



Quarterly Commentary 4th Quarter 2004

If the words you are about to read sound familiar, it is because they are...straight from our **2003** closing quarterly commentary. Substitute **2004** for **2003** and you'll get the point. "In many ways, we hated to see 2003 come to a close. This business is one in which your results are highly quantifiable. We are forced to enumerate our results in some type of time frame, which we do quarterly and annually. However, quarterly numbers, in our opinion, are meaningless and even annual numbers do not provide sufficient information until at least five consecutive years have been put together. Still, a year like the one we just finished is very gratifying, if for no other reason than the short-term performance pressures, difficult to escape in our society, are somewhat relieved. We caution all of our clients that the results just experienced in the last year are the exception rather than the norm."

The last two years have been extraordinary. The kind of equity returns experienced in 2003 and 2004 will not continue. If our clients believe they will, we have not done a very good job of coaching them into realistic expectations.

At times like these, it is easy to start feeling good about one's self, and for you, the client, to feel good about us too. We thought that it would be quite sobering for you to read a discussion of some of the mistakes we have recently made. You are plenty familiar with some of our more challenging investments. No doubt that you have not completely forgotten about **Goodyear Tire** or **Fairfax Financial**, both recent strong performers. These are mistakes of commission and are easily identified by our clients. Then there are the mistakes of omission, the ones you never see, because they never appear in your portfolio. Despite that fact, these mistakes have easily cost our clients millions in missed opportunity, so we thought you might be amused by reading about some of them (we're hoping that these unrealized millions won't damage our recently garnered goodwill too much).

Before we don our sackcloth and ashes, we would point out a theme that will run through most of the examples we are about to mention. Most of the mistakes we are citing result from us being cheapskates (we like to refer to it as conservatism). Because we always want a margin for error, we never know when we are being too conservative, so if we are going to err, we always want it to be on the side of being too conservative.

One of the opportunities that makes us sick every time we think about it is **Fording Coal**, now doing business as the **Fording Canadian Coal Trust**. Fording was a company that we have followed for a long time and actually, some of our clients own the stock as a product of their original long time holding in Canadian Pacific Limited, which distributed the stock of all its businesses early in 2002. We began to evaluate the company as soon as it began trading as a separate company. Despite the fact that the early dividend distributions indicated a yield in the 12% neighborhood, we continued to dawdle (a nice way of saying our head was in a very dark place). We thought it best to wait and see more of what the company was going to look like on its own. The stock price, which had fallen immediately upon the distribution out of Canadian Pacific to \$13, recovered quickly to \$19-\$22 and stayed there until mid 2003. When it dipped under \$20, we finally decided it was time to buy. We hate to buy in a rising market, and this

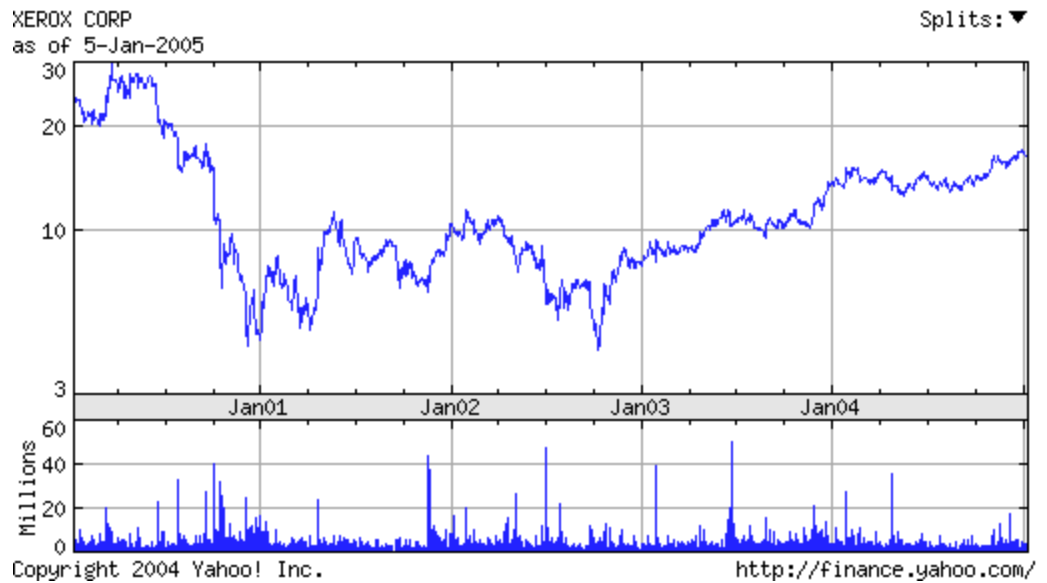


was one time that our skinflint ways caught up with us. We backed off around \$22, having bought very little stock, ever sensitive to the potential dilution from the proposed formation of the Fording Canadian Coal Trust with other parties. A wonderful return resulting from the original Canadian Pacific investment also made us cautious (in other words,

we had a ridiculously low cost basis in the stock previously owned). The company's business is the mining of metallurgical coal, most of which is exported to Asia. This coal is used in the coking process of steel making. When steel and energy prices began to rise, so did coal. Fast forwarding to today, the company is contracting export business at levels at least triple of those less than two years ago. The stock has reflected these forces, currently trading at \$72 after hitting over \$78 just a few weeks ago. Today's 6% yield doesn't reflect the prices of over \$100/ton at which new metallurgical coal contracts are being booked, double the price of this time last year. We could go on, but we are beginning to get nauseous.

We had two chances to buy **Xerox** below \$5, early in 2001 and again in the fall of 2002. A drastic reorganization of their marketing and sales area combined with a softening economy, had resulted in plummeting sales. Not unlike Goodyear, the company's balance sheet and liquidity quickly went south, along with the dividend. We studied it, talked to some of the

marketing people who were confident of a comeback and timidly bought a small position in some intermediate-term bonds while avoiding the stock. The economy has since firmed, and Xerox has improved their sales efforts. While the balance sheet still has room for improvement, and Xerox faces stiff competition, a share now costs more than \$16, which would have been a nice return in anyone's book.



At the end of 2003 and very early 2004, we researched and analyzed the world's largest exporter of soybeans and the largest processor of soybeans in the Americas, **Bunge**



(pronounced "Bung-ee") **Limited**. Bunge was founded in Amsterdam in 1815 and is considered one of the pre-eminent agricultural product companies in the world. Bunge was a privately held company before going public on the NYSE at a price of \$16 per share in August of 2001. At the time of our analysis, Bunge's stock

had traded from a high of \$32 down to \$27, and we determined that a price of \$25 per share would be an attractive entry point that would provide our investors preservation of capital and a high potential for appreciation. Unfortunately, for you and us, the stock never reached our entry point and trades today at a price of \$54 per share which is an approximate 100% appreciation in one year.

If you thought soybeans were dull, how about hog processing, salmon and shrimp farming, flour milling, and ocean shipping? **Seaboard Corporation**, based in Shawnee Mission, Kansas is a small but well-run conglomerate. With only 1.25 million shares outstanding and trading at

approximately \$200 per share, Seaboard was selling for only 50% of book value when we researched this stock in very late 2003. We believed the stock was attractively priced at these levels but were

concerned that the stock volume (average daily volume of only 1,636 shares) was extremely thin, even for a small firm like ours. Compounding the challenge was the fact that the stock began to ascend immediately without us buying any stock. We decided to be patient – what a big mistake. Today, at

\$1,000 per share, Seaboard is trading at two times a rapidly growing book value. A 2% position in Seaboard would have added a whopping 8 percentage points of return to our equity portfolios in 2004.



The last doozie we will reveal is certainly not least. Our equity investors have not been impacted by it, but our fixed income investors certainly have been. We would have never predicted that interest rates, both long and short, would go as low as they did in the recent past. For at least the last three years, the Fed has led bond investors, which is the reverse of the '90's. Unprecedented low short rates put tremendous pressure on investors starved for yield, lowering the entire yield curve. Now that the Fed has started tightening, not much has yet happened to the intermediate and long rates. Our fixed income performance in the last three years has only been partially saved by capitalizing on attractive credit spreads offered on corporate bonds during our most recent mild recession three years past. It remains to be seen whether our defensive interest rate posture will pay off in the future.

China Investing Direct?

In the last few months there has been much activity, both real and rumored, on the part of the Chinese in seeking out natural resource assets around the world. The Chinese have \$610 billion in foreign currency reserves, about 80% of which are believed to be U.S. dollars. They appear to have made a decision to use some of these reserves to buy natural resource assets. These are complicated dealings. They appear on the surface to be company-to-company (meaning a Chinese company negotiating with a company outside China), but at another level they are

government-to-government for a couple of reasons. First, China's government, an agency thereof or the army owns controlling interest of most, if not all of the major companies in China, with the minority positions of the public companies trading on a stock exchange. Thus, the Chinese government is involved. At the same time, the country of the targeted asset is involved, mainly due to the strategic and tax generating value of the assets. We are seeing particular interest on the part of the Chinese in energy and industrial metals, their largest import needs. They have already done several smaller energy deals in South America, and just completed an agreement with Castro's buddy, Hugo Chavez of Venezuela. Despite the political troubles in Venezuela in the last few years, that country has been a key supplier of oil to the U.S. Our neighbor to the north, Canada, is also involved in negotiations with the People's Republic. For several months, China Minmetals has been in discussions to purchase **Noranda**, a large miner of nickel and copper. Canadian Prime Minister Paul Martin is scheduled for a late January trip to China, as negotiations have apparently hit a snag. China apparently intends to discuss western Canada's oil sands with Martin as well. Finally, Russia has apparently offered China a piece of the recently expropriated assets from Yukos. Yukos was hit with a huge tax bill that exceeds the company's entire annual revenues. This followed the jailing of its CEO for tax evasion after he was a vocal critic of Vladimir Putin and some of his policies (seems that not much has changed in Russia).

The commodities that China seeks are heavily represented in your portfolio. Higher commodity prices have been the largest driver of your portfolio's performance for the last two years. It will be important for us to continue to monitor China's moves and these markets and to ascertain the likely impact for commodity prices and profits in these industries.

Finally, as we embark on a new year, we would like to take this opportunity to thank you for the confidence and support you have given us, which makes our job easier as we pursue your objectives. Best wishes to each of you and your families for a healthy, happy and prosperous 2005.