Fairholme's Letter to Clients 2000

History isn't the same, but it rhymes…

Market prices of financial services businesses have reverted to 2009 distressed levels. History shows that while cheap securities can become cheaper, market prices eventually regress to intrinsic values. In February, 2000 we wrote:

"It is natural to want to own securities whose prices immediately go up. However, people chasing performance are like lemmings approaching the precipice. History is replete with examples showing that market timing is a poor basis for an investment strategy. Fairholme remains focused on business values and business economics. We want to own just a few companies, researched in depth, with the strong potential for high returns. Short-term price swings do not tell you if we are right or wrong about business investments. Business results do.

We understand the present anxiety as we are subject to the same conditions – the members of Fairholme own what our clients own. Consider our actions as well as our words. We have been buyers. We retain faith in our understanding of these businesses and faith that their currently distressed prices will prove to be bargains. If we understand these businesses, and we believe we understand them very well, lower prices today mean higher future returns."

Who said the more things change, the more they remain the same?

Fairholme Capital Management, L.L.C.

February 2000

> ***Following Ben's [Graham] teachings, Charlie [Munger] and I let our marketable equities tell us by their operating results – not by their daily, or even yearly, price quotations – whether our investments are successful. The market may ignore business success for a while, but eventually will confirm it.***
>
> Warren Buffett,
> Letter to Shareholders
> Berkshire Hathaway 1987 Annual Report

To Our Clients:

This is not an easy time for value investors. As we practice the strategy, value investing has been underperforming and prices for our companies are depressed and do not reflect intrinsic value or business fundamentals. Although we believe our clients understand our approach, price declines create doubt. Investors are selling inexpensive securities to buy hugely expensive securities, afraid to miss out on the "new new thing." This enormous disparity between the value of what we own and the high-flyers of the market cannot continue indefinitely - it never has. The depressed prices of the companies we own are offering the best opportunities in years to create *significant* wealth.

Allow us to review our basic strategy.

Virtually no member of the Forbes 400 list of wealthiest Americans accumulated significant wealth by being widely diversified. Charlie Munger (Warren Buffett's partner at Berkshire) has said, "Being prepared on a few occasions in a lifetime to act promptly in scale in doing some simple things will often be enough to make the financial results of that lifetime quite satisfactory."

We have adopted such a non-diversified portfolio strategy. Business sense tells us it is best to own a few securities that we understand, that we can value, and that we believe have favorable prospects. Concentrated investing implies less risk of permanent loss as long as you maintain superior knowledge about the companies you own, but greater variance in performance when compared to broadly diversified indexes or mutual funds. Concentration means that clients have seen the value of their portfolios fluctuate significantly– and not always in the same direction as the market. We accept higher volatility, because it has resulted in higher returns over time. While intellectually compelling, this philosophy is emotionally challenging to execute.

It is natural to want to own securities whose prices immediately go up. However, people chasing performance by buying what is already up sharply are like lemmings approaching the precipice. History is replete with examples showing that momentum investing, no matter how disguised, has frequently led to ruin, and that market timing is a poor basis for an investment strategy. Fairholme remains focused on business values and business economics. We want to own just a few companies, researched in depth, with the strong potential for high returns. Short-term price swings do not tell you if we are right or wrong about business investments. Business results do.

Markets are great at fooling people. History is full of examples where extremes of optimism and pessimism provided great opportunities – in the opposite direction. With the exception of the past two years, following the rational and ignoring the emotional rewarded a disciplined buyer of value. This is not an easy strategy to employ. It means buying or holding under stress, never knowing absolutely where the bottom may be. It means going to great lengths to understand what we buy. Without that knowledge, our nerve would most certainly fail. In 1974, Berkshire Hathaway's class A stock slumped sickeningly from $76 to $40. Nobody who bought or who held on is complaining today.

In this note, we will update you on our major holdings. Household and Mercury recently reported their year-end results for 1999. Berkshire Hathaway will report earnings on March 10 and issue its annual report on March 11. We urge you to focus on the business logic of owning our companies without regard to their current prices. Then consider what current prices imply from an investment view.

Our companies are at compelling values offering higher returns than we have seen in many years. They are being neglected, even sold, as the popularity of technology has pulled capital out of other sectors. Value oriented mutual funds have been forced to liquidate holdings as clients leave for greener pastures. These conditions are not going to last. When the tech tide goes out, investors will buy our companies, which are the best in their respective fields and which have demonstrated histories of business success. Having the patience to persevere and the courage to buy now should provide emotional and financial rewards.

Consider the following investment opportunity:

We have identified a public company that:

- **Has grown net worth at a compound annual rate of nearly 25% over 30 years.**
- **Has its shares selling at the lowest price in four years.**
- **Has its shares trading at the lowest price-to-book value for more than 17 years (1983).**
- **Has one of the very few AAA ratings awarded any business.**
- **Has an extraordinary record as a smart investor.**
- **Has an extraordinary record as an acquirer of businesses, which gives it first look at many companies put up for sale.**
- **Has a management who has at least 90% of their net worth in the company on the same terms as other owners.**
- **Has a management who reports to other owners as they would wish to be reported to, and who has been quick to report any problems.**

This would appear to be an obvious and fabulous investment opportunity. Would you own a concentrated position in such an opportunity? You do. It's Berkshire Hathaway.

Berkshire Hathaway

We are distressed at the willingness of investors to assume that the managers of Berkshire have lost their touch. Investment knowledge is cumulative, and it is absurd to think that Berkshire's long history of business and investment performance was a lucky streak that has now ended.

In aggregate, the stock prices of Berkshire's major holdings did not have a great year. A pause in reported investment results is hardly an indication that the strategy is wrong. Furthermore, last year was a difficult year in the insurance industry and for Berkshire-owned GenRe, whose results were worse than we expected, but better than they appeared. Berkshire's fourth quarter will probably still reflect these short-term trends and 2000 may be a bumpy year. However, we have seen evidence of higher prices and better terms for Berkshire's insurance businesses. Their competitive position is strong and customers know it will pay claims under any adverse conditions. Berkshire's Fort Knox strategy will become clear, sooner than its current price indicates.

Berkshire owns more businesses with sustainable competitive advantages than we have seen in any other company. GEICO is a low cost producer creating a powerful national brand. See's Candy is a regional powerhouse expanding nationally through the Internet. Flight Safety has a near monopoly in training jet aircraft pilots. Executive Jet is building a near monopoly in the fractional jet ownership business. Of its major investees, Coke dominates the soft-drink business, Gillette dominates the shaving business, and American Express has a proprietary and growing position in financial services. There are other examples.

Liquid investments alone equal the current market value of Berkshire. Major equity positions approximates $37 billion or about $24,000 per class A share ($800 per class B share). <u>Cash and bond holdings currently equals an additional $24,000 per class A share ($800 per class B share), or nearly 50% of the current value of the entire Company</u>. This enormous liquidity hoard should provide a measure of comfort in determining a bedrock value for Berkshire. It also indicates just how well Berkshire is positioned to take advantage of the current values of companies and investments within its circle of competence.

Warren Buffett has been criticized for not investing in technology companies. However, Berkshire-owned companies have successfully adopted and adapted new technologies. In a recent PC Week Online survey of the Top 100 Networking Innovators, Berkshire placed <u>#12</u> on the list, ahead of many other companies with reputations for being early adopters of technology. These other companies include General Motors (#15), Wells Fargo (#24), Chase Manhattan (#31), Citigroup (#41), AIG (#44), American Express (#62), and General Electric (#65).

Berkshire-owned companies use technology to lower costs and extend their reach. Advanced technology allows GEICO to determine within 15 minutes <u>whether GEICO can profit</u> by saving someone at least 15% on their auto rates. There are millions of consumers who can benefit from this proposition. Someone seeking to purchase a large annuity contract can apply to Berkshire Hathaway Life Insurance directly over the Internet and receive a very competitive rate and the highest quality guarantee available. We buy See's Candy over the Internet. Consider visiting www.berkshirehathaway.com to see other examples for yourself.

We can't add up all the times we've heard someone say, "If only I'd put a decent portion of my net worth into Berkshire Hathaway ten or twenty years ago…." Hindsight makes that choice appear easy, but at the time one heard many of today's arguments as reasons for not buying. We have concluded that Berkshire's future is bright. The insurance businesses are growing, the investments of the company are solid, and the overall value of the Company is far above the current price. Management is motivated to treat shareholders as owners and to behave appropriately.

We do not understand those selling Berkshire today, except to the extent that mutual funds have been forced to liquidate as money has been withdrawn to pursue what is hot. <u>We believe Berkshire represents an extraordinary value at current prices and are managing accounts accordingly</u>.

Mercury General

Mercury earned $.65 per share in the fourth quarter – modestly above our expectations. More importantly, the trends about which we wrote to you six months ago now appear to be firmly established. While still competitive, the auto insurance industry is starting to see rising prices. As George Joseph, CEO of Mercury recently stated, "We are beginning to see people focus on the bottom line [profit] instead of the top line [sales]." Several times in the past, such a shift in focus has caused an explosion in Mercury's growth and profits over the several years following price increases. Mercury now trades at less than nine times trailing net operating earnings of $2.65 per share. The Company is paying a dividend yield exceeding 4%. Last quarter, the Company bought back more than 300,000 shares and they have continued to buy in the early part of this year.

Conversations with agents and other companies doing business in California (where Mercury does 90% of its business) strongly indicate that the price-cutting that plagued auto insurance over the last two years has ended. While Mercury continues to underwrite at a significant profit, other companies have been squeezed by the combination of lower prices and higher losses. There have been several minor rate increases in California and some small insurance companies have withdrawn from writing new business in the state. As the low cost operator, Mercury thrives in difficult conditions and we expect this to become apparent to more investors over the next six to nine months.

The company's expansion to other states is proceeding well. In Florida and Texas, we expect premiums to double this year. Soon, the company will be selling insurance in Virginia and New York. Within two years, half of the U.S. population will be able to purchase a policy from Mercury.

Mercury has a unique formula in the auto insurance industry. The company is dedicated to keeping costs low and making agents financially successful – concepts that most consider mutually exclusive. We believe the company has a chance to become the champion of the independent agent on a national basis. Other insurance companies are alienating their agents by also selling polices through direct channels, such as by telephone or through the Internet. Agents, who still sell about 90% of all auto insurance, are beginning to realize they would be better off dealing with insurance companies that don't directly compete with them. And despite recent gains by GEICO, we believe agents will continue to retain sizeable market share for many years. Low-cost companies, such as GEICO and Mercury can both flourish in the environment we see.

We began to invest in Mercury with the knowledge that the company had demonstrated high returns and superior management skills over many years. Furthermore, we thought competition would abate as industry profits worsened. So far, these factors are playing out the way we envisioned. The next step is to see industry-wide price increases, which should begin within six months. Price increases will accelerate Mercury's growth, as has occurred in the past under similar conditions.

<u>Given its current level of earnings, its dividend payment, and the demonstrated skill of its management, Mercury appears to be deeply undervalued.</u> We can see where, within a reasonable time, Mercury shares sell for two to three times their current price. Fairholme now owns nearly 4% of this terrific company.

Household International

Household reported earnings of $0.92 for the fourth quarter and $3.07 for the year, both records for the company. Cash earnings (adding back amortization of goodwill) were significantly higher. Household continues to fire on all cylinders and prospects for 2000 appear excellent. So why has the stock been under pressure?

Household's price has been affected by several factors, none of which relate to fundamental performance. A major competitor, Associates, reported that future results would be worse than expected. Bank One and First Union have reported similar problems. Many other smaller, less skilled competitors have failed in recent years. These problems have been self-inflicted and do not reflect problems in the core markets that Household serves.

Few realize how the competitive landscape has changed. The problems of other companies, as well as consolidating mergers, have reduced competition. The less competitive environment is giving Household the opportunity to grow faster while being more selective in making profitable loans.

Macro concerns over consumer debt levels and the specter of higher interest rates have not helped either. These factors affect most businesses to varying degree. However, Household's borrowers are carefully screened, and there is no sign that the company has abandoned its conservative loan underwriting or that its spreads are declining. Investors have yet to figure out that higher interest rates will not affect Household's profitability in a major way.

There have also been concerns that Freddie Mac and Fannie Mae may begin to invade Household's turf. This is not probable. Sub-prime consumer finance lending requires customer contact at levels banks have not been able to achieve, let alone two government-sponsored enterprises that have never talked to a single consumer in their entire histories.

Like Berkshire Hathaway, Household is not the first company that comes to mind when technology is the subject of conversation. However, the company is receiving accolades for its paperless and totally integrated "Vision" system, which allows Household's staff to be far more efficient and effective in dealing with customers. It allows for better prospecting, selling, servicing, and collecting. The competitive moat is widening between Household and other companies in the consumer finance industry.

As Household's earnings continue to grow, its stock price will be forced to respond. If it does not respond rapidly enough, the company may well draw the attention of a potential acquirer at a significant premium to current prices. Alternatively, should Wall Street wake up and agree with us that Household's success is sustainable, we would expect a stock price of roughly twice its current quote based on a multiple of 15 times estimated 2000 cash earnings of close to $4.00 per share.

Each of our holdings generates excess free cash. All are at bargain prices. Yet, our investment experience has taught us that we cannot control prices. Cheap can get cheaper, even if there is nothing fundamentally wrong. However, market history says that high quality, well-managed, companies don't stay cheap for long. The bloom is going to come off today's momentum favorites and we believe that our companies will benefit. They are leaders in their industries, have strong balance sheets, large earnings power, and are positioned to take advantage of adversity.

Human behavior has changed little over the course of history and people tend to find comfort in universally held opinions. Consensus is the enemy of high investment returns. A key to investment success is to be greedy where most are fearful and fearful where most are greedy.

We understand the present anxiety as we are subject to the same conditions - the members of Fairholme own what our clients own. Consider our actions as well as our words. We have been buyers. We retain faith in our understanding of these businesses and faith that their currently distressed prices will prove to be bargains. If we understand these businesses, and we believe we understand them very well, lower prices today mean higher future returns.