

Leyland Lines

February 2011

Leyland Lines is our monthly newsletter providing investors with our insights on the overall market, individual companies and other relevant issues. All the information contained in this newsletter is for general reading only and should not be taken as a personal recommendation. Companies and ideas discussed in this newsletter are not necessarily buy or sell recommendations. We don't know when the opportunity to purchase or sell at favourable prices may occur, but when it does we act decisively. For that reason we encourage clients to allow us discretion using our Individually Managed Account service.



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Welcome to the February 2011 edition of Leyland Lines.

Welcome to the February 2011 edition of Leyland Lines; February has been a very busy month with an important reporting season nearly behind us.

Whilst reporting season did not throw up too many surprises, the market reaction has been more interesting. Many companies which reported good results have actually fallen in share price. This is a function of many company results underperforming analyst forecasts as well as an apparent lack of confidence that earnings growth will be sustained.

Macro events have also weighed heavily during February, with continued problems in the Middle East creating global uncertainty and increasing oil prices.

Whilst it is difficult to 'ignore' these macro events, we continue to look for companies with sustainable earnings, regardless of short term fear or exuberance. Attentive readers will note that we rarely discuss resource companies in Leyland Lines; this is because it is impossible to

forecast where commodity prices will be in the medium-long term, ipso-facto it is impossible to accurately forecast the earnings of resource companies over a similar time frame. This is not to say that investors will not do well by investing in resources – it is just impossible to make a value based judgement on these businesses.

Quite often the companies we recommend are out of favour – this is the nature of value investing as popular companies tend to trade at prices which are too expensive. We have included an article from our friends at the intelligent investor entitled "the crowd will not make you rich" which succinctly explains this point.

In this edition of Leyland Lines we also discuss Blackmores Limited and QBE Insurance. We also include Warren Buffett's 1977 letter to shareholders of Berkshire Hathaway.

Please contact our Melbourne or Sydney office should you wish to discuss your portfolio management needs.

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Blackmores Limited (BKL)



Price: \$31.50 Market Cap: \$499 million

Blackmores Limited was founded in the 1930's by an English migrant Maurice Blackmore. Blackmores is a distributor of branded vitamins and supplements, with a presence in Australia (83.6% of revenue) and South East Asia (16.4% of revenue). Blackmores products can be found in retail pharmacies, supermarkets and health food stores.

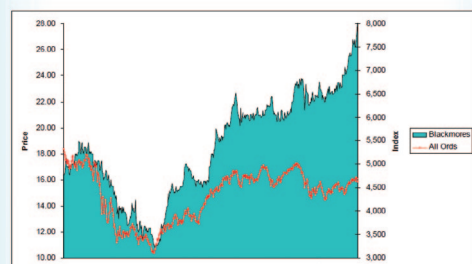
Blackmores is a company that ticks all of the boxes as being an extremely well run enterprise with a very bright future ahead, regardless of the state of the economy. Blackmores tends to focus on organic growth as they are cognisant of overpaying for acquisitions. Investors often think bigger is better with respect to earnings, however this is far from the truth. It is all about the return on investment. For example, would you rather spend \$20 million dollars on an acquisition earning \$2m or spend \$5m on plant and equipment for your business earning \$1m? Blackmores hasn't needed to make any significant acquisitions as they can earn 22% for every dollar invested back into the business. This is equivalent to making an acquisition on a PE multiple of 4.5. They derive organic growth by focusing on brand, product quality and innovation. Their marketing aims to engage and educate customers on a more personal level. This has enabled Blackmores to charge a significant premium to that of its competitors. For a distribution business, Blackmores earns a fantastic operating margin of 19%, up from 13.8% in 2001.

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In the last 10 years, Blackmores has consistently grown its net earnings year on year. Blackmores earned a NPAT of \$24m in FY10. It is estimated to increase to \$26m in FY11, up 8.3%. On FY11 numbers, one can expect to earn a 35% return on equity (ROE). For a company to consistently earn 30%+ ROE is quite amazing. Although we tend to prefer companies with low debt, Blackmores has a very manageable net debt of \$26m (1 year of profits).

Blackmores current CEO and Managing Director Christine Holgate was appointed to her current role in November 2008. She has had over 25 years of international sales and marketing experience. Although only having been in her position for a relative short time, she is well regarded within the industry as being an astute and competent MD. Current Chairman, Marcus Blackmore, is the son of the late Maurice Blackmore (Founder). Mr Blackmore currently owns 27.34% of the company, hence has a very large vested interest ensuring the continued success of Blackmores.

**Performance Relative to Market
July 2008 to September 2010**



Having assessed the merits of Blackmores underlying operations and management, we consider if current market prices represent value. Blackmores at \$31.50, is currently trading on an estimated FY11 PE of 18.36. This multiple is quite high on any value metrics. Typically an investor will find quality enterprises, such as Blackmores, trading at premiums to others. If Blackmores share price were to come off substantially for any

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Blackmores Limited (BKL) cont'd

reason, we may reconsider the investment opportunity. Until then, the sidelines are much safer than on the pitch.

Company Historicals

	6/01	6/02	6/03	6/04	6/05	6/06	6/07	6/08	6/09	6/10
Earnings (c)	36.8	32.2	40.9	59.5	73.9	85.6	104.1	118.1	127.2	146.4
Dividends (c)	33.0	33.0	35.0	60.0	58.0	69.0	81.0	90.0	96.0	112.0
Book value (\$)	1.24	1.24	1.50	1.74	1.93	2.31	2.71	3.11	3.57	4.30
Shares Outstanding (m)	15	15	15	15	15	15	16	16	16	16
Avg annual PE ratio	17.3	20.4	14.8	13.5	17.4	16.7	17.5	17.2	11.9	14.1

QBE Insurance Limited (QBE)

Price: \$18.34 Market Cap: \$19.195b

When building a portfolio to protect and build your wealth over a number of years, it is essential to include a number of high quality businesses which may not appear cheap on current earnings. However such companies have the best chance of outperforming when the macro environment normalises. One such company is QBE.

As it is often difficult to see the forest for the trees, it's probably worth looking a little further back for a clear indication of how the market can over react in bad times, and begin to price a company based on an expectation that 'bad times are here to stay'.

In September 2001, QBE was to be accountable for a very large payment due to the destruction of the World Trade Center. At that time, all insurance companies saw their share price fall to a fraction of their previous highs. QBE in particular saw its share price fall to as low as \$3.24, after being as high as almost \$12 in the months before.

Despite the fact that QBE cleared the concerns about their ability to remain solvent, the new expectation was that QBE would end up dealing with a September 11 event on a regular basis, the new 'norm' became fear. It took QBE 2 ½ years before it returned to its pre September 2001 price.

Clearly, reality was that QBE would not be dealt similar blows year in and year out.

Though current circumstances are on different scales, they are not incomparable in the context of market expectations. In recent times, QBE have struggled due to the strength of the Australian dollar, and a weakness in risk free yields. I would suggest that both 'issues' are likely to pass, and given the time, QBE will benefit from those factors which are currently holding the company back.

ACQUISITIONS:

As has been well covered in previous newsletters, QBE have for a very long time, been experts at incorporating small acquisitions into their larger group.

Given that QBE do not employ the use of outside analysts and "M&A experts" the company has been able to ensure that all acquisitions have been made from an objective position. As such, the company has one of the highest success rates for purchasing accretive, culturally compatible acquisitions, and incorporating them into their broader business.

In recent times, QBE purchased an American insurance business called Balboa - from The Bank of America. In yet another example of QBE's ability to make clever, affordable purchases, they have announced that this acquisition will be EPS (earnings per share) accretive from year one, and has a payback period of just 3 years (in essence it was bought on a PE of 3). Though the new

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QBE Insurance Limited (QBE) cont'd

deal will see EPS only increase by about 5-6%, it highlights yet again how well QBE make their decisions when it relates to spending and investing shareholder funds.

INTEREST RATES:

As a result of QBE's highly conservative approach to the use of its funds, the company's free float (the money customers have paid for insurance which has been set aside for claims), is invested in cash. Rather than investing in equities, property, or any other risky investment, QBE have continued to refuse to put its funds in harm's way. Instead, QBE have invested in either government bonds, or cash accounts.

As a result, QBE's profitability is highly leveraged to the 'risk free rate'. In the period to 30 June 2010 the company's yield was a tiny 2.70%. This is the result of both the USA and Europe dropping their interest rates to essentially zero. In fact over the past 18 months QBE had received as little as 1% on their cash at bank. Since then, QBE has improved their yield to 3.12%. Though rates remain low, it is unlikely that they will remain so far below historical averages for an extended period.

In the event that US rates head back towards their historical averages (they certainly can't go much lower – they are currently at near zero), QBE would find itself far more profitable.

OUTLOOK:

So strong is the QBE insurance business that it has become increasingly difficult to find an analyst report that actually deals with that aspect of their business – their core business!

Insurance profit margins remain high and on target for 15-18% result for the full year. Insurance profit across the board continues to increase, as does the number and value of policies held. QBE continues to perform strongly in comparison to its peers, and remain one of the best managed companies on the ASX.

However, it seems that rather than focusing on the underlying business of QBE, most market participants are fixated on the near term cash rates,

the minute detail of deals, or rumors surrounding a succession plan for the current CEO (who has clearly stated that he has no intention of stepping down). While all the above mentioned factors will influence the profitability of QBE in the near term, none represent a structural issue for the company, and all are likely to pass from the markets consciousness as cycles turn in the fullness of time.



QBE 12 month chart

Rather than make bold statements and assumptions about how markets or the environment has changed, we prefer to assume that "it isn't different this time". We prefer to assume that all things being the equal, any temporary difference in today's environment is likely to revert to the norm (or if you prefer, the mean). As such, when looking at QBE, rather than considering it in the context of a drastically changed world, where interest rates are expected to remain at zero forever, and natural disasters are due on an ever increasing basis and scale, we prefer to step back and consider things in a broader perspective. Economic conditions will eventually improve, interest rates will eventually increase, and weather patterns are likely to return to historical normality. As such, we think QBE represents a long term buying opportunity, and expect that we are currently experiencing what will eventually be looked back upon as the low in the business, interest rate and weather pattern cycle.

	2008	2009	2010e	2011e
PE	10.5	11.6	14.6	11.8
Dividend	5.5%	5.5%	6.9%	7%
Debt/equity	32.9%	29.1%	35.3%	30.8%
Margins	19.7%	17.0%	15.0%	16.6%
ROE		18.9%	14.4%	18.8%

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The crowd will not make you rich

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17 Feb 11 | Issue 313

By Gareth Brown

A bargain-priced stock can be many things but popular isn't one of them. To take advantage of cheap prices, Gareth Brown explains why you need to ring-fence your herd instinct.

Eventually, through patience, experience, expense and consideration, all investors establish their own path; one appropriate to their own psychology and means.

Momentum investors buy what's going up, theorising that things that rise tend to keep rising. Growth investors peer into the future to focus on stocks they believe will enjoy rapid earnings growth, so rapid in fact that they aren't bothered much about the price they pay for the stock. Day traders believe...well, who knows what they believe? But clearly something keeps them glued to their screens.

The true north for value investors is, of course, value. We want to buy a dollar's worth of intrinsic value for less than a dollar, and preferably far less. And the bigger the difference, the better the protection against the unexpected. That's straightforward enough isn't it?

Not really. 'Value investing is simple', our research director often extols, 'but it's not easy.' The 'simple' part of the process is actually the valuation; working out what a stock is worth. Some companies are more complex than others but if you focus on good businesses with decent managers, and don't tackle complex structures where your abilities might be over-stretched, there are plenty of stocks to keep you busy (see More on valuation).

Investing neurosis

Once you've got an estimate of a stock's intrinsic value, you're at the 'not easy' part; mastering your own emotions to take advantage of your new-found knowledge.

For some reason, people take their cues from price action rather than from values. What doesn't work is when you start doing things that you don't understand or because they worked last week for somebody else. The dumbest reason in the world to buy a stock is because it's going up.

Warren E. Buffett

Our psychology, hardwired into us over millennia, can hold us back from taking decisions that are in our own best interests. At other times it can fling us off a cliff as if we were lemmings. We're talking of course of group psychology and the herd instinct. As long as we're surrounded by others taking actions similar to our own, we feel safer, even if it means we're about to plunge to our deaths. This is what makes value investing so difficult; it demands you dispense with the herd instinct and follow facts rather than others. That's not something that comes easily to any of us.

Last week we received an interesting member query (thank you, Peter). He asks:

You have been a strong advocate of Spark (SKI). However, its price has remained stubbornly low and it has more sell/hold recommendations on it than buys from the broking houses. How do I reconcile your view with what the market seems to be saying about this stock?

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The crowd will not make you rich cont'd

See our past reviews of Spark Infrastructure

That's an understandable question. Seeking multiple opinions on an issue is, generally, a very wise thing to do. Cautious, intelligent people seek a second opinion from a doctor before surgery and divers cross check their buddy's gear before a scuba dive.

But the stockmarket is neither surgery nor scuba diving. It's a competitive system—for everyone who outperforms the market, someone else underperforms. Looking for validation of our own ideas in the opinions and actions of others is like asking the opposing coach for advice on how you can beat his team.

In the stockmarket, a true bargain can be many things; unknown, unloved, ignored, misunderstood, odd, decrepit, pitied and reviled. One thing it cannot be is popular. If it's popular it cannot be cheap.

What does a bargain look like?

Perhaps you can now see how the herd instinct adversely affects our ability to take advantage of cheap stock prices. Bargains only occur because others either flatly disagree with us or simply aren't paying attention. There has to be a level of misunderstanding to the point that other investors are willing sellers at a price you believe is a bargain.

That's why, to be a successful value investor you must have the ability to embrace the unwanted and unloved (see *The superinvestors of Oakland Athletics* of 5 Oct 07). Cheap stocks are only available when sellers are everywhere and buyers are comparatively sparse. This is what makes a stock cheap.

If, after your research you conclude a stock is underpriced, you should expect to find brokers and fund managers disagreeing with you. That might not mean you are right but it is in the natural order of the market for cheap stocks to be accompanied by negative or neutral general opinion.

Our best ever recommendations occurred at times when great numbers of investors, including brokers and fund managers, fundamentally disagreed with our views.

In the 2002/03 bear market, MAp Group and Macquarie Group were both tarnished and unloved. Similar company-specific issues caused fear and loathing in Aristocrat Leisure in 2003, and Cochlear and Leighton Holdings in 2004. All stocks were upgraded to a Buy.

Unwanted bargains

In the 2008/09 rout, Flight Centre, MAp Group, ARB Corporation and RHG Group were similarly unloved and upgraded at a fraction of their current price. The point of maximum market pessimism was also the point of maximum potential.

Of course, it matters greatly whether our (and your) analysis and conclusions are correct. Being at odds with the crowd doesn't guarantee that. But neither does following the crowd. And the reward for being correct is higher, and the consequences of being wrong are lower, when others disagree with you.

It's said that value investors need to think independently. That's true. But it would be more accurate to say they need to think, act and maintain patient resolve independently. Just because we have placed a buy on a stock does not mean everyone will suddenly wake up to the fact it is cheap. It can take years for value to be recognised by the market.

Spark Infrastructure, which is currently on our Buy list, isn't exactly swamped by pessimism. It currently attracts 3 Buys, 2 Outperforms, 4 Holds and 2 Underperforms from brokers and incurred only a small amount of net institutional selling over the past 12 months.

But neither is the market bullish on its prospects. For reasons that should by now be obvious, value investors should be unconcerned—even comforted—by this fact.

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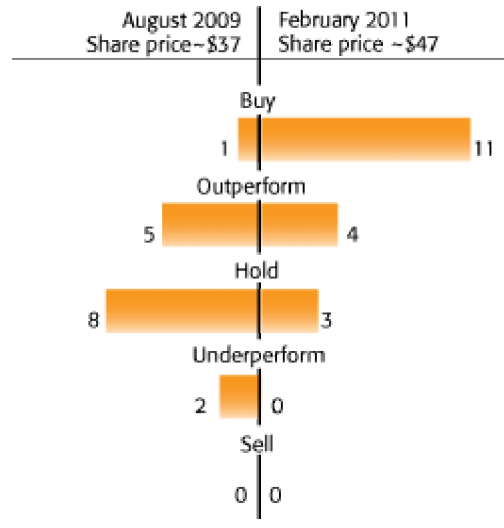
The crowd will not make you rich cont'd

For what it's worth, the one stock on which we currently have an outright Buy recommendation, QBE, currently attracts no Buys, 3 Outperforms, 8 Holds, 1 Underperform and 2 Sells from brokers. That's quite negative for a top 20 stock. By comparison, BHP Billiton enjoys 11 Buys, 4 Outperforms, 3 Holds and no negative recommendations. Tellingly, 18 months ago when BHP was \$10 cheaper it garnered 1 Buy, 5 Outperforms, 8 Holds and 2 Underperforms. That makes the point quite nicely.

In an interview recently, American investor Leon Cooperman beautifully summed up the argument against following the crowd, saying that 'the market will do whatever it's got to do to confound the largest group of investors.' There's great truth to that, which is why we feel more comfortable being in the minority. Value investing is simple to understand but it ain't easy to do.

Disclosure: Staff members, including the author Gareth Brown, own many of the shares mentioned in this article. See the Staff portfolio on the website for a full listing.

Analyst recommendations on BHP



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One of the biggest challenges for those people with Self-Managed Super Funds (SMSF) is finding the time to manage investments wisely to gain the best possible return on those investments.

Most investors want to maintain overall control, but recognise that their time and market knowledge sometimes limits their investment returns.

Please contact Leyland Private Asset Management if you would like to talk further about us managing your super fund equity investments.

Leyland Lines

Warren Buffett Letter to Berkshire Hathaway stockholders 1977

To the Stockholders of Berkshire Hathaway Inc.

Operating earnings in 1977 of \$21,904,000, or \$22.54 per share, were moderately better than anticipated a year ago. Of these earnings, \$1.43 per share resulted from substantial realized capital gains by Blue Chip Stamps which, to the extent of our proportional interest in that company, are included in our operating earnings figure. Capital gains or losses realized directly by Berkshire Hathaway Inc. or its insurance subsidiaries are not included in our calculation of operating earnings. While too much attention should not be paid to the figure for any single year, over the longer term the record regarding aggregate capital gains or losses obviously is of significance.

Textile operations came in well below forecast, while the results of the Illinois National Bank as well as the operating earnings attributable to our equity interest in Blue Chip Stamps were about as anticipated. However, insurance operations, led again by the truly outstanding results of Phil Liesche's managerial group at National Indemnity Company, were even better than our optimistic expectations.

Most companies define "record" earnings as a new high in earnings per share. Since businesses customarily add from year to year to their equity base, we find nothing particularly noteworthy in a management performance combining, say, a 10% increase in equity capital and a 5% increase in earnings per share. After all, even a totally dormant savings account will produce steadily rising interest earnings each year because of compounding.

Except for special cases (for example, companies with unusual debt-equity ratios or those with important assets carried at unrealistic balance sheet values), we believe a more appropriate measure of managerial economic performance to be return on equity capital. In 1977 our operating earnings on beginning equity capital amounted to 19%, slightly better than last year and above

both our own long-term average and that of American industry in aggregate. But, while our operating earnings per share were up 37% from the year before, our beginning capital was up 24%, making the gain in earnings per share considerably less impressive than it might appear at first glance.

We expect difficulty in matching our 1977 rate of return during the forthcoming year. Beginning equity capital is up 23% from a year ago, and we expect the trend of insurance underwriting profit margins to turn down well before the end of the year. Nevertheless, we expect a reasonably good year and our present estimate, subject to the usual caveats regarding the frailties of forecasts, is that operating earnings will improve somewhat on a per share basis during 1978.

Textile Operations

The textile business again had a very poor year in 1977. We have mistakenly predicted better results in each of the last two years. This may say something about our forecasting abilities, the nature of the textile industry, or both. Despite strenuous efforts, problems in marketing and manufacturing have persisted. Many difficulties experienced in the marketing area are due primarily to industry conditions, but some of the problems have been of our own making.

A few shareholders have questioned the wisdom of remaining in the textile business which, over the longer term, is unlikely to produce returns on capital comparable to those available in many other businesses. Our reasons are several: (1) Our mills in both New Bedford and Manchester are among the largest employers in each town, utilizing a labor force of high average age possessing relatively non-transferable skills. Our workers and unions have exhibited unusual understanding and effort in cooperating with management to achieve a cost structure and product mix which might allow us to maintain a viable operation. (2) Management also has been

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Warren Buffett Letter to Berkshire Hathaway stockholders 1977

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energetic and straightforward in its approach to our textile problems. In particular, Ken Chace's efforts after the change in corporate control took place in 1965 generated capital from the textile division needed to finance the acquisition and expansion of our profitable insurance operation. (3) With hard work and some imagination regarding manufacturing and marketing configurations, it seems reasonable that at least modest profits in the textile division can be achieved in the future.

Insurance Underwriting

Our insurance operation continued to grow significantly in 1977. It was early in 1967 that we made our entry into this industry through the purchase of National Indemnity Company and National Fire and Marine Insurance Company (sister companies) for approximately \$8.6 million. In that year their premium volume amounted to \$22 million. In 1977 our aggregate insurance premium volume was \$151 million. No additional shares of Berkshire Hathaway stock have been issued to achieve any of this growth.

Rather, this almost 600% increase has been achieved through large gains in National Indemnity's traditional liability areas plus the starting of new companies (Cornhusker Casualty Company in 1970, Lakeland Fire and Casualty Company in 1971, Texas United Insurance Company in 1972, The Insurance Company of Iowa in 1973, and Kansas Fire and Casualty Company in late 1977), the purchase for cash of other insurance companies (Home and Automobile Insurance Company in 1971, Kerkring Reinsurance Corporation, now named Central Fire and Casualty Company, in 1976, and Cypress Insurance Company at yearend 1977), and finally through the marketing of additional products, most significantly reinsurance, within the National Indemnity Company corporate structure.

In aggregate, the insurance business has worked out very well. But it hasn't been a one-way street. Some major mistakes have been

made during the decade, both in products and personnel. We experienced significant problems from (1) a surety operation initiated in 1969, (2) the 1973 expansion of Home and Automobile's urban auto marketing into the Miami, Florida area, (3) a still unresolved aviation "fronting" arrangement, and (4) our Worker's Compensation operation in California, which we believe retains an interesting potential upon completion of a reorganization now in progress. It is comforting to be in a business where some mistakes can be made and yet a quite satisfactory overall performance can be achieved. In a sense, this is the opposite case from our textile business where even very good management probably can average only modest results. One of the lessons your management has learned - and, unfortunately, sometimes re-learned - is the importance of being in businesses where tailwinds prevail rather than headwinds.

In 1977 the winds in insurance underwriting were squarely behind us. Very large rate increases were effected throughout the industry in 1976 to offset the disastrous underwriting results of 1974 and 1975. But, because insurance policies typically are written for one-year periods, with pricing mistakes capable of correction only upon renewal, it was 1977 before the full impact was felt upon earnings of those earlier rate increases.

The pendulum now is beginning to swing the other way. We estimate that costs involved in the insurance areas in which we operate rise at close to 1% per month. This is due to continuous monetary inflation affecting the cost of repairing humans and property, as well as "social inflation", a broadening definition by society and juries of what is covered by insurance policies. Unless rates rise at a comparable 1% per month, underwriting profits must shrink. Recently the pace of rate increases has slowed dramatically, and it is our expectation that underwriting margins generally will be declining by the second half of the year.

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Warren Buffett Letter to Berkshire Hathaway stockholders 1977

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We must again give credit to Phil Liesche, greatly assisted by Roland Miller in Underwriting and Bill Lyons in Claims, for an extraordinary underwriting achievement in National Indemnity's traditional auto and general liability business during 1977. Large volume gains have been accompanied by excellent underwriting margins following contraction or withdrawal by many competitors in the wake of the 1974-75 crisis period. These conditions will reverse before long. In the meantime, National Indemnity's underwriting profitability has increased dramatically and, in addition, large sums have been made available for investment. As markets loosen and rates become inadequate, we again will face the challenge of philosophically accepting reduced volume. Unusual managerial discipline will be required, as it runs counter to normal institutional behavior to let the other fellow take away business - even at foolish prices.

Our reinsurance department, managed by George Young, improved its underwriting performance during 1977. Although the combined ratio (see definition on page 12) of 107.1 was unsatisfactory, its trend was downward throughout the year. In addition, reinsurance generates unusually high funds for investment as a percentage of premium volume.

At Home and Auto, John Seward continued to make progress on all fronts. John was a battlefield promotion several years ago when Home and Auto's underwriting was awash in red ink and the company faced possible extinction. Under his management it currently is sound, profitable, and growing.

John Ringwalt's homestate operation now consists of five companies, with Kansas Fire and Casualty Company becoming operational late in 1977 under the direction of Floyd Taylor. The homestate companies had net premium volume of \$23 million, up from \$5.5 million just three years ago. All four companies that operated throughout the year achieved combined

ratios below 100, with Cornhusker Casualty Company, at 93.8, the leader. In addition to actively supervising the other four homestate operations, John Ringwalt manages the operations of Cornhusker which has recorded combined ratios below 100 in six of its seven full years of existence and, from a standing start in 1970, has grown to be one of the leading insurance companies operating in Nebraska utilizing the conventional independent agency system. Lakeland Fire and Casualty Company, managed by Jim Stodolka, was the winner of the Chairman's Cup in 1977 for achieving the lowest loss ratio among the homestate companies. All in all, the homestate operation continues to make excellent progress.

The newest addition to our insurance group is Cypress Insurance Company of South Pasadena, California. This Worker's Compensation insurer was purchased for cash in the final days of 1977 and, therefore, its approximate \$12.5 million of volume for that year was not included in our results. Cypress and National Indemnity's present California Worker's Compensation operation will not be combined, but will operate independently utilizing somewhat different marketing strategies. Milt Thornton, President of Cypress since 1968, runs a first-class operation for policyholders, agents, employees and owners alike. We look forward to working with him.

Insurance companies offer standardized policies which can be copied by anyone. Their only products are promises. It is not difficult to be licensed, and rates are an open book. There are no important advantages from trademarks, patents, location, corporate longevity, raw material sources, etc., and very little consumer differentiation to produce insulation from competition. It is commonplace, in corporate annual reports, to stress the difference that people make. Sometimes this is true and sometimes it isn't. But there is no question that the nature of the insurance business magnifies

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Warren Buffett Letter to Berkshire Hathaway stockholders 1977

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the effect which individual managers have on company performance. We are very fortunate to have the group of managers that are associated with us.

Insurance Investments

During the past two years insurance investments at cost (excluding the investment in our affiliate, Blue Chip Stamps) have grown from \$134.6 million to \$252.8 million. Growth in insurance reserves, produced by our large gain in premium volume, plus retained earnings, have accounted for this increase in marketable securities. In turn, net investment income of the Insurance Group has improved from \$8.4 million pre-tax in 1975 to \$12.3 million pre-tax in 1977.

In addition to this income from dividends and interest, we realized capital gains of \$6.9 million before tax, about one-quarter from bonds and the balance from stocks. Our unrealized gain in stocks at yearend 1977 was approximately \$74 million but this figure, like any other figure of a single date (we had an unrealized loss of \$17 million at the end of 1974), should not be taken too seriously. Most of our large stock positions are going to be held for many years and the scorecard on our investment decisions will be provided by business results over that period, and not by prices on any given day. Just as it would be foolish to focus unduly on short-term prospects when acquiring an entire company, we think it equally unsound to become mesmerized by prospective near term earnings or recent trends in earnings when purchasing small pieces of a company; i.e., marketable common stocks.

A little digression illustrating this point may be interesting. Berkshire Fine Spinning Associates and Hathaway Manufacturing were merged in 1955 to form Berkshire Hathaway Inc. In 1948, on a pro forma combined basis, they had earnings after tax of almost \$18 million and employed 10,000 people at a dozen large mills throughout New England. In the business

The strategy we've adopted precludes our following standard diversification dogma. Many pundits would therefore say the strategy must be riskier than that employed by more conventional investors. We disagree. We believe that a policy of portfolio concentration may well decrease risk if it raises, as it should, both the intensity with which an investor thinks about a business and the comfort-level he must feel with its economic characteristics before buying into it.

Warren E. Buffett

world of that period they were an economic powerhouse. For example, in that same year earnings of IBM were \$28 million (now \$2.7 billion), Safeway Stores, \$10 million, Minnesota Mining, \$13 million, and Time, Inc., \$9 million. But, in the decade following the 1955 merger aggregate sales of \$595 million produced an aggregate loss for Berkshire Hathaway of \$10 million. By 1964 the operation had been reduced to two mills and net worth had shrunk to \$22 million, from \$53 million at the time of the merger. So much for single year snapshots as adequate portrayals of a business.

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Warren Buffett Letter to Berkshire Hathaway stockholders 1977

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Equity holdings of our insurance companies with a market value of over \$5 million on December 31, 1977 were as follows:

No. of Shares	Company	Cost ('000)	Market ('000)
220,000	Capital Cities Communications, Inc.	\$ 10,909	\$ 13,228
1,986,953	Government Employees Insurance Company Convertible Preferred	19,417	33,033
1,294,308	Government Employees Insurance Company Common Stock	4,116	10,516
592,650	The Interpublic Group of Companies, Inc.	4,531	17,187
324,580	Kaiser Aluminum & Chemical Corporation	11,218	9,981
1,305,800	Kaiser Industries, Inc.	778	6,039
226,900	Knight-Ridder Newspapers, Inc.	7,534	8,736
170,800	Ogilvy & Mather International, Inc.	2,762	6,960
934,300	The Washington Post Company Class B	10,628	33,401
	Total	\$71,893	\$139,081
	All Other Holdings	34,996	41,992
	Total Equities	\$106,889	\$181,073

We select our marketable equity securities in much the same way we would evaluate a business for acquisition in its entirety. We want the business to be (1) one that we can understand, (2) with favorable long-term prospects, (3) operated by honest and competent people, and (4) available at a very attractive price. We ordinarily make no attempt to buy equities for anticipated favorable stock price behavior in the short term. In fact, if their business experience continues to satisfy us, we welcome lower market prices of stocks we own as an opportunity to acquire even more of a good thing at a better price.

Our experience has been that pro-rata portions of truly outstanding businesses sometimes sell in the securities markets at very large discounts from the prices they would command in negotiated transactions involving entire companies. Consequently, bargains in business ownership, which simply are not available directly through corporate acquisition, can be obtained

indirectly through stock ownership. When prices are appropriate, we are willing to take very large positions in selected companies, not with any intention of taking control and not foreseeing sell-out or merger, but with the expectation that excellent business results by corporations will translate over the long term into correspondingly excellent market value and dividend results for owners, minority as well as majority.

Such investments initially may have negligible impact on our operating earnings. For example, we invested \$10.9 million in Capital Cities Communications during 1977. Earnings attributable to the shares we purchased totaled about \$1.3 million last year. But only the cash dividend, which currently provides \$40,000 annually, is reflected in our operating earnings figure.

Capital Cities possesses both extraordinary properties and extraordinary management. And these management skills extend equally to

Leyland Lines

Warren Buffett Letter to Berkshire Hathaway stockholders 1977

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operations and employment of corporate capital. To purchase, directly, properties such as Capital Cities owns would cost in the area of twice our cost of purchase via the stock market, and direct ownership would offer no important advantages to us. While control would give us the opportunity - and the responsibility - to manage operations and corporate resources, we would not be able to provide management in either of those respects equal to that now in place. In effect, we can obtain a better management result through non-control than control. This is an unorthodox view, but one we believe to be sound.

Banking

In 1977 the Illinois National Bank continued to achieve a rate of earnings on assets about three times that of most large banks. As usual, this record was achieved while the bank paid maximum rates to savers and maintained an asset position combining low risk and exceptional liquidity. Gene Abegg formed the bank in 1931 with \$250,000. In its first full year of operation, earnings amounted to \$8,782. Since that time, no new capital has been contributed to the bank; on the contrary, since our purchase in 1969, dividends of \$20 million have been paid. Earnings in 1977 amounted to \$3.6 million, more than achieved by many banks two or three times its size.

Late last year Gene, now 80 and still running a banking operation without peer, asked that a successor be brought in. Accordingly, Peter

Jeffrey, formerly President and Chief Executive Officer of American National Bank of Omaha, has joined the Illinois National Bank effective March 1st as President and Chief Executive Officer.

Gene continues in good health as Chairman. We expect a continued successful operation at Rockford's leading bank.

Blue Chip Stamps

We again increased our equity interest in Blue Chip Stamps, and owned approximately 36 1/2% at the end of 1977. Blue Chip had a fine year, earning approximately \$12.9 million from operations and, in addition, had realized securities gains of \$4.1 million.

Both Wesco Financial Corp., an 80% owned subsidiary of Blue Chip Stamps, managed by Louis Vincenti, and See's Candies, a 99% owned subsidiary, managed by Chuck Huggins, made good progress in 1977. Since See's was purchased by Blue Chip Stamps at the beginning of 1972, pre-tax operating earnings have grown from \$4.2 million to \$12.6 million with little additional capital investment. See's achieved this record while operating in an industry experiencing practically no unit growth. Shareholders of Berkshire Hathaway Inc. may obtain the annual report of Blue Chip Stamps by requesting it from Mr. Robert H. Bird, Blue Chip Stamps, 5801 South Eastern Avenue, Los Angeles, California 90040.

Warren E. Buffett, Chairman
March 14, 1978

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