh.]

Continuing from that article, " 'At least 95% of these customers are trying to escape what inflation is doing to their stocks,' stated Vice President Ronald Mulholland. 'Given this type of consistent high level of inflation we have been experiencing, the stock market represents speculation and some tangible assets represent the opposite,' said Edward McMillan, chief economist for Rainier Bank."

I think about this and think to myself how at the top of the market when we're at 18-20 times earnings or more, people are thinking that it is properly priced, but at the bottom of the market in 1979, when the stocks were selling at 8 times earnings, the economists referred to them as "outright speculation", and gold at $850 was the investment of choice. I just wonder what this guy would think of today's market at 20 times earnings, but I can only guess.

Continuing from that same article, "Today, one of the strongest proponents of gold investment is Alaska's W.J. Hammond." And here was this guy's wisdom: "He plans to submit a bill to the legislature early next year to lift a law that was passed in the early '60s that prevents the state public teacher's retirement fund from investing in gold. And at least three other states are currently interested in tangible assets for their retirement plans."

I want you to look at these statements from 1979 — and then I want you to look at what gold was selling for at that time. If you do, you'll see how every time when everybody gets involved in the act, it's too late.

If you listen to the media and analysts, you'll be misled.

A. Van Den Berg: And the media always gets converted to the prevailing point of view. They are a mirror and an echo of what everybody is thinking. They're going to convince you that you're doing the right thing.

[Editor's note: In our August 11, 2003 *OID* edition, Clipper Fund's Jim Gipson commented on the fact that, "...if there is bad news on the front page of the newspaper as opposed to the back page of the business section, that by itself may attract us to it."]

A. Van Den Berg: Now, if you followed their advice and bought gold at $850, a $100 investment would be worth $50 today. And if you followed their advice ... to sell stocks at the time, a $100 investment in the S&P would be worth *$1,500* today. So the score would've been $1,500 to $50.

This is what the popular media was recommending at the time. That's why when you listen to the TV programs and read these research reports on these companies — and you read *the New York Times* and all of these other blatherers — you are going to be misled.

Two pieces of advice: Buy cheap and avoid the crowd.

A. Van Den Berg: There is only one way you can make money in the investment business — and that is the way you buy all your *other* things except stocks. You buy 'em *cheap*. You buy 'em at a discount. It's like my mother used to say: "Arnold — you gotta buy it *wholesale*."

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That's the way you buy stocks. You've gotta buy 'em wholesale. Anyway, now you know why it was easy for me to convert to the value approach.

To sum up the words of Gustave Le Bon, who wrote a book on crowd behavior [the 1895 classic, *The Crowd: A Study of the Popular Mind*]: Any individual, when alone, can be a cultivated person. However, put him in a crowd and he immediately becomes a blockhead. The crowd always gets taken in.

[Editor's note: On a more somber note, this would not seem to bode well for democracies in the nuclear age — when oceans, for the first time in history, no longer represent the moat (and forgiving margin of safety for being asleep at the switch) that they always did before. Just one miscalculation like the one the Allies made during the years leading up to World War II, and Pax Americana could be over and mankind could be back in the Dark Ages — perhaps, because of technology, even darker than ever.

In other words, if the price of freedom always is eternal vigilance — and we believe it is — then the price of freedom during the nuclear age is far heightened vigilance. And we would strongly second Van Den Berg's comments and suggest that you not rely on the media to help you reach the right conclusion in matters of geopolitics either.

We apologize for jumping on our soapbox. However, we thought it was just too important to go unsaid.]

PENSION FUNDS ARE THE LAST TO GET SUCKED IN. BUT WHEN THEY DO, *BOY* DOES THE MONEY GUSH IN.

Pension funds don't get sucked into the latest fad.

A. Van Den Berg: Let me tell you one thing about pension funds — because they are a wonderful indicator. Pension funds are designed to protect you. So they have the most conservative laws. So whenever a new fad starts, they *never* get involved — because they're prudent men and women. And they're not going to get sucked into a fad. So they always resist the new ideas.

Then a little bit of time goes by — and they get pressure from the people who they're managing the money for at the pension plan. They say, "Look, stocks haven't done well, bonds haven't done well, but gold and diamonds are up — we want gold and diamonds." So they have meetings. However, nothing happens. They vote it down.

But eventually the pressure becomes irresistible....

A. Van Den Berg: Then the pressure gets greater. More people come in, brokerage house reports start to pour out — and universities all of a sudden start looking at the new ideas and see how well they've done and how poor the old ones have done. So out comes the research from the universities.

And now it just keeps going and going. Once it becomes a mania, all bets are off. There is no way that the trustee of a pension fund can resist. They have to eventually give in to the pressure from the public, from the liberated trustees, from the brokerage community, from the media and from the university.

And that is why these pension funds always get in at the tail end of *whatever* it is — because they're the last ones to get converted. But once they get converted, *boy* can the money gush in — all of these billions of dollars going into these investments and driving them right up at the top.

The latest big idea? Hedge funds....

A. Van Den Berg: Now, are you interested in what the pension funds' latest big idea is — the one they're having meetings on to change the law today? It's hedge funds. The latest thing that the pension funds are getting big on is hedge funds. It's an idea that's been around for 50 years, but it's only gotten its new life in the last five years.

Basically what a hedge fund can do is use any conceivable speculative idea known to man. And they can *make* huge amounts of money — and they can *lose* huge amounts of money.

The great thing about a hedge fund is that they don't have to report to the government. They are not regulated. So they can do anything they want. They can invest in anything they want to....

And here's another good feature. They don't even have to tell their clients what they're invested in. So you can just imagine what these things are invested in. They're not regulated and they don't report what they own. And now, because of their track record, these pension funds are moving into them in a big way....

Price determines respectability, not vice versa.

A. Van Den Berg: I think you've got the idea from the gold market that you can have a huge run-up in a market that has never been invested in — and eventually you're going to get everybody in.

Any market will gain respectability if it goes up high enough — and any market will *lose* respectability if it goes down enough. That is the *huge* swing in emotion that happens. And that's why conventional wisdom in the investment field changes so much.

And the only way you can get your bearings is to look through history to see what the great investments really have been.

THE INDEX FUND CONCEPT IS A GOOD ONE, BUT THERE'S THE LITTLE MATTER OF PRICE.

Conditions were great to start a bull market in 1949....

A. Van Den Berg: Now we're going to move on to the next U.S. bull market. This is the 1949-1966 bull market. And in that bull market, the Dow Jones Industrial Average went from 162 to 995 — up more than six times. And then it went sideways for 16 years.

Here is the condition that created the '49 bull market: The country had been in a war. So because everything had gone into the war effort, everybody was flush with cash. And the debt ratio was the lowest it had ever been in the history of this country. People owed less then than they ever had. And that is a great way to start a bull market — because all of that cash can just come in and create another big bubble. And that's exactly what it did.

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Sometimes index funds are a *bad* idea — like today.

A. Van Den Berg: Seventeen years later, at the top of the bull market in '66 and '68, you just can't believe what was going on. That's when *I* got into the business — in 1968 — shortly after the market had begun a six-year downward slide punctuated with an occasional rally. And that market hit bottom in 1974. And as you all know, 1974 was the year we started Century Management.

Now what I want you to note is that this market went sideways for 16 years. It peaked out in 1966 at 995 — and it didn't break out above that level until 1982. During that time, if you'd owned an index fund — the *latest* thing that gained such popularity — you wouldn't have made any money for 16 years. **(See CHART 4.)**

We wrote an article back in 1999 in which we said that if you got into an index fund, over the next 10 years, the most we could see you making was a 3% per year return. And so far, it's right on schedule — because if you would've bought that index fund, it would've still been down 27%. And mind you, that's after five years.

Index funds are fine. But there's also the matter of price.

A. Van Den Berg: Why did indexing get so popular? It was a good idea that went to an extreme....

[Editor's note: As Charlie Munger recounted at the Wesco annual meeting featured in our December 31,1999 *OID* edition, that's "a phenomenon Ben Graham talked about over and over again. He said, 'It's not the *bad* ideas that do you in, it's the *good* ideas.'...

"He meant that if a thing is a bad idea, it's hard to overdo it.... You'll recognize it as a bad idea, so it's not going to cause much investment trouble. But where there is a good idea with a core of essential and important truth, you can't ignore it. After all, it's a good idea with important truth in it causing big effects. And then it's easy to overdo it. So the good ideas are a wonderful way to suffer terribly if you overdo them."]

A. Van Den Berg: The idea of an index fund is a wonderful thing: You've got a basket of stocks of the best companies in the U.S. They're low cost. You don't need a money manager. There's only one thing they forgot to tell you. You've gotta buy it *wholesale*. You've gotta buy it at the right *price*. And if you don't buy it at the right price, you can lose money in an index fund just like you can any other way.

And so if you buy an index fund within a value zone, it's a great idea. But if you overpay for it, you're going to lose money just as shareholders have lost millions — no, make that *trillions* — of dollars using these silly ideas. Great idea, kernel of truth, big lie wrapped around it. The big lie is that you can buy it at any price, and you'll do well because you're diversified and own a piece of America.

Doesn't that sound great? It's apple pie/piece of America. But do you want to pay $25 for an apple pie? You don't like it *that* much, do you? How can you expect to make money by owning an index fund if you buy it when its holdings are selling at two or three times their sales?

So during that period, the market went nowhere....

IF PAST BUBBLES ARE ANY INDICATION,
THIS ONE'S AFTERMATH OF WILL BE A DOOZY.

The most recent bull market was a doozy.

A. Van Den Berg: Please keep something in mind: The roaring '20s bull market ending in the 1929 bubble went up 6.3 times. The 1949-1966 bull market went up 6.1 times. And here you have the most recent bull market — and it went up *15* times. Does that kind of give you an idea that it might've been overdone a little bit?

The bull market that ended in '29 was not exactly a

CHART 4

DJIA Daily Close
1949-1966 Bull Market

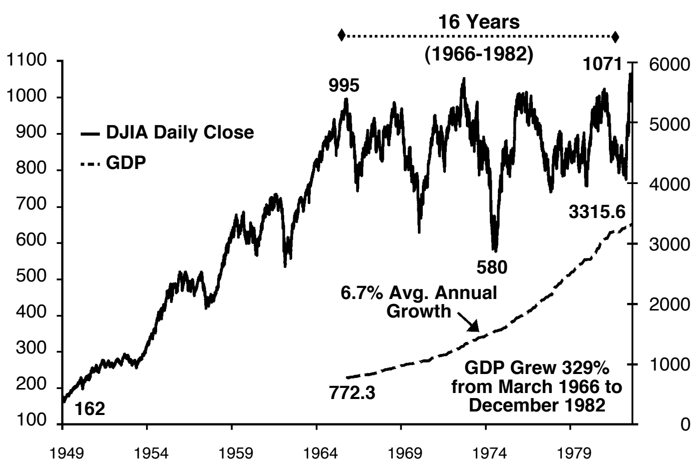
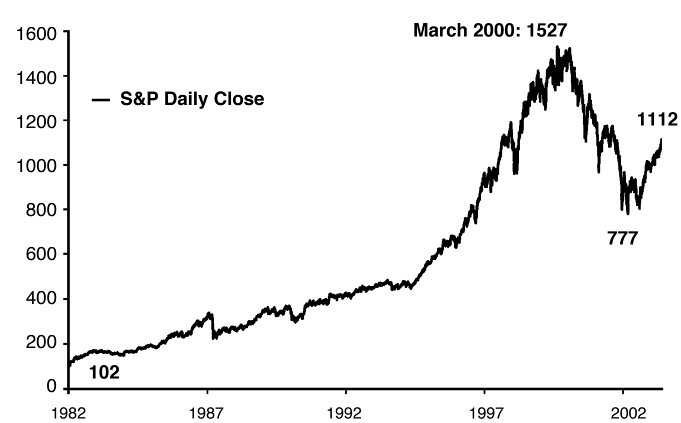


CHART 5

S&P Daily Close
1982-2000 Bull Market
Current Bull Market Ending in 2000



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normal one. Neither was the one that began in '49. And for that matter, neither was the most recent one — but it went up more than twice as much. That's extraordinary.... Just take a look at this extraordinary rise. **(See CHART 5.)**

These aren't just squiggly lines; they're people's life savings.

A. Van Den Berg: All of you were reading the papers about the tech bubble. You knew what a great thing this internet was. You knew how these tech stocks were just gonna go and keep going and going and going — that the internet was just starting, that it was only a few percent of GNP. You were just at the birth of a new era.

And then the bubble burst. The sad thing is that there is still $3 trillion of people's life savings that has been lost in this market. Even after this big rally, there's still been $3 trillion lost. I want you to think about that. Think about all these people that worked 30 and 40 years to accumulate their life's savings. I've sat across the table from many of them where they've lost half their money. And that is something you never get used to hearing about. It's something you can never stand to hear.

I walk out of those meetings shaking my head and thinking, "These people spent most of their lives — 30-40 years in many cases — accumulating this money. And look what happens — almost in the blink of an eye, poof! — half or more of their life's savings is gone."

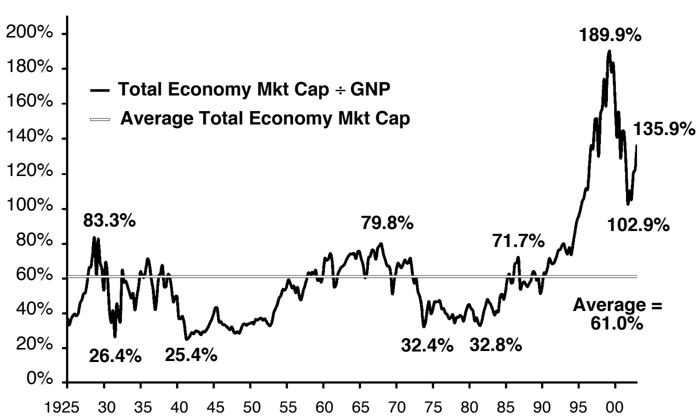
That's what bubbles do. They are absolutely extraordinary in terms of the pain that they inflict.

You can learn now or suffer later. The choice is yours.

A. Van Den Berg: And that's why it's so important for you to go back to these eras and read what happened

CHART 6

Market Cap ÷ GNP 12/31/24 – 12/31/03
Consensus Forecast for 12/31/2003



Source: Blue Chip Econometric Detail Consensus Forecast, NYSE, NASDAQ, AMEX, BEA

and see it repeated over and over again. It reminds me of a quotation by my favorite author, James Allen: "We either learn by wisdom and knowledge or suffering and woe. And we continue to suffer until we learn."

[Editor's note: As Buffett said in our August 8, 1997 *OID* edition, "Regarding learning from your own mistakes, the best thing to do is to learn from the *other* guys' mistakes.... Our approach is to try and learn vicariously. As Patton used to say, 'It's an honor to die for your country, but make sure the *other* guy gets the honor.' "]

A. Van Den Berg: These markets are here for you to learn from. And you can learn from them through wisdom, or you are going to continue to suffer until you do learn. One way or another, you will learn. You may not have all your *money* left if you learn through suffering. However, you will have improved your spiritual balance sheet....

Relative to GNP, U.S. stocks remain near historic highs.

A. Van Den Berg: If Saddam Hussein were still around, he would say that this is the mother of all bubbles. This next chart takes the total market cap of all of the stocks that are trading on all U.S. stock exchanges, and then divides that figure by the total economy — the GNP [Gross National Product] which is the value of all the goods and services produced by the U.S. economy (about $11 trillion). So it's basically like doing a price-to-sales ratio of the entire nation. **(See CHART 6.)**

Let me give you an example: A lot of businesses are sold on the basis of their sales. Take a doctor's practice. Let's say a doctor has $350,000 in revenues. Well, it used to sell for about 80% of sales — whatever the revenues were, it sold for about 80% of that. Doctors' practices have since gone down. And they're now only selling at about 60% of revenues. But that's the idea.

So if a typical company has, say, $100 million in sales, it might sell at something around $80 million at its peak price, and maybe $60 million as an average price.

Market cap to GNP's reflected valuations well in the past.

A. Van Den Berg: In '29, people were *very* optimistic about the future — so they were paying 83% of sales. And then you saw what happened afterwards. People *weren't* as optimistic when they *should've* been — and so prices were at 25% of sales. Then the bull market started, confidence returned, respectability for stocks was restored, and everybody was putting money into stocks — so that by December of 1968, the ratio of market cap to GNP of around 79% had returned to its 1929 level.

And then they started on a sickening slide — which I remember very well. They bottomed out at the 32% level. And it was from that level that the 1982-2000 bull market started up. By the way, take a look at 1979 on your chart. Again, that's when that scholarly piece of work on the equity market, "The Death of Equities", came out — with stocks at about 32% of GNP. That's when they were telling you that it was all over for stocks — and that instead you had to buy gold at $850 an ounce.

Based on historical market cap to GNP, we're in for it.

A. Van Den Berg: Anyway, the market started up. And it got a little heated in 1987 — it got to 71% of sales — and it promptly came back. And then it started rising in

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earnest with the arrival of the technology revolution and the internet. And boy, did it do wonders for the stock market. As you can see, the ratio of market cap to GNP rose relentlessly 'til it got all the way up to 190% in 1999.

Again, you can't even *imagine* how big that is unless you compare it to the other bubbles. And that's why I had to show you the other bubbles first. You can't appreciate this chart until you compare it to the other bubbles. And now you can see what we're in for.

In 2002, we could find cheap stocks in a pricey market.

A. Van Den Berg: Now we've had a major correction. And the market cap to GNP got all the way down to 100%.... In September of 2002, about nine days before the bottom, we came out with a newsletter and said that was the time to buy stocks — because we were actually buying stocks at 30-40% of sales.

The rest of the market wasn't there. And we couldn't buy all we wanted. But we were buying stocks at 30-40% of sales — and that has *always* been a good time to buy, no matter *what* the regular market's been.

And we could find plenty back in 2000. But not today....

A. Van Den Berg: As a matter of fact, ... at the top of the market in 2000, the median P/E of the Value Line was actually between 14 and 15 when the median P/E of the S&P was between 25 and 30. That was the largest discrepancy between the median P/Es of those two indices that we've ever seen. So we were able to buy many, many ideas.

The reason was that there were old economy stocks and new economy stocks. And what *everybody* wanted was the new economy stocks. So they sold these old economy companies all the way down to 30-40% of sales — which is where we bought 'em. And that's why we had such a terrific year in 2000 — there were still cheap stocks.

And today? Well, with U.S. stocks in aggregate at 135% of sales today, we can't find a *thing*. And the reason why is that the rest of the market has finally caught up with the bubble. So big cap stocks have gone down, but the rest of the market is now way up there....

[Editor's note: Indeed, it appears to us that the median P/E of *Value Line* stocks in March 2000 was about 36% below that of the DJIA. Today, it's *above* it.]

THERE ARE TWO WAYS FOR NORMALCY TO RETURN,
BUT NEITHER IS PARTICULARLY ENCOURAGING.

What do current valuations tell you about the future?

A. Van Den Berg: Anyway, here we are today with U.S. stocks in aggregate at something like 135% of sales. And here's what I want you to think about: During the last 50 years, the economy has grown at about 7% per year. And corporate earnings have grown about 7% per year. Isn't that logical to think earnings growth should track pretty closely with sales growth? It may be a bit erratic, but over the long run, the two should be reasonably close.

So I'm going to ask you a question: Starting from an overvalued position, if the market goes up 35%, you know what that's discounting? Five years of growth. And so that's what this last rally just cost you — five years — because it was already overvalued to begin with. So now it's that much *more* overvalued....

Some combination of two things has to happen....

A. Van Den Berg: So what will happen? Basically, here's the answer: Let's take an individual who's about six feet tall. Most men should weigh around 32 pounds per foot. So he should weigh about 190 pounds. Well, let's say this individual weighs around 320 pounds. How are we going to get this individual to a normal weight? The obvious answer is that you can take the weight off. But that's not the *only* way. He could grow four feet [the audience laughs]. In that case, he'd be 10 feet tall, weigh 320 pounds and be just right.

How are we going to do that with the market? Well, it's 130 pounds overweight. So that weight can either come off, or the economy has to grow four feet. The only problem is that it only grows 7% a year. And if it's going to grow 35%, it's going to take five years to grow those four feet.

So how do we get back to equilibrium? There are only two ways. Either GNP has to go up — and fortunately it is going up, so that's probably going to give us 7% a year — or the market has to go down. If it doesn't go down and it's 60% overweight, and it's only going to grow 7% a year, then it's going to take 12 years to get where it should be.

Bear markets tend to be long. But there is a way to beat it.

A. Van Den Berg: So you either grow into the sales, take the stock price level down or have some combination of both. And that's why, after bubbles break, they take 10, 15 or even 20 years to recoup their losses. In other words, they have been so overpriced that it just takes all these years to work it off.

And the only way you can beat these markets is to buy stock down around 30-60% of sales. And it doesn't matter where the market is. But when stocks are at 135% of GNP, it's hard to find something to buy at 30-60% of sales. And that's the problem we're having today....

PRICE TO SALES IS A GOOD BENCHMARK
FOR MARKET AND STOCK PRICE ALIKE.

Buffett likes market cap to GNP even better than we do.

A. Van Den Berg: Warren Buffett wrote an article in the December 10, 2001 edition of *Fortune* magazine entitled, "Warren Buffett on the Stock Market". He used this very chart. **(See CHART 6.)** And he said that if he had to use one single measure of corporate equities, that would be the one he would use. He said that it has some flaws, but that overall, it's a very good indication.

I personally agree with it. I have another indicator — a chart like this — that I like even better. But I won't disagree with anybody, because basically you're looking at the total gross national product — all the sales of everything in the whole country — and you're dividing it by the value of all the stocks. It's hard to go wrong doing that.

Market cap to GNP bypasses the earnings shenanigans.

A. Van Den Berg: And there is one major advantage to this approach — that you're not dealing with earnings.

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And as we're going to show you later on, earnings can be almost anything economists *want* them to be. [There's a smattering of laughter among clients.] It's not a straight math discipline they use in developing these earnings.

But you can't argue with the gross national product — and you can't argue with what prices stocks are selling for. So this flushes out all of the accounting games that are very prevalent nowadays. Again, it's kind of like looking at a price-to-sales ratio. It's not to be used by itself, but it's a very good indication.

Averages be damned. If a stock's price is right, we buy....

A. Van Den Berg: Buffett said that a good spot to start buying stocks is when the ratio falls to 70% or 80%.

[Editor's note: The exact quote is as follows: "If the percentage relationship falls to the 70% or 80% area, buying stocks is likely to work very well for you. If the ratio approaches 200% — as it did in 1999 and part of 2000 — you are playing with fire...."]

A. Van Den Berg: Now, I've already shown you that the average is 61%. However, I wouldn't again argue with buying stocks at 70-80%. All of the stocks that we buy, generally speaking — not always, but usually — are selling below 50% of sales.

So when we buy a stock, it tends to be 50-60% cheaper than what this chart shows the market trading for today.... [Ed. note: Over 63% cheaper, but who's counting?]

If you bought right, you'd have made money always.

A. Van Den Berg: If you start buying stocks when they're selling at 50% of sales — and then average down if they go lower to 30-40% so that you pay an average of 40% — would there have been any time in the history of this chart in which you wouldn't have subsequently made a lot of money? Can you see any place where you would've bought them at 30%, 40% or 50% and not have made money? No. You can't.

Stocks don't stay that cheap — or this expensive.

A. Van Den Berg: And that's because when stocks do get that cheap, they don't *stay* cheap. Similarly, when they get this expensive, they don't stay expensive. And that's the important lesson that one should learn from history — they never stay that expensive.

Benjamin Graham once said in the short term, the stock market a voting machine; in the long term, it's a weighing machine. So when the market weighs values, they get back to where they should be. And you can see that they're not there yet.

[Editor's note: We challenged Van Den Berg by suggesting that perhaps today's high profit margins and rich P/E multiples, as well as the way above average ratio of market cap to GDP, are justified, at least in part, because a higher proportion of those earnings come from branded goods companies — many of whom have significant international sales. As a result, we suggested, profit margins and returns on capital *should* be higher. And likewise, the P/Es on those earnings should be higher.

While acknowledging that we may very well be right on those particulars, he quickly provided the *coup de grace* to our argument by providing us with the following chart **(See CHART 7)** and explanation:]

A. Van Den Berg: I think our chart that shows market cap to GNP shows just how expensive stocks are today just fine. But when you factor in corporate debt — by looking at the ratio of market cap plus corporate debt to GNP — you see that valuations are even *more* out of sync. And almost nobody is talking about that.

When people lament that this market is selling at a price/earnings multiple of 19 or 20, I don't hear anybody saying it should be lower because of the additional debt.

OID: Because the higher leverage means that the financial risk is greater and, therefore, that the earnings quality is lower.

A. Van Den Berg: Exactly. And it also shows that not only is the consumer tapped out, but that businesses are near record levels of indebtedness, too.

OID: There's no need to get personal.

[Editor's note: We now return you to our coverage of this year's Century Management Client Conference.]

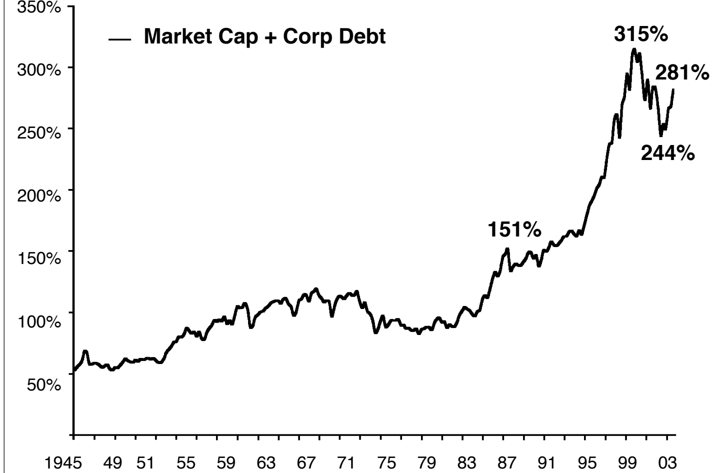
BULL MARKETS DON'T BEGIN FROM HIGH DEBT LEVELS — AND INDEBTEDNESS TODAY IS HIGHER THAN EVER.

The problem with democracy? Citizens get what they want.

A. Van Den Berg: Now I want to give you some ideas on how to judge this presentation — because I know that

CHART 7

Market Cap + Corporate Debt



Source: Century Management

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we're throwing a lot of information at you. And I know that some of you like to research this kind of thing for yourself. And we encourage that. The more people there are in this country who know what's going on, the better chance we've got of getting the right people in office — because when you see the next chart, you're going to know that we've had some people in office that should've never been there.... **(See CHART 8.)**

How did we get here? Let me read you a quote: "I wish it were possible to obtain an article to our constitution ... I mean an article taking from the federal government the power of borrowing."

Who do you think said that? Would you believe it was Thomas Jefferson? How about that for some wisdom? He knew that when you empowered the government to borrow money, the politicians would give you what you want — and this is what they did. They gave you all these wonderful programs. But take a look at the price tag — because it hasn't been paid yet.

[Editor's note: These comments sound remarkably similar to comments subsequently made by living legend John Templeton (of whom Van Den Berg reminds us in many ways) in *Forbes* in an article dated February 4, 2004 (available on Forbes.com).]

Current deficits are unsustainable....

A. Van Den Berg: Take a look at 1970 and 1980 and you can see what happened to the government debt. Today, we're running a deficit of $400 to $500 billion. So you can just imagine what this chart's going to look like in a few years.

I want to remind you that the interest on this debt at 5% is $350 billion — billion with a "b" like in "babies" — $350 billion. And if interest rates go up 2%, it's going to add another $70 billion for interest alone. If that were to occur, adding that $70 billion to the $500 billion deficit would mean that we'd be talking about a deficit of $570 billion. And you get the idea as we go on into the future. It is not sustainable.

And total indebtedness is already higher than ever.

A. Van Den Berg: You'll think that I made up this next chart, but I didn't. We downloaded it right from the Federal Reserve. And it's got the source right there if any of you want to download it yourself. **(See CHART 9.)**

When you take a look at this chart, it tells you *everything* that's going on in this country. We've had the greatest debt accumulation in the history of this country. And that includes debt of all kind — mortgages, government and consumer. And when I look at the numbers year by year since 1994 — a 10-year period — as a nation, we've added $10 trillion of debt.

Now to put that in perspective, the U.S. economy took over 200 years to grow to its current $11 trillion. Just think about that. In the past 10 years, we've added $10 trillion worth of debt.

Plus, the biggest segment of the economy is tapped out.

A. Van Den Berg: The consumer now accounts for 70% of the economy — 70%. It used to be 66%. However, now he's moved up to 70% — because of all of this easy money, borrowing against homes, etc. Most people today use their houses as an ATM machine. If they need money, they borrow it. So the mortgages have grown to be greater than they've *ever* been.

With the tremendous appreciation in house prices, you'd think people would have more equity in their houses. It turns out they have *less*. That's because they borrowed it all up — and they spent it. And then they borrowed some more.

Now we keep hearing about the economy growing and expanding. And we look at the consumer who's tapped out to his eyeballs. So I'm just wondering, where are they going to get these consumers? Are they going to import 'em from Mars? You just don't have that many people in this country who are that flush in cash.

Compare it to the beginning of the bull market in '49 when the debt to GNP was only one to one. Today, it's *three* to one. So the consumer is really tapped out. And the interest on his debt is now 18% of what they refer to as "financial responsibility payments" — in other words, 18% of his disposable income. That's a pretty big burden. And it's pretty hard to imagine that this can go on.

BESIDES HIGH LEVELS OF INDEBTEDNESS,
I WORRY ABOUT DERIVATIVES AND MARGIN DEBT.

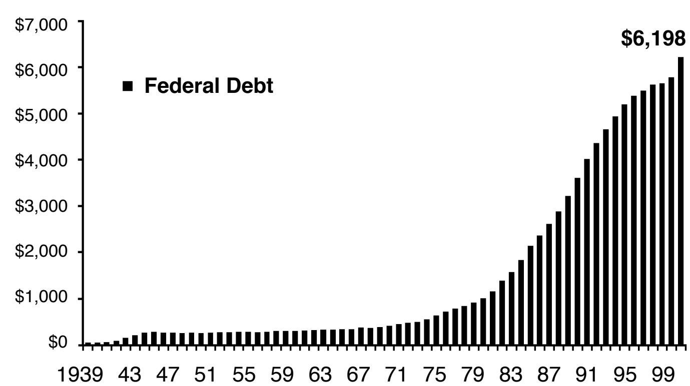
Derivatives may transfer risk, but they also create it.

A. Van Den Berg: I'm going to show you something. I don't want to dwell on it too much, but it's something that is of great concern to me — and that is derivatives. **(See CHART 10.)**

Because of the low interest rates, everyone has to

CHART 8

Total US Federal Debt
1939-2002 US$ (Billions)



"I wish it were possible to obtain a single amendment to our constitution ... I mean an additional article, taking from the federal government the power of borrowing." — Thomas Jefferson, 1798

Source: St. Louis Federal Reserve, FRED II

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hedge in the mortgage market. Currencies have to be hedged against each other. And corporations that don't want to take a risk can always find somebody at the other end of a derivative to hedge that risk....

So banks are involved in all of these different schemes to hedge everybody's risk — never realizing that they're creating more risk by doing so.

Now, guess what is the most popular method of investing in the hedge funds? Using derivatives. That's because you can place a bet for less than 10% — sometimes as little as 5%. But let's just take 10%. The notional value — the word they use for the aggregate nominal value of these financial schemes — is $67 trillion. That's with a "t" like in "terrible". Again, that's $67 trillion. Only 10 years ago — in 1991 — there was only $7 trillion of this kind of nonsense going on.

We're going to talk to you a little bit about what happens when these things blow up. But I can tell you that they've added another dimension of risk to the economy — because in any of these things, if somebody can't deliver on the other end, you've got a loss.

And they're a new source of risk we've never had before.

A. Van Den Berg: There are some banks ... that have 25-30% of their assets in this type of thing. So you can just imagine what could happen. I'm not saying it's *going* to happen, but I'm saying that it could happen. And it's an element of risk we've never had in the economy.

Now Greenspan says that it's a good thing because it allows people to *hedge* their risks.... Well, in the good old days, you got paid for taking risks. Now you can pass 'em on to somebody else.

But that doesn't mean that you're totally hedged — because what if the speculator doesn't pay up? What if the loss is so fast and so great that he figures, "To hell with it, I'll lose my money. I'm not going to make up the difference."

Another source of risk — margin debt....

A. Van Den Berg: When you go to a brokerage house and buy stocks at 50% margin, the brokerage house is protected because most stocks don't drop 50%. However, in 1987, when the market fell nearly 23% in one day, there were people whose stocks went down so fast that they lost all of their money. And the brokerage firms had to go after 'em and even sue 'em in order to bring in the rest of the money. But if the brokerage house customers didn't *have* the money, they were on the hook.

So if we ever get a meltdown, there's going to be a lot of people that are not going to be able to make good on those margin calls. And that's *another* thing to be concerned about.

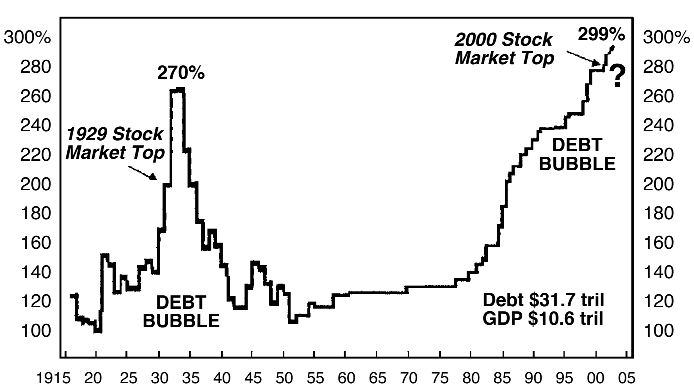
Leverage is a double-edged sword. It cuts both ways.

A. Van Den Berg: What created this bull market, as you can see, was government debt, consumer debt, and everybody else leveraging up. And if it's done over a sufficiently long period of time, you don't even *notice* it. But when you see that number from 1994 — when I saw it, I had to go back and check it two or three times, because I could hardly believe that we, as a nation, put on as much debt in 10 years as the gross national product. That is a mind-boggling figure.

I don't even want to *think* about how we are going to pay this all back. I have a feeling that there are going to be a lot of banks with some extra boats and cars and planes and whatever else that are out there. So there's going to be a real opportunity to buy bargains at some point in the future on consumer products.

CHART 9

Total Credit Market Debt
(All Sectors) as % of U.S. GDP

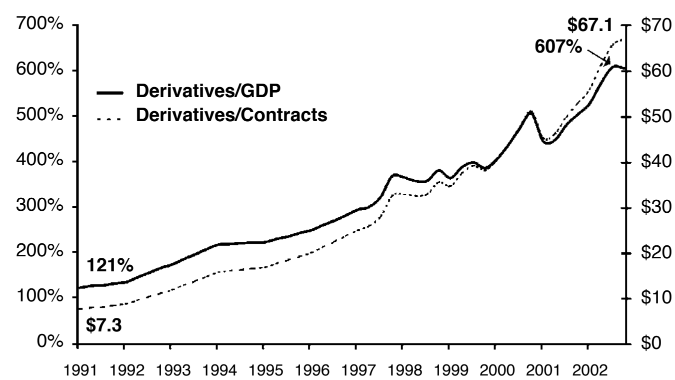


"When we are living on this much borrowed money, we are also living on borrowed time." — Paul Volcker, Federal Reserve Chairman, 1979-1986

Source: St. Louis Federal Reserve, FRED II, BEA

CHART 10

Derivatives vs. GDP
(in Trillions of Dollars)
1991 – September 2003



Source: BEA, U.S. Treasury's OCC

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CENTURY MANAGEMENT'S
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AS BUFFETT SAYS, ONLY WHEN THE TIDE GOES OUT DO YOU FIND OUT WHO'S BEEN SWIMMING NAKED.

It's easy to start down the slippery slope of fraud....

A. Van Den Berg: The second thing that causes bubbles to rise is fraud — down and outright fraud. Now you may say to yourself, "Why do bubbles create fraud?" Bubbles create fraud because there is an expectation built in. These companies promise rosy earnings. Some of them actually believe they're going to bring 'em in. And they trot these numbers out — and the stock goes up.

And then, all of a sudden, they're sitting in a board meeting and saying, "Gosh, sales dried up. It must be an aberration. But if we tell the stockholders, the stock is going to tank. So why don't we move some inventories or receivables around — or load up our boxes with rocks and send 'em out and call 'em sales — and book those sales. And then by the next quarter, we'll adjust it."

You know, it sounds like an OK idea if you can get by with it for a quarter.

And there are powerful incentives not to 'fess up.

A. Van Den Berg: But at the next quarter's meeting they're sitting there, and they say, "Gosh, the sales dropped even more. So what can we do *now*? Well, maybe we can sell some assets. Maybe we can figure out a way to bring those into the income statement. Or maybe we can fill up some more boxes full of rocks and ship 'em out and increase our reported sales. Or maybe we can show some inventories." There are a lot of different things you can do if you want to play the game.

Think about what corporations' boards are into. If they come out with the truth, the stock tanks. And if the stock starts to tank, the banks start looking at their bonds. And if the banks get worried about their bonds, they could call their loans. So they're all sitting around and saying, "You know, if we tell them the way it is, they're going to call the loans, and the stockholders are going to sell the stocks, and then everybody's going to lose. So let's just play the game and lie to the people and maybe get by this thing."

And then, of course, the truth catches up — because

(continued in next column)

the sales usually slide down as a function of the economy rolling over.

And nobody cares while stocks are going up.

A. Van Den Berg: In this gigantic bubble, very few people cared when these stocks were going up whether the balance sheets were good — whether they made any money. Some of 'em didn't even have sales! But if they're going up, who *cares*? If you're making 50% per year on your money, who needs to get that particular? *Something* must be working OK with the companies. Otherwise, why would their stocks go up? Never mind that they're going up because you're buying them.

Which kind of reminds me of a broker who's talking to his client. He says, "I've got this great little company." And he tells him about it. And the client says, "Well, buy me $1,000 worth." So he buys him $1,000 worth. And he says, "You know that little stock I sold you the other day. It's up to $3,000 already." So the client says, "Oh my God! Buy me some *more*!" So he keeps on moving it up until it's about $10,000 — at which point the client says, "Boy, this is great. This is a hell of a run. Why don't you go ahead and sell some?" — to which the broker says, "To *whom*?" [Attendees laugh.] That's what happens in these markets.

But the moment of truth eventually arrives.

A. Van Den Berg: So these companies came out and stretched. But then there's a moment of truth. Well, take a look at the moment of truth in this chart. **(See CHART 11.)**

These are companies that have either committed fraud or been accused of committing fraud with total pre-bankruptcy assets of at least $274 billion.... Do you know what the total corporate earnings projected for next year are? They're $600 billion. So this isn't a small number. You're talking about huge numbers that will have ramifications for the next few years.

And then recently, in Italy, they discovered a fraud — Parmalat Corporation, the eighth largest company in Italy with 36,000 employees, went bankrupt. It seems that their reported $5.4 billion in their Bank of America account just didn't exist. No one was worried about the company because it had so much cash. But they were issuing debt and selling more debt — and people called them and said, "Why are you selling debt when you have that much cash?"

"Oh, we've got a lot of strategic plans for that cash. So we want to raise the debt." But they eventually got to the point where they couldn't pay their bills. And then the creditors started investigating them. And Bank of America apprised them that they didn't *have* $5.4 billion in their bank account.

You have to wonder what happened to their auditor, or anyone else connected with their financial statements. Well, they found one guy — he just committed suicide. So that's probably a pretty good lead as to who was involved. But they still haven't figured it out.

However, it doesn't matter — because it's bankrupt. These are the kinds of things that happen. In every economy — in every bubble — people have committed fraud. As a matter of fact, in the '29 bubble, the president of the New York Stock Exchange went to jail because of the fraud involved.

Whenever you've got things going up, you've just got people who are going to be doing that kind of thing. Therefore, we have to be on our toes for it.

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ADJUSTING STATED EARNINGS FOR FLUFF,
P/E MAY BE MUCH HIGHER THAN IN PAST BUBBLES.

Excluding hot air, the current P/E may be around *24*.

A. Van Den Berg: Another thing that causes bubbles is overstatement of earnings — not necessarily fraud, but just stretching the truth a little bit, sometimes legally. Now, how do we detect that? Well, you can go to the IRS, download the corporation's profits, and you can see what they report to the government. So *there*'s a clue, isn't it? You see what the corporation's reported as profit to the government, and then you see what they've reported to shareholders. And by golly, there's quite a difference today — something in the neighborhood of 25% in aggregate.

Well, have you ever heard of anyone overstating their earnings to the IRS? I don't think so. Therefore, it's a pretty good bet that those are pretty conservative numbers. I don't think there's any bragging in reports to the IRS. But boy — when they dress those numbers up for their shareholders, they're something to behold. And today, the difference between reported numbers and IRS numbers is 25%.

Mind you, it's not all fraud. Some of it is legal. And we're going to show you how that's done. But my point is that when we take the total corporate profits of corporate America and divide them by the total market cap of all publicly-traded companies, we come up with a P/E of 24.6.

The important thing to understand — the only thing you need to understand — about this ratio is that it's much higher relative to corporate profits than it's been historically by a big margin.... **(See CHART 12.)**

CHART 11

Bankruptcy or Fraud

	Bankruptcy Date	Total Assets Pre- Bankruptcy (US$ Billion)
1. WorldCom	07/21/02	107.0
2. Enron	12/02/01	63.4
3. Global Crossing	01/28/02	25.5
4. Adelphia Commun	06/01/02	24.4
5. Pacific Gas & Electric	04/06/01	21.5
6. KMART Corp.	01/22/02	17.0
7. Reliance Group	06/12/01	12.6
8. HealthSouth	06/01/01	2.7
Total Pre-Bankruptcy Assets		$274 Billion

Firms listed above have either been proven to have committed fraud or have been accused thereof.

Source: Century Management

Stated earnings aren't docked properly for stock options.

A. Van Den Berg: Analysts project that the companies that comprise the S&P will earn $60 in 2004. So dividing that by the market cap of those same companies, the S&P is trading for 19 times earnings. Meanwhile, based on the projected earnings those same companies report to the government, they're trading at over *24* times 2004 earnings.

Why such a big difference? Well, let me give you some hints. First of all, corporations do not expense stock options. That means if a company hires a valuable employee and gives him part of the company as part of his compensation, as far as the balance sheet and income statement are concerned, it doesn't cost the company anything. Well, that would be like you giving me 2% or 3% of your home to manage your portfolio and claiming that you still own 100% of your home. Well, you *wouldn't*. I would own 2% or 3% of it for every year that we had that arrangement. Did it cost you anything? Well, *I* think so. And I think that you would say so. And if any of you *don't* think it cost you anything, I'd like to speak with you about implementing that arrangement later today.

So it costs them. But they don't put it down that way. They feel they get it back in terms of productivity. Well, maybe they do. However, it's still a cost. And if they accounted for that cost properly, that would reduce their earnings by 10-15%....

Accounting for pensions properly would hit 'em 10% more.

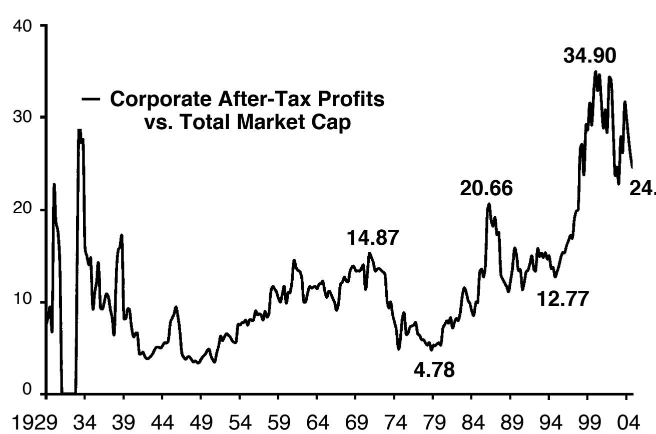
A. Van Den Berg: Number two, these companies have costs associated with pension administration. But the way they account for the pension expense is that they say there's so much money coming due when our people retire, and we're going to make 9% on our money — and bingo, 20 years from now, here's your pension check.

Well, what happens if companies only earn *6*% on

CHART 12

Total Economy P/E

Consensus Forecast through 12/31/04



Source: Blue Chip Econometric Detail Consensus Forecast, NYSE, NASDAQ, AMEX, BEA

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their pension assets? Or what happens if they don't make *any* money on their investments as has happened in many companies over the last five years? What do you do then?

Well, you had an expectation of 9% — and you only made 6%. So that means 3% is missing. How does the accounting work? Oh, don't worry about it. They don't have to write it off this year. They can just spread it out over the next 20-30 years as a loss.

But if they *make* money on their pension plan — if they estimate that they'll make 9% and wind up making 12% — then they can recognize that as operating income. Now what kind of accounting is *that*? They make money on their pension and put it in as part of corporate profits. And if they lose money, they spread it out over 30 years. You get the idea? If you account for pension expense properly, that would result in their earnings being lower by *another* 10%.

Adjusting for other shenanigans would hit 'em 5-8% more.

A. Van Den Berg: And then it would result in reported earnings dropping another 5-8% if you just eliminate your garden variety of stretching the truth — which they do by playing games with their inventories, receivables, moving things around, etc. By God, they're just getting more creative all the time. Frankly, if they would just be as creative running their businesses as they are when they're playing games with their accounting, we'd have some serious productivity gains. But they don't.

So most corporations are overstating their earnings by about 25%. And the overstatements are especially great among the big companies — those are the most overvalued companies.

But accounted for properly or not, the truth will come out.

A. Van Den Berg: But the truth will come out eventually. And it may come out sooner than you think. In the year 2005, it looks like they're going to have to start expensing their stock options — and that's a good start. So all those rosy earnings you're hearing from Wall Street might have to be adjusted. And if they are, I believe the market will have to be adjusted, too. Eventually, that will have to come out. There will be a moment of truth.

And if there *isn't* a moment of truth, it's going to come out anyway — because all those other options they create,

(continued in next column)

when those people turn those options into shares of stock, the earnings pie is going to be divided into more pieces. So these companies are going to make less per share.... When these options come due, and when they're reworked into the capitalization of the company, they're going to reduce the earnings. We call it "fully diluted earnings".

Whenever we look at a company, we factor in the likely impact of the options. We buy it with all the options already figured in.... And that lowers the valuation quite a bit.

BUT EVEN USING *STATED* EARNINGS,
WE'RE IN A VERY HIGH MARKET TODAY.

We pay attention to the *Value Line* median P/E.

A. Van Den Berg: I want to turn you over now to something that'll give you an idea of where we are today.... In September of 2002, when the market was coming down very dramatically and people were getting very nervous and prices were collapsing pretty much across the board, we thought we would send out a newsletter to our clients to let 'em know where they were. And to do that, we introduced them to the Value Line median P/E. And if you will recall, I told you I was going to give you my favorite indicator of value. Well, here it is. That's not to say that I don't like the other one that Warren Buffett mentioned. However, I think for us, this is a much better one.

Every week, *Value Line* takes 1,700 stocks and figures out their P/E. But they don't use the *average* P/E like the S&P does, they use the *median*. And what exactly is the median P/E? Well, to calculate the P/E of 500 companies, it's the P/E of the 250th or 251st company — of the one that's right in the middle.... So it eliminates the outliers at both ends that might otherwise distort the value.

Using medians rather than averages reduces distortion.

A. Van Den Berg: For example, in 1999 and 2000, we wrote an article pointing out that 10 members of the S&P, because they were so huge and weighed so much in the calculation, accounted for 77% of the performance of the S&P. So these big stocks can really distort an index. But if you take the median, it eliminates that distortion....

Everybody always likes averages. However, averages tend to distort things by a huge amount. If you have your head in your freezer and your feet in your stove, for example, you may have a fairly average temperature averaged out — but I just don't think you're going to be comfortable. [Clients crack up.] So we don't like averages. We like the midpoint. That's the figure we like to use when we're looking at P/Es.

We compare the *Value Line* median P/E to bond rates.

A. Van Den Berg: Now, what I have done over the past 25-30 years is I've compared this median P/E — and you can use the median P/E on the S&P or whatever — and compared it to bond rates. And the logic of it is, if bonds are cheaper than stocks, why buy stocks? We buy bonds. And when stocks are cheaper than bonds, we buy stocks.

So if we've got a bond rate at 7%, we wait until stocks yield 7%. And it's a little bit more involved... But by inverting that P/E and dividing it by 100, we get the earnings yield of a stock. So, for example, if there's a P/E of 14, that's the same as a 7% earnings yield on a bond.

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But if we can buy a stock at the same yield as a bond, we also get the earnings growth. And in the average stock, that's historically been around 7%. So we have a bargain, right? Wouldn't you rather have something that's a little bumpier but that gives you the same yield right now as a bond, but whose yield also grows at 7%? I mean, a bond may give you 7%, but it doesn't grow. With a stock, you get the yield *and* the growth.

When stocks yield as much as bonds, you get the growth free. Well, when that happens, stocks are an enormous bargain — and that usually happens at the time when most stocks bottom.

With a 14 P/E, there was much upside and little downside.

A. Van Den Berg: So when we wrote the newsletter, the median P/E according to *Value Line* was around 16.2. And the 10-year AAA corporate bond was yielding 6.19%. But we used a figure of 6.75% because that's our estimate of the normalized rate.

So anyway, we said stocks are starting to look cheap, but they've still got some risk. In a small down market, they'll decline 8-9%. In a larger market decline, they'll fall 13-14%. But we said the point of maximum pessimism — the time when people are just not being rational about stocks — is when you can buy a stock with the same earnings yield as a bond and get the growth for nothing. And that would be when the median P/E gets down to about 14. Well, lo and behold, it actually got down to 13.84 before the market turned around.

And from the bottom — from a median valuation of around 14 times earnings — we figured the median stock had appreciation potential [to a peak P/E multiple of 20.5] of approximately 46% with very little risk on the downside. So we figured that the risk from that price was negligible.

Today, it's reversed. We're in a very high market.

A. Van Den Berg: Well, guess where we are today? The median P/E according to *Value Line* is at 19.5. And the highest peak that we've *ever* had in a median P/E is 20.7. However, we don't like to wait until we break new records before we sell....

So with a median P/E of 19.5, we have potential appreciation of about 6% if it goes to 20.7.... But we have potential downside of 28%.

Now, is that the way it's going to happen? Well, I don't *know*. The market could set a new record peak. However, the average stock is as high as it was in 2000 — if you can believe it. And I don't mean the S&P 500 — because it's still down 27% from its peak. But the *average* stock is that high. So we are in a very high market.

ASSUME WHAT YOU WILL, THE S&P'S OVERPRICED — AND WE THINK PROFIT MARGINS ARE UNSUSTAINABLE.

Century's take on the Fed model....

A. Van Den Berg: But let's look at the next chart — which I also included it in our September 2002 newsletter. This is what we come up with when we use the so-called Fed model [method of estimating fair market value (FMV)]. Admittedly, it's an oversimplification. However, it gives you the idea. **(See CHART 13.)**

By the way, when you use this valuation method, the first thing that you've got to believe is the earnings — which we don't. Looking forward to this year's earnings, we use the same $50 we did in September. If you use $60, of course, you'd come up with a lot higher result.

The "E" in P/E is well above any sustainable level.

A. Van Den Berg: But there is no way the market can earn more than $50, on a long-term sustained basis — once things get washed out. Mind you, it could do it for a very short period of time — perhaps a year or so. It could even do it for a year-and-a-half — or even two years. However, it's not going to do it over the long run.

And here's why I say that: The S&P has $700 of sales per share. The average net profit margin that corporations have earned over the last 50 years is anywhere between 4% on the low side to, at *most*, 7% on the high side. There's been a few years — during the high inflation of the '40s and '70s — when, because of inflation, the margins temporarily pushed up to 8% or so, but that certainly wasn't sustainable. Based on what it's been over the last 50-60 years, I expect it to usually be between 4% and 5%, and maybe hit 6% every once in a while.

But if you take the $60 that Wall Street is projecting, you would have to project 8-1/2% margins. And that's just not sustainable. So if you're using $60, you may get away with it for a year, but not much more.

Whatever your assumptions, the S&P's overpriced.

A. Van Den Berg: Even if we assume profits reach 6% of the S&P's sales of $700 per share, that would still only give you $42. And again, they're using *$60*. But let's be generous, give 'em the benefit of the doubt, and use $50. Based on that $50, as we said in September of 2002, the

CHART 13

The Fed Fair Market Value (FMV) Model

	S&P 500 Price Level (Current @ 830)	Upside Potential (to FMV)	Downside Potential (to 35% below FMV)
15% Above	1265		
10% Above	1210		
FMV	**1100**	**0.00%**	**-35.00%**
-10% Below	990	11.11%	-27.78%
-20% Below	880	25.00%	-18.75%
-25% Below	**830**	**32.05%**	**-13.86%**
-30% Below	770	42.86%	-7.14%
-35% Below	715	53.85%	

Source: Century Management, September 2002 Newsletter

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fair value of the market is 1,100 — and we're already there. In fact, the S&P 500 is now closer to *1,150*.

[Editor's note: We understand that many bulls use the Fed Model to suggest that stocks are *under*valued. Accounting for the difference, besides the reduced earnings assumption described above, is Van Den Berg's use of a higher normalized 10-year Treasury rate — about 4-1/2% — to discount those earnings to a present value. (In fact, it's since risen from around 4% to almost exactly that.)]

A. Van Den Berg: So *now* what? In September, we said the S&P 500 could go to 1,210 — because markets go to 10% over value fairly regularly. That doesn't mean it's a good value. It doesn't mean you'll make money that way over the long run. It just means it could *go* there.

More importantly, it just means it will go down *more*. Markets even get *15*% overvalued — and that would put it at 1,265. So you've got upside of another 10-15% if you're wildly optimistic, if you believe Wall Street, and if you believe all the stuff that you read in the newspaper. And I've already told you how reliable they are. If you believe every one of those things, you can get there. And even if you do get there, so what?

And it could get *more* overpriced — but not with us in it.

A. Van Den Berg: But we can't find any stocks that meet our criteria to buy right now. So what should we do? Do you want us to buy something that's overpriced just because we think it's going to go up? We will *not* do that — I assure you. But we know that most people will — including many money managers. But that's not the idea of the value discipline.

Now people say, "Well, you can't time the market." But I'm not talking about timing the market. I'm just saying if it's not cheap, I'm not gonna *buy*. It doesn't mean that the market won't go up. It'll go up. It'll just go up without *us*. Meanwhile, eventually, people will come to their senses just like they always do. And when they do, we'll be able to buy stocks at the prices we want to pay....

VALUES AND PRICES CAN MEET IN TWO WAYS —
THE SLOW WAY, THE FAST WAY OR A MIX OF BOTH.

We can grow into today's value — in about 12 years.

A. Van Den Berg: Now, let's talk about how this market could unwind. In the first column of this next chart is the total market value of all U.S. stocks — which today is about $15.3 trillion. And in the second column is U.S. GNP — which is the total value of all the goods and services produced by everyone in the U.S. For 2003, it's estimated to have been around $11.3 trillion.

And if you divide that $11.3 trillion into $15.3 trillion, you see that you're at 135% of GNP — which, once again, is what I showed you earlier in that big bubble chart.... [Ed. note: See CHART 6 on page 27.] So anyway, that's where we are today.

Now let's assume the market is not going to go down. We're just going to grow four feet taller. Right? Instead of taking weight off, the way we'll get to our normal weight is by growing taller. So we're going to grow the economy. We're going to hold the market cap of stocks constant at $15 trillion, and assume that the economy is going to grow. (**See CHART 14a.**)

And as you can see, as the economy grows, the ratio does go down. By 2008, the ratio will have fallen to 98%. But please take note that by the time you get down to where stocks become real bargains again, it would be 2016.

And that's what's happened in the past....

A. Van Den Berg: Well, at this point, you probably think I'm nuts. You're probably thinking, "Are you trying to tell me that if this market doesn't go down, that the economy has to grow 6.7% per year for 10 years?" Well, that's *exactly* what I'm telling you.

That's what's happened in the past. In the '29 bubble it took *25* years. In the '66 bubble, it took *16* years. So far, in this bubble, it's been five years. And it isn't anywhere near its peak. So it's countdown time. You're five years into process. But you've got a long way to go.

Again, that's assuming the market doesn't go down. So if the market stays here, all we need is nice growth for the next 11 or 12 years — and by 2014 or 2015, U.S. stocks wil ... them today.

Stock pri ...

A. V ... tion. And we show t ... nario, we've ass ... S. stocks will drop ... things up. If stock prices drop 10% a year and GNP grows by 6.7% per year, then U.S. stocks would be fairly valued by historical standards, by golly, in only *five* years. (**See CHART 14b.**)

But bear in mind that stock prices would also be down 50% — 10% a year. In fact, by the end of 2008, stocks would be trading slightly below their historical percentage of GNP. So they would be a bargain and perhaps a great opportunity. The only problem is that those bargains would be around five years out and a 50% stock market decline away....

THE PRECEDING WAS EXCERPTED FROM OUR 24-PAGE FEATURE WITH:

CENTURY MANAGEMENT'S
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