

Outstanding Investor Digest

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

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Volume XII Number 3

December 29, 1997

OID MAILBAG:

THIRD AVENUE VALUE FUND'S MARTY WHITMAN
"THE SAFEST, CHEAPEST EQUITIES IN THE WORLD —
LIKE CLOSED-END FUNDS AT 50-80% OFF, ONLY BETTER."

When Third Avenue Value Fund's Marty Whitman says he's finding bargains, we pay close attention — especially when they involve financial stocks. So when he told us that he was buying some financials that were the equivalent of closed-end funds at 50-80% off, only *better*, and that he'd laid out the story in his latest letter, we figured it was time to share it with you. So without further ado...

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TEMPLETON FUNDS' MARK HOLOWESKO
"WE'RE MORE A SELLER THAN A BUYER OF U.S. STOCKS.
GIVEN MORE VALUE IN ASIA, WE'VE BEGUN TO BUY THERE."

Succeeding living legend John Templeton is similar to succeeding Mickey Mantle in center field for the Yankees — a hard act to follow at best. Mark Holowesko, however, continues to pull it off just fine. The trailing 10-year returns of Templeton Growth Fund, which he reportedly began managing in 1987, rank it among the top 1% of funds in its category at the same time its downside volatility has been below that of 85% of its peers. All the while, it's been the

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VALUEVEST MANAGEMENT'S
MARK BAKAR AND JOHN BURBANK
"LIQUIDATION UNDERWAY IN MORE THAN A FEW NATIONS —
THE MOST EXTREME UNDERVALUATIONS I'VE EVER SEEN."

Because Mark Bakar founded ValueVest Management only about 2-1/2 years ago, his track record is quite brief by OID standards. However, during that short period, he piqued our interest with some unusually intriguing ideas.

Therefore, with some of his favorite hunting grounds, which include the emerging markets, recently savaged, (a casualty of the turmoil in Asia), we thought that it might be

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WESCO FINANCIAL'S CHARLIE MUNGER
WORLDLY WISDOM REVISITED: LESSON #2
"HOW DO YOU GET WORLDLY WISDOM?
JUST TAKE THE BEST MODELS FROM ALL DISCIPLINES."

At Berkshire Hathaway's most recent annual meeting, Buffett noted, "Every investor in the world ought to read ... [Charlie Munger's 'Lesson on Elementary Worldly Wisdom'] before they invest. It's a classic."

We agree — in spades. Both we and more than a few of our most thoughtful contributors and subscribers refer to the principles and examples from his original lecture, (which appeared in our May 5th, 1995 edition,) again and again.

For all of those reasons and more, we're very pleased to
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WESCO FINANCIAL'S CHARLIE MUNGER
WORLDLY WISDOM REVISITED
(cont'd from page 1)

bring you Worldly Wisdom Revisited — excerpts from a lecture and answers to student questions thereafter during a visit last year to a Stanford Law School course he endowed entitled, "Business: What Lawyers Should Know." The course is taught by Professor William Lazier, without whose assistance this feature would not have been possible.

As always, we highly recommend that you give Munger's comments a thorough reading, re-reading, etc. We believe the vein to be enormously rich and very well worth the mining. We hope you find it equally so.

HOW DO YOU GET WORLDLY WISDOM?
TAKE THE BEST MODELS FROM ALL DISCIPLINES.

Without learning, Berkshire wouldn't be what it is today.

Charlie Munger: What I'm going to try to do today is to extend the remarks I made two years ago at the U.S.C. Business School.... You were assigned a transcript of my U.S.C. talk. And there's nothing I said then that I wouldn't repeat today. But I want to amplify what I said then....

[It's] perfectly clear ... that if Warren Buffett had never learned anything *new* after graduating from the Columbia Business School, Berkshire would be a pale shadow of its present self. Warren would have gotten *rich* — because what he learned from Ben Graham at Columbia was enough to make anybody rich. But he wouldn't have the kind of enterprise Berkshire Hathaway is if he hadn't kept *learning*.

What do you need? The best models from all disciplines.

Munger: How do you *get* worldly wisdom? What system do you use to rise into the tiny top percentage of the world in terms of having sort of an elementary practical wisdom?

I've long believed that a certain system — which almost any intelligent person can learn — works way better than the systems that *most* people use. As I said at the U.S.C. Business School, what you need is a latticework of mental models in your head. And you hang your actual experience and your vicarious experience (that you get from reading and so forth) on this latticework of powerful models. And, with that system, things gradually get to fit together in a way that enhances cognition.

And you need the models — not just from one or two disciplines, but from *all* the important disciplines. You need the best 100 or so models from microeconomics, physiology, psychology particularly, elementary mathematics, hard science and engineering [and so on].

You need not be an expert, but you must learn 'em right.

Munger: You don't have to be a huge expert in any of those fields. All you've got to do is take the really *big* ideas and learn them early and well.

You *can't* learn those 100 big ideas you really need the way many students do — where you learn 'em well enough to bang 'em back to the professor and get your grade and then you empty them out as though you were emptying a bathtub so you can take in more water next time. If *that's*

the way you learn the 100 big models you're going to need, [you'll be] an "also ran" in the game of life.

You have to learn the models so that they become part of your ever-used repertoire.

THINK THINGS THROUGH FORWARD AND BACKWARD.
IT WORKS IN ALGEBRA AND IT WORKS IN LIFE.

An incredibly useful trick: thinking things through backwards.

Munger: By the way, there's no rule that you can't add another model or two even fairly late in life. In fact, I've clearly done that. I got *most* of the big ones quite *early*. However, once you've gotten these models in your head, what else do you need?

Well, there's one mental trick that's *unbelievably* useful. And that is, as you think through reality using these models, think it through forward and also think it through *backward*. In other words, follow the injunction of the great algebraist, Carl Jacobi, who said, "Invert. Always invert."

You're absolutely no good in algebra if you can't turn the problems around and solve them backwards. Indeed, if I ask any of you who plan to get married and have five children, "What are the odds that at least one of them will be a girl?", you can all solve that immediately if you do it backwards. But if you try and do it forward, it's hell on earth. So Jacobi was plainly *right*.

What worked for Jacobi in algebra works in life.

Munger: And what worked for Jacobi in algebra works in the rest of life. For example, if you were hired by the World Bank to help India, it would be very helpful to determine the three best ways to *increase* man-years of misery in India — and, then, turn around and *avoid* those ways. So think it through backward as well as forward. It's a trick that works in algebra and a trick that works in life.

If you don't, you'll never be a really good thinker. That's just the way [it is]. When it gets complicated, it's very helpful to think it through forward and backward.

Always try to disprove your own assumptions.

Munger: And, of course, the mental habit of thinking backward *forces* objectivity — because one of the ways you think a thing through backward is you take your initial assumption and say, "Let's try and *disprove* it."

That is *not* what most people do with their initial assumption. They try and *confirm* it. It's an automatic tendency in psychology — often called "first-conclusion bias." But it's only a tendency. You can train yourself away from the tendency to a substantial degree. You just constantly take your own assumptions and try and disprove them. That's part of the winning game of thinking both forward and backward.

Darwin proved the value of a diligent, objective curiosity.

Munger: Darwin is a *great* model in terms of objectivity. And the reason why I especially like Darwin is that his example provides reasonable hope of mental improvement to a great many people. Almost everyone in this room has a higher I.Q. than Darwin. Yet, Darwin's body now lies right next to Newton's in Westminster Abbey.

Part of his secret was *doggedness*. Part of his secret was an immense *objectivity*. And part of his secret, of course,

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WESCO FINANCIAL'S CHARLIE MUNGER
WORLDLY WISDOM REVISITED: LESSON #2
(cont'd from preceding page)

was an extreme *curiosity*. And what a diligent, objective curiosity will do for you in this life to elevate you above your intellectual betters — [who have] minds that work faster than yours — is a lot. If Darwin could take modest intellectual endowments and end up next to Newton in Westminster Abbey, we can *all* learn something from him.

And one of the great things to learn from Darwin is the value of extreme objectivity. He tried to *disconfirm* his ideas as soon as he got 'em. He quickly put down in his notebook anything that disconfirmed a much-loved idea. He *especially* sought out such things.

Well, if you keep doing that over time, you get to be a perfectly *marvelous* thinker instead of one more klutz repeatedly demonstrating first-conclusion bias.

AND FORCES FROM THESE MODELS COMBINE
— SOME NEGATIVELY, SOME EXPLOSIVELY.

Big forces from these models combine in more ways than one.

Munger: The next great model is the idea that especially big *forces* often come out of these 100 models — when several models *combine*.... You get *lollapalooza* effects when two, three or four forces are all operating in the same direction. And, frequently, you don't get simple addition. It's often like a critical mass in physics where you get a nuclear *explosion* if you get to a certain point of mass — and you don't get anything much worth seeing if you *don't* reach the mass.

Sometimes the forces just add like ordinary quantities and sometimes they combine on a break-point or critical-mass basis. And you've just got to understand....

It's true. Life is just one damn relatedness after another.

Munger: More commonly, the forces coming out of these 100 models are *conflicting* to some extent. And you get huge, miserable trade-offs.

But if you can't think in terms of trade-offs and recognize trade-offs in what you're dealing with, you're a horse's *patoot*. You clearly are a *danger* to the rest of the people when serious thinking is being done. You have to recognize how these things combine. And you have to realize the truth of biologist Julian Huxley's idea that, "Life is just one damn relatedness after another." So you [must] have the *models* and you [must] see the *relatedness* and the effects from the relatedness.

You want a lot of autocatalysis in your career & business life.

Munger: Another model that I very much like, I've taken from E.O. Wilson, Harvard's great ant specialist biologist — and that's *autocatalysis* in chemistry. If you get a certain kind of process going in chemistry, it speeds up on its own.

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So you get this marvelous *boost* in what you're trying to do that runs on and on. Now, the laws of physics are such that it doesn't run on *forever*. But it runs on for a goodly while. So you get a huge boost. You accomplish A — and, all of a sudden, you're getting A + B + C for awhile.

Well, you want a lot of autocatalysis in your career and your business life, etc. So you *look* for autocatalytic effects.

THE BEST ACADEMIC VALUES REALLY WORK
AS WELCH, BUFFETT & GRAHAM HAVE SHOWN.

Worldly wisdom is quite academic. Witness Welch & Buffett.

Munger: Well, doesn't this sound way too academic for somebody who's coming in from the marts of trade and talking about worldly wisdom? Is practical worldly wisdom as academic as all this sounds? My answer is, "Yeah, it is."

Your assigned reading for today included the latest annual letters from Jack Welch and Warren Buffett relating to General Electric and Berkshire Hathaway, respectively. Jack Welch has a Ph.D. in engineering. And Warren plainly could have gotten a Ph.D. in any field he wanted to pursue. And both gentlemen are inveterate teachers.

Worldly wisdom is *quite* academic when you get right down to it. Look at what General Electric has achieved — and, for that matter, what Berkshire Hathaway has achieved.

And don't forget Graham....

Munger: Of course, Warren had a professor/mentor — Ben Graham — for whom he had great affection. Graham was so academic that when he graduated from Columbia, three different academic departments invited him into their Ph.D. programs and asked him to start teaching immediately as part of the Ph.D. program: [those three departments being] literature, Greek and Latin classics, and mathematics.

Graham had a *very* academic personality. I knew him. He was a lot like Adam Smith — very preoccupied, very brilliant. He even *looked* like an academic. And he was a good one. And Graham, without ever really *trying* to maximize the gaining of wealth, died rich — even though he was always generous and spent 30 years teaching at Columbia and authored or co-authored the best textbooks in his field.

So I would argue that academia has a *lot* to teach about worldly wisdom and that the best academic values really *work*.

DON'T BE LIKE THE WORLD GENERALLY.
INSTEAD, BE LIKE THE LITTLE RED HEN.

Be multi-disciplinary — whatever academia & business say.

Munger: Of course, when I urge a multi-disciplinary approach — that you've got to have the main models from a broad array of disciplines and you've got to use them *all* — I'm really asking you to ignore jurisdictional boundaries.

And the world isn't organized that way. It *discourages* the jumping of jurisdictional boundaries. Big bureaucratic businesses discourage it. And, of course, academia *itself* discourages it. All I can say there is that, in that respect, academia is horribly wrong and dysfunctional.

And some of the *worst* dysfunctions in businesses come from the fact that they balkanize reality into little individual departments with territoriality and turf protection and so

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WESCO FINANCIAL'S CHARLIE MUNGER
WORLDLY WISDOM REVISITED: LESSON #2
(cont'd from preceding page)

forth. So if you want to be a good thinker, you must develop a mind that can *jump* the jurisdictional boundaries.

You don't have to know it all. It's like contract bridge....

Munger: You don't have to know it all. Just take in the best, big ideas from all these disciplines. And it's not that hard to do....

I might try and demonstrate that point by [using the analogy of] the card game of contract bridge. Suppose you want to be good at declarer play in contract bridge. Well, you know the contract — you know what you have to achieve. And you can count up the sure winners you have by laying down your high cards and your invincible trumps.

But if you're a trick or two short, how are you going to get the other needed tricks? Well, there are only six or so different, standard methods: You've got long-suit establishment. You've got finesses. You've got throw-in plays. You've got cross-ruffs. You've got squeezes. And you've got various ways of misleading the defense into making errors. So it's a very limited number of models.

But if you only know one or two of those models, then you're going to be a horse's patoot in declarer play.

What works in contract bridge works in life.

Munger: Furthermore, these things *interact*. Therefore, you have to know how the models interact. Otherwise, you can't play the hand right.

Similarly, I've told you to think forward and backward. Well, great declarers in bridge think, "How can I take the necessary winners?" But they think it through *backwards*, [too. They also think,] "What could possibly go wrong that could cause me to have too many *losers*? And *both* methods of thinking are useful. So [to win in] the game of life, get the needed models into your head and think it through forward and backward. What works in bridge will work in life.

That contract bridge is so out of vogue in your generation is a tragedy. China is way smarter than we are about bridge. They're teaching bridge in *grade* school now. And God knows the Chinese do well enough when introduced to capitalist civilization. If we compete with a bunch of people that really know how to play bridge when our people don't, it'll be just one more disadvantage we don't need.

The world isn't multi-disciplinary. But you can be.

Munger: Since your academic structure, by and large, doesn't encourage minds jumping jurisdictional boundaries, you're at a disadvantage because, in that one sense, even though academia's very useful to you, you've been mistaught.

My solution for you is one that I got at a very early age from the nursery: the story of the Little Red Hen. The punch line, of course, is, "Then I'll do it *myself*", said the Little Red Hen."

So if your professors won't give you an appropriate multi-disciplinary approach — if each wants to overuse his own models and underuse the important models in other disciplines — you can correct that folly *yourself*. Just because he's a horse's patoot, you don't have to be one, too. You can reach out and grasp the model that better solves the overall problem. All you have to do is *know* it and

develop the right mental habits.

And it's kind of *fun* to sit there and outthink people who are way smarter than you are because you've trained yourself to be more objective and multi-disciplinary....

Furthermore, there's a lot of *money* in it — as I can testify from my own personal experience.

TESTING OUT OUR MULTI-DISCIPLINARY APPROACH
WITH A (MOSTLY) HYPOTHETICAL EXAMPLE....

Does this stuff really work? Let's find out....

Munger: If I'm right in this multi-disciplinary approach which exalts proper academic values, I ought to be able to come up with some exercise that demonstrates its value. So I want you to join me today in a very odd mental construct: Let's go back to 1885 in Atlanta and invent from scratch a new nonalcoholic beverage business out of which we will all get rich. What are we going to do?

Our first decision: Will our beverage be hot or cold?

Munger: Well, our first [decision] is [whether we're] going to have a *cold* beverage or a *hot* beverage. By the way, today we're allowed to use all the models that academia has developed — including those developed after 1885. That's the rule of today's game.

Well, to me, it's obvious that we go for a cold beverage. Man has had fire for many eons and hot beverages are widely available. Cold beverages are *hard*. There's no *refrigeration* in 1885. And the general delivery of ice is galloping like crazy, but it's far from having [become ubiquitous]. Furthermore, we know enough physics to see that refrigeration is feasible and will come along in due course. We also know that physiology requires huge ingestion of preferably cold liquid when man is working hard or is hot from climatic effects. So there's a huge *tailwind* to be gained [by creating] a cold beverage that we aren't going to have with a hot beverage.

So just by knowing a few simple models from physics and physiology, we can see it has to be a cold beverage.

FROM ECONOMICS & LAW, TRADEMARK & PROTECTION.
FROM PSYCHOLOGY, CONDITIONED REFLEXES....

We'll never get very rich without a trademark and a brand.

Munger: How do we make a lot of money out of a new cold beverage? Out of twin doctrines from microeconomics and law, obviously it must be a *trademarked* beverage with its own label and trade dress. And we must have legal protection for that trademark and trade dress.

And we have to arrange that people don't order just a generic bottle or glass of our beverage. They must order it by name — our trademarked name. We'll never get very rich from this business except by using a trademark and creating a brand strong enough that people order our new beverage by its trademarked name.

That, again, is obvious based on elementary models taken from the disciplines of law and microeconomics.

If it's repeat behavior we want, we next turn to psychology....

Munger: Obviously, we must get a lot of repeat business for our beverage — repeat business that is *triggered* by our trademark.

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WORLDLY WISDOM REVISITED: LESSON #2
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Well, what model am I talking about whereby people automatically repeat the activity of buying and consuming something in response to a trademark? Well, you look in your psychology book. And, lo and behold, in the most important two segments in every psychology book, you find *conditioned reflexes*. Obviously, if someone is constantly buying a trademarked beverage, they're demonstrating a conditioned reflex — with the trademark, the shape of the bottle, the color of the liquid, etc. being the *stimulus* and their buying it and consuming it being the *response*.

In major part, your business is operant conditioning.

Munger: So you read on in the psychology book [looking for] very elementary models. And [under] conditioned reflexes is *operant conditioning* — Skinnerism. The food value and so forth of the beverage is the *reinforcer*. And the trade dress, trade name and look of the beverage is the *stimulant*. So you've got operant conditioning — straight out of B.F. Skinner. That, in major part, is what your business is when you try to establish a beverage sold under a trademark.

MERE ASSOCIATION HAS ENORMOUS POWER
IN BUSINESS — AT LEAST, AS PROPERLY DEFINED.

"Pavlovian mere-association effects" have enormous power.

Munger: Then, you go on to the second kind of conditioned reflex — and that's straight Pavlov, except the textbooks often call it "classical conditioning." That's a terrible name — because it doesn't guide the mind to the full power of the idea.

So, like the Little Red Hen, I don't have to use a silly name just because the psychology professors do. So I'll invent my own name. I call what the textbooks refer to as classical conditioning "Pavlovian mere-association effects" — because mere association has *enormous* power. And your mind is guided to recognition of that when you use a name like "Pavlovian mere-association effects."

Well, how do you *get* Pavlovian mere-association effects? Obviously, you *associate* this beverage and its trademarks with every other good thing that people like generally: exalting events, sex objects, happy times — you name it.

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Pavlovian mere association even distorts cognition.

Munger: Of course, that's what *Coca-Cola's* advertising campaign *does*. There's never a big, important, positive-image-type event in the world that *Coca-Cola* isn't there. They *know* that these Pavlovian mere-association effects [increase the consumption] of their beverage.

In fact, it actually improves the drinker's *experience*. The human mind, under principles of psychology, works in such manner that advertising actually makes you *enjoy* Coke more when you're drinking it. It doesn't just induce you to try it. It actually improves its *effects*. In effect, cognition is *distorted* by Pavlovian mere-association effects.

And, therefore, we're going to use *tons* of Pavlovian mere-association effects. We're also going to make this beverage a maximized reinforcer. And we're going to develop a very clever trade name and trade dress in order to maximize Pavlovian mere-association effects.

Business school professors haven't quite got it yet.

Munger: If you ask the average business school professor, "What's the business of the *Coca-Cola Company*?", he won't give you the right answer. But the right answer was given to me once by Don Keough — the very eminent, recently retired president of *Coca-Cola*. And what Keough said was, "The business of the *Coca-Cola Company* is to create and maintain conditioned reflexes."

So Keough and **Munger** have the same idea exactly. And, by the way, we're right. As for the business school professors who talk in a different language — well, maybe they should change.

BY COMBINING AND REINFORCING ELEMENTS,
WE CAN ACHIEVE LOLLAPALOOZA EFFECTS.

Next, we want as powerful a reinforcing effect as we can get.

Munger: In designing our new beverage, we're mindful of *combinatorial* effects. And we're mindful of *autocatalysis* and so forth. Once we get this thing going, we want it to run. We want as powerful a reinforcing effect as we can possibly get. So we together think out what we're going to do to this beverage to make it a powerful reinforcer. And what do we do? We put in *food value*. The reason rats, pigeons and so forth are trained in operant conditioning with food is that food is nearly an automatic reinforcer. So we're going to include some caloric value in our drink.

And why stop with food value? We can include a stimulant.

Munger: Another reinforcing trick is a *stimulant* — for instance, caffeine. Why should we hold back? We want fancy combinatorial effects. And once we realize that we get extra-powerful effects — what I call lollapalooza effects — from combining a bunch of things to work in the same direction, we're not going to stop with food value. We're going to have food value *plus* a stimulant: caffeine. It's *obvious*.

Both plainly work. [So there's] no reason not to combine them. We want the double effect. It's better reinforcement.

And we care about the totality of the experience. So flavor.

Munger: *Flavor* is a very important reinforcer. And, here again, we know enough physiology and biology to know that people are genetically programmed to like sweet flavors. So it's going to be some kind of a sweet flavor.

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Aroma and texture are also very much part of the experience. And, therefore, we're going to care about the totality of the essential experience which people have as they consume our new beverage.

You win big by getting two or three forces working together.

Munger: We'll put sugar in because it's a stimulant, too. By making our caloric content sugar, we get food value plus two kinds of stimulants.... Again, I'm trying to get lollapalooza effects by combining. It's perfectly *obvious*. This is the way you win big in the world — by getting two or three forces working together in the same direction.

NEXT, THINKING BACKWARD, WHAT DON'T WE WANT?
AFTERTASTE, COPYCATS, NEGATIVE ASSOCIATIONS....

What don't we want? People discouraged from drinking it.

Munger: But, as I said, you have to think things through forward and backward. So, next, we'll think it through backward. It's *dangerous* to just think forward. That way, you miss important points. Let me demonstrate:

What don't we want in our new drink? Well, again, we know enough elementary physiology to know that animals are genetically programmed to reject *surfeits* of certain flavors. It's not good for animals just to gorge and gorge and gorge on some things. So there are automatic turnoff mechanisms in human physiology.

And we want people to just keep *swilling* our new drink — time after time with no surfeit mechanism discouraging additional consumption. If you try and drink six cream sodas in a row on a hot day, you'll *choke* to death on the aftertaste. It will be a ghastly experience.

So by just thinking backward, we get a huge and useful bit of wisdom. We don't want *any* aftertaste. We want people to be [able to swill] this stuff all day long in hot climates — in cold climates, too, for that matter. We don't want them *discouraged* by their own physiological response to an aftertaste.

So we want to experiment around and get a flavor with virtually no aftertaste. And, incidentally, that's exactly what Coca-Cola has — except they weren't smart enough to do it my way on purpose when they started out. They just stumbled onto the right answer.

And we don't want the huge cost of shipping water.

Munger: What else don't we want? Well, again, just [using] elementary engineering and mathematics, we know that we don't want to ship a lot of *water* and extra weight and volume of containers all over the world. Obviously, that would cost us a fortune. Therefore, basically, what we're going to sell is *syrup*.

What else don't we want? We don't want it easily copied.

Munger: Also, we're trying to add additional lollapalooza effects. So what else can we do? Well, it happens that *carbonation* increases the overall sensual experience — in terms of flavor and so forth.... Besides, we like making it a little more difficult for competitors to copy.

We want it to be reasonably complicated because we want to achieve a big edge that others can't easily copy. Therefore, we carbonate our drink.

So far, so good....

Munger: So after we've experimented, ...we're going to use caffeine and sugar as stimulants, have a marvelous flavor with virtually no aftertaste, carbonate our beverage and make it cold. All of this takes care of providing reinforcement to maximize the creation of a conditioned reflex based on operant conditioning....

And we know that we don't want it to look cheap.

Munger: The next problem is to maximize the obtaining of a conditioned reflex grounded in Pavlovian mere-association effects. But when we finally solve the earlier problems, our liquid is clear — like 7-Up. But if we think in terms of Pavlovian mere-association effects, we realize that our liquid looks cheap and *ordinary* — like water. And we don't want *that*. We want it to look *expensive* and *exotic*. So we stick in burnt caramel or whatever and color the natural flavor of the drink to something vaguely like wine.

We think Pavlovian mere-association effects will be way stronger if our product doesn't look cheap and ordinary. So we stick in this artificial color. And, now, we pretty well have our beverage.

Pavlovian mere-association effects suggest we make it look expensive, exotic and unusual. So we invent a name. And, somehow, we come up with Coca-Cola. We have an exotic script. We make the bottles shaped in a slightly unusual way — and the glasses, too, for that matter. And now we've got trade dress.

So now we're prepared to go out into the world with our new beverage.

HERE-ASSOCIATION EFFECTS DICTATE LOOK & FEEL
— A SECRET FORMULA, HEAVY ADVERTISING, ETC.

We can't copyright the flavor. So we'll do the next best thing.

Munger: And, obviously, we want *protection*. We know enough microeconomics to know that anything that works will get competition.... We think forward and backwards. And thinking backwards, we know that we need *antidotes* to competition.

Well, you can't copyright or trademark a flavor. So we do the next best thing. We're going to keep the formula *secret*.

Flavors can be quite tricky to duplicate — even today.

Munger: And this is [way back in] 1885. They don't have mass spectrometers. It's *hard* to duplicate flavors.

One of my favorite business stories comes from *Hershey*. They get their flavor because they make their cocoa butter in old stone grinders that they started with in the 1800s in Pennsylvania. And a little bit of the husk of the cocoa bean winds up in the chocolate. Therefore, they get that odd flavor that people like in Hershey's chocolate.

Hershey knew enough when they wanted to expand into Canada to know they shouldn't change their winning flavor. Therefore, they copied their stone grinders.... Well, it took them five *years* to duplicate their *own* flavor. As you can see, flavors can be *quite* tricky.

(continued on next page)

WESCO FINANCIAL'S CHARLIE MUNGER
WORLDLY WISDOM REVISITED: LESSON #2
(cont'd from preceding page)

Flavors are so tricky that permanent royalties are paid.

Munger: Even today, there's a company called International Flavors and Fragrances. It's the only company I know that does something on which you can't get a copyright or a patent, but which nevertheless receives a *permanent royalty*. They manage to do that by helping companies develop flavors and aromas in their trademarked products — like shaving cream. The slight aroma of shaving cream is *very* important to consumption. So all of this stuff is terribly important.

At any rate, we're going to keep our formula secret. We'll make a big hoopla over our secrecy. And that will add to our product's *mystique* — which will further enhance its mere-association effects....

Mere-association effects dictate heavy advertising & free signs.

Munger: And since we want to play this Pavlovian mere-association game in all of our advertising, we know a *heavy* percentage of revenues will have to go into advertising.

And we know we have to give free signs to everybody who sells our product because (A) it advertises the product; (B) there's an *informational* advantage (it tells people where they can get the product if they want it); and (C) we don't have to pay for the space; all we have to do is pay for the sign. So we're going to give free signs to all the drug stores, etc.

GETTING THERE FIRST OFFERS HUGE ADVANTAGES:
E.G., SOCIAL PROOF, ECONOMIES, DISTRIBUTION, ETC.

If we sweep the country fast, we can harness social proof.

Munger: And we get the idea early that we're going to sell it both in syrup form to drugstores, etc., and as a complete beverage in containers.

Now we get into problems about how we're going to distribute our product. So we think through autocatalysis again. And we realize that if we can sweep the country *fast* with our product, we harness another doctrine right out of the psychology books: *social proof*. If you see everybody else drinking Coca-Cola, you're likely to drink it. People are *enormously* influenced by what they see other people doing. Indeed, they're *enormously* influenced to *misthink* because they see other people *misthinking* in the same way....

There are just huge advantages to getting there first.

Munger: Also, we get a big informational advantage if we can buy all kinds of advertising, sweep the country first and cheaply spread our image over countrywide sales while competitors suffer under poorer advertising economics. So there are *huge* advantages to getting there first.

Competitive factors dictate being ubiquitous, too.

Munger: Also, think through operant conditioning — again, going into a reverse mode. How do you *lose* a conditioned reflex that's working for you? Well, the customer tries something else and discovers that it's a big reinforcer. So he shifts brands.

We know, in matrimony, that if you're always *available*, the spouse is less likely to shift brands. And people don't

tend to organize marriage to include permanent long separations. Similarly, if you're selling a product and it's always available, people are less likely to shift to some other product and get reinforced by it.

So availability has to be a *religion* in our new business. And, indeed, availability is a religion at Coca-Cola. And, again, it ties right into the psychology books.

It helps distribution as a matter of logistics and so on, too. But it *protects* the *conditioned reflex* business by preventing the other guy's product from getting reinforced because yours is always available.

LIKE COCA-COLA, WE'LL FRANCHISE —
BUT WE WON'T MAKE THEIR MISTAKES.

The fastest way to sweep the country is to franchise.

Munger: All right, now we have Coca-Cola. We have our distribution in mind. We then have to decide *how* we're going to sweep the country fast. Now we get into *relatedness* — trade-offs. The fastest way to do it is to franchise. After all, we're poor and small when we start. And that's the way that Coca-Cola did it.

We won't count on there never again being inflation.

Munger: But we have the advantage in today's exercise of playing the game in 1885, but knowing what we know today — of having modern knowledge. And, therefore, very importantly, we won't do what the Coca-Cola Company was so mistaken to do as it started out — which was to give bottling franchises in perpetuity at *fixed* prices for syrup. That was *insane*.

Well, it just so happened that 1885 was right in the middle of a long period of stable-to-declining prices in the English-speaking world — a very remarkable period. However, the Coke people failed to think rationally about what they were doing.

If they'd assimilated a broad, general education, they'd have remembered that the price of wheat in drachmas during the decline of the Roman empire rose by 50,000% and that the failure rate of all great civilizations is 100% — and they wouldn't have assumed there was never going to be any *inflation*.

Again, if you have an appropriate education, you can avoid some mistakes that other people make. Of course, the Coke people should have made a different decision under which they could make bottlers pay for advertising that the whole system, including the bottlers, needed.... And, clearly, you won't guarantee a fixed price for syrup with its expensive ingredients, including sugar. An ever-fixed syrup price can *ruin* you — under inflationary conditions or under conditions requiring more advertising.

And we'll model our distribution more like McDonald's.

Munger: And, clearly, we want more control over our franchisees than Coca-Cola originally got. We want to do it more like McDonald's did way later....

Well, you get the general idea. These academic ideas are *enormously* practical. And thinking things through forward and backward has enormous utility. As my life and career tend to demonstrate, you can have many defects, as I do — and this way of thinking will carry you through.

(continued on next page)

WESCO FINANCIAL'S CHARLIE MUNGER
WORLDLY WISDOM REVISITED: LESSON #2
(cont'd from preceding page)

OUR BRAINS ARE MORE SUITED FOR MOTION THAN MATH.
FORTUNATELY, THERE'S A REMEDY — THE GRAPH.

There's a reason based in biology why graphs work so well.

Munger: Now let's turn to another subject. Suppose that we have a different problem — only this time in real time. This time, it's 1996. And we want to predict the future of the Coca-Cola Company. Will elementary models help us make a good prediction?

I have distributed to the class a Value Line graph demonstrating the Coca-Cola Company's recent history and financial results. I was willing to do that without paying a royalty to the Value Line Company because I'm going to tout its product. The Value Line graphs, as short-form digests of reality, company by company, are the best things of their kind that America produces. The Value Line people have a sensationally good idea — to put the data in exactly the form they put it in and to put it in graph form.

And there's a reason rooted in biology why graphs work so well. If you turn a somersault or juggle milk bottles, your neural apparatus is doing automatic differential equations with huge accuracy. Yet, if you try and think out numbers in ordinary probabilities, you're a considerable klutz.

Our brains are more suited to motion than math.

Munger: My friend, Dr. Nat Myhrvold, who's the chief technology officer at Microsoft, is *bothered* by this. He's a Ph.D. physicist and knows a lot of math. And it *disturbs* him that biology could create a neural apparatus that could do automatic differential equations at fast speed — and, yet, everywhere he looks, people are total klutzes at dealing with ordinary probabilities and ordinary numbers.

By the way, I think Myhrvold's wrong to be amazed by that. The so-called fitness landscape of our ancestors forced them to know how to throw spears, run around, turn corners and what have you long before they had to *think* correctly like Myhrvold. So I don't think he should be so surprised. However, the difference is so *extreme* that I can understand how he finds it incongruous.

A system that actually taps into our primitive neural network.

Munger: At any rate, mankind invented a system to cope with the fact that we are so intrinsically lousy at manipulating numbers. It's called the *graph*. Oddly enough, it came out of the Middle Ages. And it's the only intellectual invention of the monks during the Middle Ages I know of that's worth a damn. The graph puts numbers in a form that looks like motion. So it's using some of this primitive neural stuff in your system in a way that helps you *understand* it. So the Value Line graphs are very useful.

Value Line graphs and data are just marvelously useful.

Munger: The graph I've distributed is on *log* paper — which is based on the natural table of logarithms. And that's based on the elementary mathematics of *compound interest* — which is one of the most important models there is on earth. So there's a reason why that graph is in that form.

And if you draw a straight line through data points on a graph on *log* paper, it will tell you the rate at which compound interest is working for you. So these graphs are *marvelously* useful....

I don't use their predictions because our system works better for us than theirs — in fact, a *lot* better. But I can't *imagine* not having their graphs and their data. It's a marvelous, marvelous product....

AND IF YOU'RE TRYING TO LOOK FORWARD,
BIG, SIMPLE MODELS CAN HELP THERE, TOO.

Will it continue? The answer lies in our models.

Munger: So we're trying to figure out if Coca-Cola Company can continue its utterly remarkable performance. Here's a company that earns way more than 50% per annum on book value *after* taxes. And it's growing like crazy.

How are we going to figure out if it's going to continue? It doesn't help just to sit there and mumble its past numbers to yourself mindlessly. What you have to do is reach into your head for two or three of the big, simple models.

We now know that it's a conditioned reflex company that relies on trademarks. What are the chances that they can continue doing it?

Will they continue having legal protection internationally?

Munger: Obviously, the first thing we have to decide is whether they're going to continue having legal protection for their trademarks. Otherwise, we shouldn't buy Coca-Cola.

Well, that involves knowing enough microeconomics, knowing enough law and knowing enough about the history of the international arena, (because Coke makes over 80% of its profit outside of North America), so that you can make a *guess* as to whether trademarks are going to continue to be pretty well respected all over the world.

Trademarks create huge incentives to make products reliable.

Munger: Well, we know that in counterfeiting, in most of the long history of the world, the ordinary remedy has been *death* — because everybody can see that a money exchange system won't work if people can counterfeit the currency.

And it's only a small step from that to realize that if you're talking about a food product — and, after all, it can make you sick, it can kill you, it can do a *lot* of things — if you protect the trademark, you create this *huge* incentive in people to make the product *reliable*.

A fish story (one that got away) about the power of trademarks.

Munger: I might tell a little story to illustrate that point. Carnation didn't have the total trademark on the name "Carnation" when it started out. And as it got bigger and bigger, it kept buying up all the little Carnation trademarks that other people had on their products.

But there was this one guy who sold Carnation Fish. So help me, God, that was his trade name. Don't ask me why. And every time they'd say, "We'll pay you \$250,000," he'd say, "I want \$400,000." And, then, four years later, they'd say, "We'll give you \$1 million," and he'd say, "I want \$2 million." And they just kept doing that all the way through. And they never *did* buy the trademark — at least, they hadn't bought it the last time I looked.

In the end, Carnation came to him sheep-facedly and

(continued on next page)

WESCO FINANCIAL'S CHARLIE MUNGER
WORLDLY WISDOM REVISITED: LESSON #2
(cont'd from preceding page)

said, "We'd like to put our quality control inspectors into your fish plants to make sure that your fish are perfect; and we'll pay all the costs," — which he quickly and smirkingly allowed. So he got free quality control in his fish plants — courtesy of the Carnation Company.

So they should be protected, have been and probably will be.

Munger: This history shows the enormous incentive you create if you give a guy a trademark [he can protect]. And this incentive is very useful to the wider civilization.... As you see, Carnation got so that it was protecting products that it didn't even own.

That sort of outcome is very, very desirable [for society]. So there are some very fundamental microeconomic reasons why even communist countries should protect trademarks. They don't all do it, but there are very powerful reasons why they *should*. And, by and large, averaged out around the world, trademark protection's been pretty good.

So I think we can bet reasonably that Coca-Cola will enjoy pretty good trademark protection in the future. But we have to be able to make a judgement on that subject before we know enough to buy stock in the Coca-Cola Company. So that's one judgement.

OUR MODELS SUGGEST LOTS OF UPSIDE POTENTIAL
AND POWERFUL COMPETITIVE ADVANTAGES.

Quantity of liquid consumed is finite, but it's also huge.

Munger: Next, we have to figure out how big this market could be. Well, that isn't so hard. We just need ordinary physiology and ordinary arithmetic.

Every human being needs about 64 ounces of liquid every day to stay alive. We have about 6 billion people on Earth. So we just multiply the product of these numbers by the number of days in the year.... And, obviously, we're not going to get more beverage sold per year than that. But that's a *hell* of a lot of beverage.

Coke has room to grow its worldwide volume many-fold.

Munger: And, then, we can figure out roughly what share of the world's liquid is currently ingested in the form of Coca-Cola Company products. It's an *awesome* number — particularly in the U.S....

But per capita consumption of Coca-Cola products worldwide averages out much lower than it is in the U.S. And much of the world's population lives in markets where average consumption is still less than 10 8-ounce servings per year. So Coca-Cola still has *miles* to go. Clearly, they have room to multiply their current volume *many*-fold.

[Editor's note: In its 1996 annual report, Coca-Cola estimated U.S. per capita consumption of their products (excluding those distributed by their Minute Maid division) at 363 8-ounce servings per year. By comparison, the comparable figure was 5 servings and 3 servings, respectively, per capita — in effect, 98% and 99% less — for the 2.2 billion people of China and India.

Meanwhile, U.S. consumption of their products has also been growing (about 5% annually).]

And an extra 1-2¢ of profit per serving isn't inconceivable.

Munger: What else could impact the profits of the Coca-Cola Company? Well, we've got to figure out how much they're *making* out of each serving of Coca-Cola. And I haven't done that computation recently. But my guess is that it's something within hailing distance of 1¢ per serving. That's all that's sticking to the ribs of the Coca-Cola Company pretax.

Could it go to 2¢ — or even 3¢? That doesn't seem inconceivable for a company so dominant, does it?

So there's no reason Coke's profits couldn't grow 16 times.

Munger: Then, of course, there's the possibility of a little inflation. After all, they're selling syrup. You could hardly imagine a better protected position versus inflation.

And when you put all three of these factors together [— higher consumption, higher profits per serving and inflation —] it isn't hard at all for me to imagine the profits of the Coca-Cola Company in due course being 16 times what they are today — even though they're [already] making more than \$3 billion a year after tax.

Now that may strike you as very extreme. But if you go through the arithmetic, it's not inconceivable. So, at least, something very good *could* happen. It may take a long time. But what the hell, you people *have* a long time. I wish I did.

They've competed successfully for years — for good reasons.

Munger: We also want to estimate the chances that competition will do in Coca-Cola. Remember — think it through forward and think it through in reverse.

Well, they've been competing for a long time. And look how they're winning. Coca-Cola has certain advantages: They can afford to sponsor the Olympics. They can afford *lots* of things. They have a lot of advantages of scale.

And they're available all over the Earth. That's an edge that others don't have. And in recent years, their market share has actually been going up a little, net — in spite of the fact that they have so much already.

You can quarrel with my conclusion, but not the approach.

Munger: So, going through these simple models, you get at least a rational way to look at Coke's future. You may disagree with me when I say something as extreme as I've just said. But I don't think you can quarrel with my basic approach. It's a rational way to examine the outer limit of possibility on the upside. And, as you can see, it's quite *high*.

You don't have to sit there just twiddling your thumbs....

Munger: However, if you *don't* have the basic models and the basic mental methods for dealing with the models, then all you can do is to sit there twiddling your thumbs as you look at the *Value Line* graph. But you don't *have* to twiddle your thumbs. You've just got to learn 100 models and a few mental tricks and keep doing it all of your life. It's not that hard.

And the *beauty* of it is that most people *won't* do it — partly because they've been miseducated. And I'm here trying to help you avoid some of the perils which might otherwise result from that miseducation....

—OID

SETH KLARMAN, BAUPOST GROUP

"Our best investments, that in retrospect seem like free money, seemed not at all that way when we made them. When markets are dropping hard (as they are in Asia) and an investment you think attractive, even compelling, keeps falling, you aren't human if you aren't scared you've made a gigantic mistake. The challenge is to do the fundamental analysis, understand the downside as well as the upside, remain rational when others become emotional and not take advice from Mr. Market, who again and again is a wonderful creator of opportunities, but whose advice should never, ever be followed." Graham and Dodd Breakfast Lecture — November 13, 1997

Dear Subscriber,

Notwithstanding the possibility our contributors and we may suffer from a severe case of "first-conclusion bias", (see *Worldly Wisdom Revisited* beginning on page 1), and Wally Gaye's admonition about widely known information very rarely being of value, we're struck by the following:

In the late '80s, Cundill Value Fund's Peter Cundill, Baupost Group's Seth Klarman, Jean-Marie Eveillard of SoGen International and John Templeton, among others, warned *OID* subscribers clearly and repeatedly about dangerous overvaluation in the Japanese stock market. All were early and all were proven to be absolutely correct when the Nikkei subsequently declined more than 50% — a decline, we might add, from which it has yet to recover.

More recently, all have made similar comments — only this time about overvalued stocks in the U.S. For example, Peter Cundill was one of the few who *profited* from the Nikkei's decline. Today, Cundill is long Japan and reports finding net-nets there essentially as abundant as they were in the U.S. in the early 1970s. The puts he reports owning today? Among others, S&P puts.

Templeton Growth Fund's Mark Holowesko (page 1) comments on the relative scarcity of value in the U.S. and puts today's valuations in historical perspective. He then explains how, after having been absent from Asia for some time, that they were finding certain Asian markets among the cheapest in the world (even *before* this fall's turmoil).

We believe that Cundill, Templeton, Holowesko et al., as before, may be early, but that they won't be wrong.

We note, too, that Third Avenue's Marty Whitman (see page 1) — whom we'd never known to venture overseas — sounds most excited about the bargains he's finding among the Japanese non-life insurers. Says Whitman, "[I'm] convinced that ... [they're] among the ... safest and cheapest equities ... in the industrial world ... and [that they sell] at huge discounts ... [to] net asset value."

He tells your editor that he views these companies as closed-end funds selling at 50-80% discounts, only better. Why better? Because, Whitman tells us, not incorporated in those discounts is the value of the company's business.

And just as he was right about the bargains in U.S. financial service firms, (see our edition of June 23, 1994), we believe he will be no less right today.

Among the reasons why we think so are that this

year's decline in Asian markets and emerging markets followed three *prior* years of badly lagging performance. Using *Morningstar* data, for example, we estimate that emerging markets funds and Pacific ex-Japan funds were down 9.4% and 7.1%, respectively, for the three years ended December 31, 1996 before falling 16.3% and 32.3% more, respectively, through November 28th of this year.

And, as Valuevest's Mark Bakar and John Burbank observe, some of those markets declined *far* more — up to 70-80% in dollar terms *this year* as a result of their currencies withering vs. the dollar. Furthermore, as they convinced us, those markets appear to offer no shortage of eye-popping bargains. (Feature begins page 1.)

Not in the feature, but also intriguing, was Bakar's observation that the very high returns U.S. companies have earned in recent years have been aided by a cheap dollar — a tailwind a stronger dollar could eliminate or even reverse.

We found his observations more interesting still when we noted (1) that Japan's 1989 crash and subsequent woes had been preceded by the yen rising 100%± vs. the dollar in the prior three years, and (2) that the dollar has already strengthened nearly 66% vs. the yen since its early 1995 low.

On its face, that would not seem to bode well for U.S. corporate profits — particularly if a stronger dollar is as essential to restarting Japan's economy and bailing out certain developing countries in Asia as it seems today.

Lastly, an idea for all seasons from Fairholme Capital's Bruce Berkowitz and Third Avenue's Marty Whitman: After selling Colonial Penn to GE Capital, Leucadia National (LUK) now sells at a tiny premium to a very liquid book. Also, today's environment would seem to be just what the doctor ordered to allow Ian Cumming and Joe Steinberg to put at least a bit of their cash to work. (For more on LUK, see Berkowitz's comments in our November 3, 1994 edition.)

Until next edition,


Your Editor

P.S. Whatever else you read this edition, don't even *think* about missing Charlie Munger's *Worldly Wisdom Revisited*.

P.P.S. Thank you for your patience and your support. Happy Holidays to you and yours.

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