

# Leyland Lines

May 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 May 2011 edition of Leyland Lines.

With the extreme volatility in the market and media commentary turning sharply negative this month, investors would be forgiven for thinking that value has become irrelevant, and the financial world truly is coming to an end.

While we remain cautious about the broader direction of the Australian economy, we remain convinced that there are a number of companies which display attractive earnings outlooks to warrant our interest.

As we have continuously mentioned, we find it far too difficult to predict short term market movements, and we have preferred to avoid the commodities market in recent times. That is not to say that we are convinced that the China story (and commodity market with it) is about to turn, but as was very clearly illustrated in the stunning volatility in the silver markets

this month, commodities have the ability to be volatile far beyond our expectations.



For all the concerns at both a global level and domestically, we believe there are significant gains to be made for investors who are able to navigate their portfolios into companies that

MARKET UPDATE

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display the sorts of value characteristics for which investors should always be looking for.

In the light of market swings, in this month's edition we consider the value of investing in Woolworths. We also revisit Bluescope in the after effects of the proposed introduction of a carbon tax and continuingly high iron ore prices.

We have also included a copy of Warren Buffett's letter to share holders from 1980. We would

point out that much like the market in the past, if investors persist with their tried and proven methods, the rewards will be reflected in their results.

We hope that you enjoy this month's edition, and invite all readers to be in touch with their portfolio manager should you have any questions about our articles or any portfolio related needs.

MARKET UPDATE

*Leyland*  
Private Asset Management



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## Woolworths

### Background

Woolworths is Australia's largest grocery retailer with about 30% market share. The company has over 1,500 stores and annual sales of over A\$45bn in Australia and New Zealand. The food and liquor division represents over 80% of Woolworths sales and operating earnings. The remainder is made up of general merchandising (BigW, Dick Smith, Powerhouse and Tandy) and New Zealand supermarkets.

As over 80% of WOW earnings is dependent on supermarkets, the performance of Woolworths is dependent on margin expansion, increase in foot traffic and basket size in food and liquor.

### Competition

The recent price war with Coles is negatively impacting margins, and remains a key risk. However, promotional activity by Coles has had little impact Woolworths sales growth. Both Coles and Woolworths have enjoyed sales growth which suggests the uplift is coming from other sources than simply customer switching. Cost of living pressures may be contributing factor to more at-home dining.

A rational supermarket pricing environment and strong cost management remain the drivers for WOW. Given this recent competition, it would seem that a further deterioration in margins is unlikely.

Australian supermarkets are amongst the most concentrated in the world and as result the possibility of restrictions imposed through government regulation is a risk. There is also an industry wide strategy of store roll-outs amongst not only the major chains, but also IGA and ALDI.

Woolworths has recently entered the home improvements market plans to open 150 sites under the name of "Masters" over the next five years. This is a positive for the company, and will provide Bunnings with much needed competition.

### CEO Succession and Strategy

WOW has announced the retirement of CEO Michael Luscombe and the appointment of Grant O'Brien as Deputy CEO and CEO Designate. This has had little impact of WOW given O'Brien's long history with Woolworths, proving for a continuation of strategy. The new distribution centre is operational and store merchandising and layout is complete.

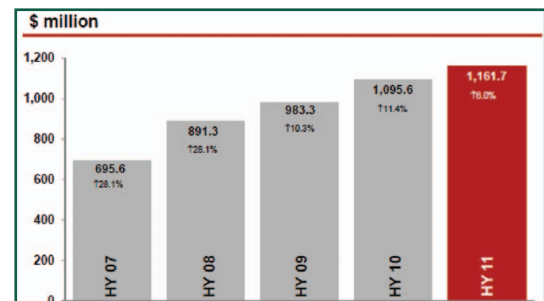
Strategic issues confronting the new CEO include engaging Coles with regards to differentiating their offering, rather than being reactive to competition. Additionally, anecdotal evidence suggests that organisational and operational issues remain, and customer service requiring improvement.

The 2015 supermarket offer, with a move to fresh and the new Macro brand have been positively received and should contribute positively to margins. Margins are also targeted through direct sourcing, supply chain efficiencies and private labels sales. Private label sales now account for ~20% of total supermarket sales.

### Q3 2011 sales Results and guidance

Woolworths has demonstrably sustainable earnings growth and provided full-year guidance of 5-8% NPAT growth (6-9% EPS growth).

### Profit after tax



Whilst higher input costs are a risk (labour and raw materials) the non-discretionary nature of Supermarkets ensures they are more able to push through input cost pressures than their more discretionary peers.

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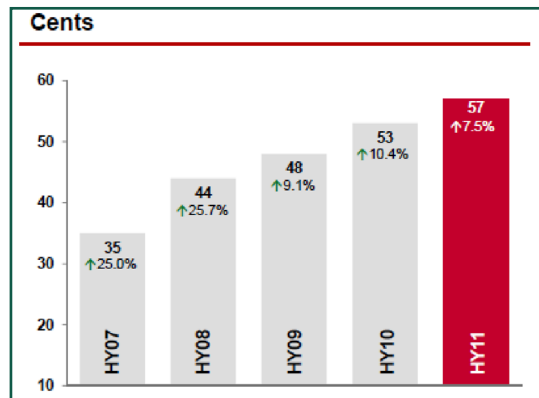
## Woolworths cont'd

The discretionary portion of Woolworths business is also improving with Big W growing at 2% and Electronics growing at 6.4% versus 3.4% in the previous quarter.

WOW is trading on 13.5x EPS, with a yield of 6% grossed up (60% pay-out ratio), an undemanding valuation with defensive earnings characteristics.

## Dividends per Share

Woolworths completed a \$704m off-market buy-back in October 2010 improving Earnings Per Share and Return On Equity. Profit growth, coupled with balance sheet management will have delivered over \$9.5bn payout to shareholders since 2001.



## Sector Comparison

		P/E		ROE	EPS		DPS	Yield	Franking
		2010	2011	2011	2010	2011	2011	2011	2011
MTS	Metcash Limited	12x	11x	22%	\$0.30	\$0.32	\$0.26	6.60%	100%
WES	Wesfarmers	18x	15x	12%	\$1.36	\$1.78	\$1.42	4.30%	100%
WOW	Woolworths	15x	13.5x	30%	\$1.64	\$1.78	\$1.24	4.20%	100%

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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.**



## BlueScope Steel

BlueScope Steel is Australia's largest steel company and the only Australian manufacturer of flat steel products. The company was spun out of BHP in 2003 and was formerly known as BHP Steel. They focus on steel products including slab, hot rolled coil and plate as well as specialty steels, such as metallic coated and paint steel solutions.

BlueScope's main facility is its Port Kembla Steelworks in New South Wales, which has a capacity of 5.3Mtpa of raw steel and is the largest steel production facility in Australia. The company also owns and operates primary steelmaking facilities in North America and New Zealand, and has downstream coated-steel markets in Asia, with the products principally sold to building and construction markets. In the US, they own 50% of a mini-mall venture and are one of the largest producers of pre-engineered buildings following its 2004 acquisition of Butler Manufacturing.

They are one of the lowest-cost steel producers in the world and this has been achieved through proximity to raw materials, efficient production technology and good distribution channels. In Australia, the company's major clients are steel distributors (led by OneSteel), the construction sector and major manufacturers, including the white goods and car sectors.

### Event

The last time we examined BlueScope, we flagged the following concerns as potentially weighing down the stock being:

- Flat prices for steel.
- High raw material costs. The recent move to quarterly pricing and significant price increases has increased raw material costs. When combined with flat steel prices, this has led to margin compression.
- A rising Australian dollar.

- A distinct softening in Australian domestic demand, particularly in the industrial market segment.

Since then, the company has realised all these concerns to an increasingly worsening extent. On the 11th of May 2011, following major downgrades announced from their major competitor Onesteel, BlueScope provided a trading update to the market. They guided a 'small' net loss after tax in the second half 2011 after a review of their operations to April and expectations for May and June. Prior guidance was break-even. The drivers of the earnings downgrade were the stronger Australian dollar (impacts export sales, translation of offshore earnings and domestic commoditised steel sales), softer steel prices, and demand weakness in the domestic distribution and pipe and tube market.



### Outlook

It can be argued the market is becoming overly concerned, with a scenario of no recovery in volume, further rises in the Australian dollar, no restoration of commodity steel margins, no management pre-emptive action in response to market conditions and the proposed Gillard Government carbon tax. Whilst all legitimate, and conditions could further deteriorate, these issues are currently well and truly factored in to the dramatically sold-off share price.

The market has also turned its attention to BlueScope's business stress and potential debt covenant risk. The company is operating under the worst environment yet experienced and their debt is modest. Further downturn leaves

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## Bluescope Steel cont'd

the highly experienced board and management with many strategies such as; renegotiation of covenants, debt reduction through asset sales, deep operational cost cuts, a capital raising or a combination of these.

The medium-term outlook remains challenging for BlueScope due to the well documented concerns previously mentioned in this article. Longer-term valuation metrics appear compelling at current levels, however there is likely to be significant volatility and hence risk around earnings. The major swing-factor for a turnaround would be a falling Australian dollar. Taking this all in to account, BlueScope does still have some appeal for the patient investor.

BSL \$1.375	2009 A	2010 A	2011 E	2012 E	2013 E
EPS (cps)	2.75	6.60	-3.78	7.88	14.23
PE (x)	50.00	20.83	NA	17.46	9.67
DPS (cps)	5.00	5.00	3.00	4.73	7.25
Yield (%)	3.64%	3.64%	2.18%	3.44%	5.27%
Franking (%)	100%	100%	100%	100%	100%

## Warren Buffett Letter to Berkshire Hathaway stockholders 1979

Operating earnings improved to \$41.9 million in 1980 from \$36.0 million in 1979, but return on beginning equity capital (with securities valued at cost) fell to 17.8% from 18.6%. We believe the latter yardstick to be the most appropriate measure of single-year managerial economic performance. Informed use of that yardstick, however, requires an understanding of many factors, including accounting policies, historical carrying values of assets, financial leverage, and industry conditions.

In your evaluation of our economic performance, we suggest that two factors should receive your special attention - one of a positive nature peculiar, to a large extent, to our own operation, and one of a negative nature applicable to corporate performance generally. Let's look at the bright side first.

### Non-Controlled Ownership Earnings

When one company owns part of another company, appropriate accounting procedures pertaining to that ownership interest must be selected from one of three major categories. The percentage of voting stock that is owned, in large

part, determines which category of accounting principles should be utilized.

Generally accepted accounting principles require (subject to exceptions, naturally, as with our former bank subsidiary) full consolidation of sales, expenses, taxes, and earnings of business holdings more than 50% owned. Blue Chip Stamps, 60% owned by Berkshire Hathaway Inc., falls into this category. Therefore, all Blue Chip income and expense items are included in full in Berkshire's Consolidated Statement of Earnings, with the 40% ownership interest of others in Blue Chip's net earnings reflected in the Statement as a deduction for "minority interest".

Full inclusion of underlying earnings from another class of holdings, companies owned 20% to 50% (usually called "investees"), also normally occurs. Earnings from such companies - for example, Wesco Financial, controlled by Berkshire but only 48% owned - are included via a one-line entry in the owner's Statement of Earnings. Unlike the over-50% category, all items of revenue and expense are omitted; just the proportional share of net income is included. Thus, if Corporation

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## Warren Buffett Letter to Berkshire Hathaway stockholders 1979

cont'd

A owns one-third of Corporation B, one-third of B's earnings, whether or not distributed by B, will end up in A's earnings. There are some modifications, both in this and the over-50% category, for intercorporate taxes and purchase price adjustments, the explanation of which we will save for a later day. (We know you can hardly wait.)

Finally come holdings representing less than 20% ownership of another corporation's voting securities. In these cases, accounting rules dictate that the owning companies include in their earnings only dividends received from such holdings. Undistributed earnings are ignored. Thus, should we own 10% of Corporation X with earnings of \$10 million in 1980, we would report in our earnings (ignoring relatively minor taxes on intercorporate dividends) either (a) \$1 million if X declared the full \$10 million in dividends; (b) \$500,000 if X paid out 50%, or \$5 million, in dividends; or (c) zero if X reinvested all earnings.

We impose this short - and over-simplified - course in accounting upon you because Berkshire's concentration of resources in the insurance field produces a corresponding concentration of its assets in companies in that third (less than 20% owned) category. Many of these companies pay out relatively small proportions of their earnings in dividends. This means that only a small proportion of their current earning power is recorded in our own current operating earnings. But, while our reported operating earnings reflect only the dividends received from such companies, our economic well-being is determined by their earnings, not their dividends.

Our holdings in this third category of companies have increased dramatically in recent years as our insurance business has prospered and as securities markets have presented particularly attractive opportunities in the common stock area. The large increase in such holdings, plus the growth of earnings experienced by those

*Never count on making a good sale. Have the purchase price be so attractive that even a mediocre sale gives good results.*

*Warren Buffett*

partially-owned companies, has produced an unusual result; the part of "our" earnings that these companies retained last year (the part not paid to us in dividends) exceeded the total reported annual operating earnings of Berkshire Hathaway. Thus, conventional accounting only allows less than half of our earnings "iceberg" to appear above the surface, in plain view. Within the corporate world such a result is quite rare; in our case it is likely to be recurring.

Our own analysis of earnings reality differs somewhat from generally accepted accounting principles, particularly when those principles must be applied in a world of high and uncertain rates of inflation. (But it's much easier to criticize than to improve such accounting rules. The inherent problems are monumental.) We have owned 100% of businesses whose reported earnings were not worth close to 100 cents on the dollar to us even though, in an accounting sense, we totally controlled their disposition. (The "control" was theoretical. Unless we reinvested all earnings, massive deterioration in the value of assets already in place would occur. But those reinvested earnings had no prospect of earning anything close to a market return on capital.) We have also owned small fractions of businesses with extraordinary reinvestment possibilities whose retained earnings had an economic value to us far in excess of 100 cents on the dollar.

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## Warren Buffett Letter to Berkshire Hathaway stockholders 1979

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The value to Berkshire Hathaway of retained earnings is not determined by whether we own 100%, 50%, 20% or 1% of the businesses in which they reside. Rather, the value of those retained earnings is determined by the use to which they are put and the subsequent level of earnings produced by that usage. This is true whether we determine the usage, or whether managers we did not hire - but did elect to join - determine that usage. (It's the act that counts, not the actors.) And the value is in

no way affected by the inclusion or non-inclusion of those retained earnings in our own reported operating earnings. If a tree grows in a forest partially owned by us, but we don't record the growth in our financial statements, we still own part of the tree.

Our view, we warn you, is non-conventional. But we would rather have earnings for which we did not get accounting credit put to good use in a 10%-owned company by a management we did not personally hire, than have earnings for which we did get credit put into projects of more dubious potential by another management - even if we are that management.

(We can't resist pausing here for a short commercial. One usage of retained earnings we often greet with special enthusiasm when practiced by companies in which we have an investment interest is repurchase of their own shares. The reasoning is simple: if a fine business is selling in the market place for far less than intrinsic value, what more certain or more profitable utilization of capital can there be than significant enlargement of the interests of all owners at that bargain price? The competitive nature of corporate acquisition activity almost guarantees the payment of a full - frequently more than full price when a company buys the entire ownership of another enterprise. But the auction nature of security markets often allows finely-run companies the opportunity to purchase portions of their own businesses at a price under 50% of that needed to acquire the same earning

power through the negotiated acquisition of another enterprise.)

### Long-Term Corporate Results

As we have noted, we evaluate single-year corporate performance by comparing operating earnings to shareholders' equity with securities valued at cost. Our long-term yardstick of performance, however, includes all capital gains or losses, realized or unrealized. We continue to achieve a long-term return on equity that considerably exceeds the average of our yearly returns. The major factor causing this pleasant result is a simple one: the retained earnings of those non-controlled holdings we discussed earlier have been translated into gains in market value.

Of course, this translation of retained earnings into market price appreciation is highly uneven (it goes in reverse some years), unpredictable as to timing, and unlikely to materialize on a precise dollar-for-dollar basis. And a silly purchase price for a block of stock in a corporation can negate the effects of a decade of earnings retention by that corporation. But when purchase prices are sensible, some long-term market recognition of the accumulation of retained earnings almost certainly will occur. Periodically you even will receive some frosting on the cake, with market appreciation far exceeding post-purchase retained earnings.

In the sixteen years since present management assumed responsibility for Berkshire, book value per share with insurance-held equities valued at market has increased from \$19.46 to \$400.80, or 20.5% compounded annually. (You've done better: the value of the mineral content in the human body compounded at 22% annually during the past decade.) It is encouraging, moreover, to realize that our record was achieved despite many mistakes. The list is too painful and lengthy to detail here. But it clearly shows that a reasonably competitive corporate batting average can be achieved in spite of a lot of managerial strikeouts.

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## Warren Buffett Letter to Berkshire Hathaway stockholders 1979

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Our insurance companies will continue to make large investments in well-run, favorably-situated, non-controlled companies that very often will pay out in dividends only small proportions of their earnings. Following this policy, we would expect our long-term returns to continue to exceed the returns derived annually from reported operating earnings. Our confidence in this belief can easily be quantified: if we were to sell the equities that we hold and replace them with long-term tax-free bonds, our reported operating earnings would rise immediately by over \$30 million annually. Such a shift tempts us not at all.

### So much for the good news.

#### Results for Owners

Unfortunately, earnings reported in corporate financial statements are no longer the dominant variable that determines whether there are any real earnings for you, the owner. For only gains in purchasing power represent real earnings on investment. If you (a) forego ten hamburgers to purchase an investment; (b) receive dividends which, after tax, buy two hamburgers; and (c) receive, upon sale of your holdings, after-tax proceeds that will buy eight hamburgers, then (d) you have had no real income from your investment, no matter how much it appreciated in dollars. You may feel richer, but you won't eat richer.

High rates of inflation create a tax on capital that makes much corporate investment unwise - at least if measured by the criterion of a positive real investment return to owners. This "hurdle rate" the return on equity that must be achieved by a corporation in order to produce any real return for its individual owners - has increased dramatically in recent years. The average tax-paying investor is now running up a down escalator whose pace has accelerated to the point where his upward progress is nil.

For example, in a world of 12% inflation a business earning 20% on equity (which very few manage consistently to do) and distributing it all

to individuals in the 50% bracket is chewing up their real capital, not enhancing it. (Half of the 20% will go for income tax; the remaining 10% leaves the owners of the business with only 98% of the purchasing power they possessed at the start of the year - even though they have not spent a penny of their "earnings"). The investors in this bracket would actually be better off with a combination of stable prices and corporate earnings on equity capital of only a few per cent.

Explicit income taxes alone, unaccompanied by any implicit inflation tax, never can turn a positive corporate return into a negative owner return. (Even if there were 90% personal income tax rates on both dividends and capital gains, some real income would be left for the owner at a zero inflation rate.) But the inflation tax is not limited by reported income. Inflation rates not far from those recently experienced can turn the level of positive returns achieved by a majority of corporations into negative returns for all owners, including those not required to pay explicit taxes. (For example, if inflation reached 16%, owners of the 60% plus of corporate America earning less than this rate of return would be realizing a negative real return - even if income taxes on dividends and capital gains were eliminated.)

Of course, the two forms of taxation co-exist and interact since explicit taxes are levied on nominal, not real, income. Thus you pay income taxes on what would be deficits if returns to stockholders were measured in constant dollars. At present inflation rates, we believe individual owners in medium or high tax brackets (as distinguished from tax-free entities such as pension funds, eleemosynary institutions, etc.) should expect no real long-term return from the average American corporation, even though these individuals reinvest the entire after-tax proceeds from all dividends they receive. The average return on equity of corporations is fully offset by the combination of the implicit tax on capital levied by inflation and the explicit taxes levied both on

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## Warren Buffett Letter to Berkshire Hathaway stockholders 1979

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dividends and gains in value produced by retained earnings.

As we said last year, Berkshire has no corporate solution to the problem. (We'll say it again next year, too.) Inflation does not improve our return on equity.

Indexing is the insulation that all seek against inflation. But the great bulk (although there are important exceptions) of corporate capital is not even partially indexed. Of course, earnings and dividends per share usually will rise if significant earnings are "saved" by a corporation; i.e., reinvested instead of paid as dividends. But that would be true without inflation. A thrifty wage earner, likewise, could achieve regular annual increases in his total income without ever getting a pay increase - if he were willing to take only half of his paycheck in cash (his wage "dividend") and consistently add the other half (his "retained earnings") to a savings account. Neither this high-saving wage earner nor the stockholder in a high-saving corporation whose annual dividend rate increases while its rate of return on equity remains flat is truly indexed.

For capital to be truly indexed, return on equity must rise, i.e., business earnings consistently must increase in proportion to the increase in the price level without any need for the business to add to capital - including working capital - employed. (Increased earnings produced by increased investment don't count.) Only a few businesses come close to exhibiting this ability. And Berkshire Hathaway isn't one of them.

We, of course, have a corporate policy of reinvesting earnings for growth, diversity and strength, which has the incidental effect of minimizing the current imposition of explicit taxes on our owners. However, on a day-by-day basis, you will be subjected to the implicit inflation tax, and when you wish to transfer your investment in Berkshire into another form of investment, or into consumption, you also will face explicit taxes.

*Ben's Mr. Market allegory may seem out-of-date in today's investment world, in which most professionals and academicians talk of efficient markets, dynamic hedging and betas. Their interest in such matters is understandable, since techniques shrouded in mystery clearly have value to the purveyor of investment advice. After all, what witch doctor has ever achieved fame and fortune by simply advising 'Take two aspirins'?*

*Warren E. Buffett*

### Sources of Earnings

The table below shows the sources of Berkshire's reported earnings. Berkshire owns about 60% of Blue Chip Stamps, which in turn owns 80% of Wesco Financial Corporation. The table shows aggregate earnings of the various business entities, as well as Berkshire's share of those earnings. All of the significant capital gains and losses attributable to any of the business entities are aggregated in the realized securities gains figure at the bottom of the table, and are not included in operating earnings. Our calculation of operating earnings also excludes the gain from sale of Mutual's branch offices. In this respect it differs from the presentation in our audited financial statements that includes this item in the calculation of "Earnings Before Realized Investment Gain".

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## Warren Buffett Letter to Berkshire Hathaway stockholders 1979

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	Earnings Before Income Taxes				Net Earnings After Tax	
	Total		Berkshire Share		Berkshire Share	
(in thousands of dollars)	1980	1979	1980	1979	1980	1979
Total - all entities	\$85,945	\$68,632	\$70,146	\$56,427	\$53,122	\$42,817
Earnings from Operations: Insurance Group:						
Underwriting	\$6,738	\$3,742	\$6,737	\$3,741	\$3,637	\$2,214
Net Investment Income	30,939	24,224	30,927	24,216	25,607	20,106
Berkshire-Waumbec textiles	-508	1,723	-508	1,723	202	848
Associated Retail Stores, Inc.	2,440	2,775	2,440	2,775	1,169	1,280
See's Candies	15,031	12,785	8,598	7,598	4,212	3,448
Buffalo Evening News	-2,805	-4,617	-1,672	-2,744	-816	-1,333
Blue Chip Stamps - Parent	7,699	2,397	4,588	1,425	3,060	1,624
Illinois National Bank and Trust Company	5,324	5,747	5,200	5,614	4,731	5,027
Wesco Financial Corporation - Parent	2,916	2,413	1,392	1,098	1,044	937
Mutual Savings and Loan Association	5,814	10,447	2,775	4,751	1,974	3,261
Precision Steel	2,833	3,254	1,352	1,480	656	723
Interest on Debt	-12,230	-8,248	-9,390	-5,860	-4,809	-2,900
Other	2,170	1,342	1,590	996	1,255	753
Total Earnings from Operations	\$66,361	\$57,984	\$54,389	\$46,813	\$41,922	\$35,988
Mutual Savings & Loan - sale of branches	5,837	--	2,803	--	1,293	--
Realized Securities Gain	10,648	13,796	9,614	13,395	6,829	9,190
Total Earnings	\$68,632	\$66,180	\$56,427	\$54,350	\$42,817	\$39,242

Blue Chip Stamps and Wesco are public companies with reporting requirements of their own. On pages 40 to 53 of this report we have reproduced the narrative reports of the principal executives of both companies, in which they describe 1980 operations. We recommend a careful reading, and suggest that you particularly note the superb job done by Louie Vincenti and Charlie Munger in repositioning Mutual Savings and Loan. A copy of the full annual report of either company will be mailed to any Berkshire shareholder upon request to Mr. Robert H. Bird for Blue Chip Stamps, 5801 South Eastern Avenue, Los Angeles, California 90040, or to Mrs. Bette Deckard for Wesco Financial Corporation, 315 East Colorado Boulevard, Pasadena, California 91109.

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## Warren Buffett Letter to Berkshire Hathaway stockholders 1979

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As indicated earlier, undistributed earnings in companies we do not control are now fully as important as the reported operating earnings detailed in the preceding table. The distributed portion, of course, finds its way into the table primarily through the net investment income section of Insurance Group earnings.

We show below Berkshire's proportional holdings in those non-controlled businesses for which only distributed earnings (dividends) are included in our own earnings.

No. of Sh.		Company	Cost	Market
			(000s omitted)	
434,550	(a)	Affiliated Publications, Inc.	\$2,821	\$8,800
464,317	(a)	Aluminum Company of America	25,577	27,685
475,217	(b)	Cleveland-Cliffs Iron Company	12,942	15,894
1,983,812	(b)	General Foods, Inc.	62,507	68,045
7,200,000	(a)	GEICO Corporation	47,138	105,300
2,015,000	(a)	Handy & Harman	21,825	58,435
711,180	(a)	Interpublic Group of Companies, Inc.	4,531	22,135
1,211,834	(a)	Kaiser Aluminum & Chemical Corp.	20,629	27,569
282,500	(a)	Media General, Inc.	4,545	8,334
247,039	(b)	National Detroit Corporation	5,930	6,299
881,500	(a)	National Student Marketing	5,128	5,895
391,400	(a)	Ogilvy & Mather International	3,709	9,981
370,088	(a)	Pinkerton's, Inc	12,144	16,489
245,700	(b)	R.J Reynolds Industries	8,702	11,228
1,250,525	(b)	SAFECO Corporation	32,062	45,177
151,104	(b)	The Times Mirror Company	4,447	6,271
1,868,600	(a)	The Washington Post Company	10,628	42,277
667,124	(b)	E W Woolworth Company	13,583	16,511
			\$298,848	\$497,591
		All Other Common Stockholdings	26,313	32,096
		Total Common Stocks	\$325,161	\$529,687

(a) All owned by Berkshire or its insurance subsidiaries.

(b) Blue Chip and/or Wesco own shares of these companies. All numbers represent Berkshire's net interest in the larger gross holdings of the group.

From this table, you can see that our sources of underlying earning power are distributed far differently among industries than would superficially seem the case. For example, our insurance subsidiaries own approximately 3% of Kaiser Aluminum, and 1 1/4% of Alcoa. Our share of the 1980 earnings of those companies amounts to about \$13 million. (If translated dollar for dollar into a combination of eventual market value gain and dividends, this figure would have to be reduced by a significant, but not precisely determinable, amount of tax; perhaps 25% would be a fair assumption.) Thus, we have a much larger economic interest in the aluminum business than in practically any of the operating businesses we control and on which we report in more detail. If we maintain our holdings, our long-term performance

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will be more affected by the future economics of the aluminium industry than it will by direct operating decisions we make concerning most companies over which we exercise managerial control.

### GEICO Corp.

Our largest non-controlled holding is 7.2 million shares of GEICO Corp., equal to about a 33% equity interest. Normally, an interest of this magnitude (over 20%) would qualify as an "investee" holding and would require us to reflect a proportionate share of GEICO's earnings in our own. However, we purchased our GEICO stock pursuant to special orders of the District of Columbia and New York Insurance Departments, which required that the right to vote the stock be placed with an independent party. Absent the vote, our 33% interest does not qualify for investee treatment. (Pinkerton's is a similar situation.)

Of course, whether or not the undistributed earnings of GEICO are picked up annually in our operating earnings figure has nothing to do with their economic value to us, or to you as owners of Berkshire. The value of these retained earnings will be determined by the skill with which they are put to use by GEICO management.

On this score, we simply couldn't feel better. GEICO represents the best of all investment worlds - the coupling of a very important and very hard to duplicate business advantage with an extraordinary management whose skills in operations are matched by skills in capital allocation.

As you can see, our holdings cost us \$47 million, with about half of this amount invested in 1976 and most of the remainder invested in 1980. At the present dividend rate, our reported earnings from GEICO amount to a little over \$3 million annually. But we estimate our share of its earning power is on the order of \$20 million annually.

Thus, undistributed earnings applicable to this holding alone may amount to 40% of total reported operating earnings of Berkshire.

We should emphasize that we feel as comfortable with GEICO management retaining an estimated \$17 million of earnings applicable to our ownership as we would if that sum were in our own hands. In just the last two years GEICO, through repurchases of its own stock, has reduced the share equivalents it has outstanding from 34.2 million to 21.6 million, dramatically enhancing the interests of shareholders in a business that simply can't be replicated. The owners could not have been better served.

We have written in past reports about the disappointments that usually result from purchase and operation of "turnaround" businesses. Literally hundreds of turnaround possibilities in dozens of industries have been described to us over the years and, either as participants or as observers, we have tracked performance against expectations. Our conclusion is that, with few exceptions, when a management with a reputation for brilliance tackles a business with a reputation for poor fundamental economics, it is the reputation of the business that remains intact.

GEICO may appear to be an exception, having been turned around from the very edge of bankruptcy in 1976. It certainly is true that managerial brilliance was needed for its resuscitation, and that Jack Byrne, upon arrival in that year, supplied that ingredient in abundance.

But it also is true that the fundamental business advantage that GEICO had enjoyed - an advantage that previously had produced staggering success - was still intact within the company, although submerged in a sea of financial and operating troubles.

GEICO was designed to be the low-cost operation in an enormous marketplace (auto insurance) populated largely by companies whose

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marketing structures restricted adaptation. Run as designed, it could offer unusual value to its customers while earning unusual returns for itself. For decades it had been run in just this manner. Its troubles in the mid-70s were not produced by any diminution or disappearance of this essential economic advantage.

GEICO's problems at that time put it in a position analogous to that of American Express in 1964 following the salad oil scandal. Both were one-of-a-kind companies, temporarily reeling from the effects of a fiscal blow that did not destroy their exceptional underlying economics. The GEICO and American Express situations, extraordinary business franchises with a localized excisable cancer (needing, to be sure, a skilled surgeon), should be distinguished from the true "turnaround" situation in which the managers expect - and need - to pull off a corporate Pygmalion.

Whatever the appellation, we are delighted with our GEICO holding which, as noted, cost us \$47 million. To buy a similar \$20 million of earning power in a business with first-class economic characteristics and bright prospects would cost a minimum of \$200 million (much more in some industries) if it had to be accomplished through negotiated purchase of an entire company. A 100% interest of that kind gives the owner the options of leveraging the purchase, changing managements, directing cash flow, and selling the business. It may also provide some excitement around corporate headquarters (less frequently mentioned).

We find it perfectly satisfying that the nature of our insurance business dictates we buy many minority portions of already well-run businesses (at prices far below our share of the total value of the entire business) that do not need management change, re-direction of cash flow, or sale. There aren't many Jack Byrnes in the managerial world, or GEICOs in the business

world. What could be better than buying into a partnership with both of them?

### Insurance Industry Conditions

The insurance industry's underwriting picture continues to unfold about as we anticipated, with the combined ratio (see definition on page 37) rising from 100.6 in 1979 to an estimated 103.5 in 1980. It is virtually certain that this trend will continue and that industry underwriting losses will mount, significantly and progressively, in 1981 and 1982. To understand why, we recommend that you read the excellent analysis of property-casualty competitive dynamics done by Barbara Stewart of Chubb Corp. in an October 1980 paper. (Chubb's annual report consistently presents the most insightful, candid and well-written discussion of industry conditions; you should get on the company's mailing list.) Mrs. Stewart's analysis may not be cheerful, but we think it is very likely to be accurate.

And, unfortunately, a largely unreported but particularly pernicious problem may well prolong and intensify the coming industry agony. It is not only likely to keep many insurers scrambling for business when underwriting losses hit record levels - it is likely to cause them at such a time to redouble their efforts.

This problem arises from the decline in bond prices and the insurance accounting convention that allows companies to carry bonds at amortized cost, regardless of market value. Many insurers own long-term bonds that, at amortized cost, amount to two to three times net worth. If the level is three times, of course, a one-third shrink from cost in bond prices - if it were to be recognized on the books - would wipe out net worth. And shrink they have. Some of the largest and best known property-casualty companies currently find themselves with nominal, or even negative, net worth when bond holdings are valued at market. Of course their bonds could rise in price, thereby partially, or conceivably even fully, restoring the integrity of

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stated net worth. Or they could fall further. (We believe that short-term forecasts of stock or bond prices are useless. The forecasts may tell you a great deal about the forecaster; they tell you nothing about the future.)

It might strike some as strange that an insurance company's survival is threatened when its stock portfolio falls sufficiently in price to reduce net worth significantly, but that an even greater decline in bond prices produces no reaction at all. The industry would respond by pointing out that, no matter what the current price, the bonds will be paid in full at maturity, thereby eventually eliminating any interim price decline. It may take twenty, thirty, or even forty years, this argument says, but, as long as the bonds don't have to be sold, in the end they'll all be worth face value. Of course, if they are sold even if they are replaced with similar bonds offering better relative value - the loss must be booked immediately. And, just as promptly, published net worth must be adjusted downward by the amount of the loss.

Under such circumstances, a great many investment options disappear, perhaps for decades. For example, when large underwriting losses are in prospect, it may make excellent business logic for some insurers to shift from tax-exempt bonds into taxable bonds. Unwillingness to recognize major bond losses may be the sole factor that prevents such a sensible move.

But the full implications flowing from massive unrealized bond losses are far more serious than just the immobilization of investment intellect. For the source of funds to purchase and hold those bonds is a pool of money derived from policyholders and claimants (with changing faces) - money which, in effect, is temporarily on deposit with the insurer. As long as this pool retains its size, no bonds must be sold. If the pool of funds shrinks - which it will if the volume of business declines significantly - assets must be sold to pay off the liabilities. And if those assets consist of bonds with big unrealized

*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 Buffett*

losses, such losses will rapidly become realized, decimating net worth in the process.

Thus, an insurance company with a bond market value shrinkage approaching stated net worth (of which there are now many) and also faced with inadequate rate levels that are sure to deteriorate further has two options. One option for management is to tell the underwriters to keep pricing according to the exposure involved - "be sure to get a dollar of premium for every dollar of expense cost plus expectable loss cost".

The consequences of this directive are predictable: (a) with most business both price sensitive and renewable annually, many policies presently on the books will be lost to competitors in rather short order; (b) as premium volume shrinks significantly, there will be a lagged but corresponding decrease in liabilities (unearned premiums and claims payable); (c) assets (bonds) must be sold to match the decrease in liabilities; and (d) the formerly unrecognized disappearance of net worth will become partially recognized (depending upon the extent of such sales) in the insurer's published financial statements.

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Variations of this depressing sequence involve a smaller penalty to stated net worth. The reaction of some companies at (c) would be to sell either stocks that are already carried at market values or recently purchased bonds involving less severe losses. This ostrich-like behavior - selling the better assets and keeping the biggest losers - while less painful in the short term, is unlikely to be a winner in the long term.

The second option is much simpler: just keep writing business regardless of rate levels and whopping prospective underwriting losses, thereby maintaining the present levels of premiums, assets and liabilities - and then pray for a better day, either for underwriting or for bond prices. There is much criticism in the trade press of "cash flow" underwriting; i.e., writing business regardless of prospective underwriting losses in order to obtain funds to invest at current high interest rates. This second option might properly be termed "asset maintenance" underwriting - the acceptance of terrible business just to keep the assets you now have.

Of course you know which option will be selected. And it also is clear that as long as many large insurers feel compelled to choose that second option, there will be no better day for underwriting. For if much of the industry feels it must maintain premium volume levels regardless of price adequacy, all insurers will have to come close to meeting those prices. Right behind having financial problems yourself, the next worst plight is to have a large group of competitors with financial problems that they can defer by a "sell-at-any-price" policy.

We mentioned earlier that companies that were unwilling - for any of a number of reasons, including public reaction, institutional pride, or protection of stated net worth - to sell bonds at price levels forcing recognition of major losses might find themselves frozen in investment posture for a decade or longer. But, as noted, that's only half of the problem. Companies that

have made extensive commitments to long term bonds may have lost, for a considerable period of time, not only many of their investment options, but many of their underwriting options as well.

Our own position in this respect is satisfactory. We believe our net worth, valuing bonds of all insurers at amortized cost, is the strongest relative to premium volume among all large property-casualty stockholder-owned groups. When bonds are valued at market, our relative strength becomes far more dramatic. (But lest we get too puffed up, we remind ourselves that our asset and liability maturities still are far more mismatched than we would wish and that we, too, lost important sums in bonds because your Chairman was talking when he should have been acting.)

Our abundant capital and investment flexibility will enable us to do whatever we think makes the most sense during the prospective extended period of inadequate pricing. But troubles for the industry mean troubles for us. Our financial strength doesn't remove us from the hostile pricing environment now enveloping the entire property-casualty insurance industry. It just gives us more staying power and more options.

### Insurance Operations

The National Indemnity managers, led by Phil Liesche with the usual able assistance of Roland Miller and Bill Lyons, outdid themselves in 1980. While volume was flat, underwriting margins relative to the industry were at an all-time high. We expect decreased volume from this operation in 1981. But its managers will hear no complaints from corporate headquarters, nor will employment or salaries suffer. We enormously admire the National Indemnity underwriting discipline - embedded from origin by the founder, Jack Ringwalt - and know that this discipline, if suspended, probably could not be fully regained.

John Seward at Home and Auto continues to make good progress in replacing a diminishing number of auto policies with volume from less

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competitive lines, primarily small-premium general liability. Operations are being slowly expanded, both geographically and by product line, as warranted by underwriting results.

The reinsurance business continues to reflect the excesses and problems of the primary writers. Worse yet, it has the potential for magnifying such excesses. Reinsurance is characterized by extreme ease of entry, large premium payments in advance, and much-delayed loss reports and loss payments. Initially, the morning mail brings lots of cash and few claims. This state of affairs can produce a blissful, almost euphoric, feeling akin to that experienced by an innocent upon receipt of his first credit card.

The magnetic lure of such cash-generating characteristics, currently enhanced by the presence of high interest rates, is transforming the reinsurance market into "amateur night." Without a super catastrophe, industry underwriting will be poor in the next few years. If we experience such a catastrophe, there could be a bloodbath with some companies not able to live up to contractual commitments. George Young continues to do a first-class job for us in this business. Results, with investment income included, have been reasonably profitable. We will retain an active reinsurance presence but, for the foreseeable future, we expect no premium growth from this activity.

We continue to have serious problems in the Homestate operation. Floyd Taylor in Kansas has done an outstanding job but our underwriting record elsewhere is considerably below average. Our poorest performer has been Insurance Company of Iowa, at which large losses have been sustained annually since its founding in 1973. Late in the fall we abandoned underwriting in that state, and have merged the company into Cornhusker Casualty. There is potential in the homestate concept, but much work needs to be done in order to realize it.

*Most people get interested in stocks when everyone else is. The time to get interested is when no one else is. You can't buy what is popular and do well.*

*Warren Buffett*

Our Workers Compensation operation suffered a severe loss when Frank DeNardo died last year at 37. Frank instinctively thought like an underwriter. He was a superb technician and a fierce competitor; in short order he had straightened out major problems at the California Workers Compensation Division of National Indemnity. Dan Grossman, who originally brought Frank to us, stepped in immediately after Frank's death to continue that operation, which now utilizes Redwood Fire and Casualty, another Berkshire subsidiary, as the insuring vehicle.

Our major Workers Compensation operation, Cypress Insurance Company, run by Milt Thornton, continues its outstanding record. Year after year Milt, like Phil Liesche, runs an underwriting operation that far outpaces his competition. In the industry he is admired and copied, but not matched.

Overall, we look for a significant decline in insurance volume in 1981 along with a poorer underwriting result. We expect underwriting experience somewhat superior to that of the industry but, of course, so does most of the industry. There will be some disappointments.

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### Textile and Retail Operations

During the past year we have cut back the scope of our textile business. Operations at Waumbec Mills have been terminated, reluctantly but necessarily. Some equipment was transferred to New Bedford but most has been sold, or will be, along with real estate. Your Chairman made a costly mistake in not facing the realities of this situation sooner.

At New Bedford we have reduced the number of looms operated by about one-third, abandoning some high-volume lines in which product differentiation was insignificant. Even assuming everything went right - which it seldom did - these lines could not generate adequate returns related to investment. And, over a full industry cycle, losses were the most likely result.

Our remaining textile operation, still sizable, has been divided into a manufacturing and a sales division, each free to do business independent of the other. Thus, distribution strengths and mill capabilities will not be wedded to each other. We have more than doubled capacity in our most profitable textile segment through a recent purchase of used 130-inch Saurer looms. Current conditions indicate another tough year in textiles, but with substantially less capital employed in the operation.

Ben Rosner's record at Associated Retail Stores continues to amaze us. In a poor retailing year, Associated's earnings continued excellent - and those earnings all were translated into cash. On March 7, 1981 Associated will celebrate its 50th birthday. Ben has run the business (along with Leo Simon, his partner from 1931 to 1966) in each of those fifty years.

Disposition of Illinois National Bank and Trust of Rockford

On December 31, 1980 we completed the exchange of 41,086 shares of Rockford Bancorp Inc. (which owns 97.7% of Illinois National Bank) for a like number of shares of Berkshire Hathaway Inc.

Our method of exchange allowed all Berkshire shareholders to maintain their proportional interest in the Bank (except for me; I was permitted 80% of my proportional share). They were thus guaranteed an ownership position identical to that they would have attained had we followed a more conventional spin off approach. Twenty-four shareholders (of our approximate 1300) chose this proportional exchange option.

We also allowed overexchanges, and thirty-nine additional shareholders accepted this option, thereby increasing their ownership in the Bank and decreasing their proportional ownership in Berkshire. All got the full amount of Bancorp stock they requested, since the total shares desired by these thirty-nine holders was just slightly less than the number left available by the remaining 1200-plus holders of Berkshire who elected not to part with any Berkshire shares at all. As the exchanger of last resort, I took the small balance (3% of Bancorp's stock). These shares, added to shares I received from my basic exchange allotment (80% of normal), gave me a slightly reduced proportional interest in the Bank and a slightly enlarged proportional interest in Berkshire.

Management of the Bank is pleased with the outcome. Bancorp will operate as an inexpensive and uncomplicated holding company owned by 65 shareholders. And all of those shareholders will have become Bancorp owners through a conscious affirmative decision.

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### Financing

In August we sold \$60 million of 12 3/4% notes due August 1, 2005, with a sinking fund to begin in 1991.

The managing underwriters, Donaldson, Lufkin & Jenrette Securities Corporation, represented by Bill Fisher, and Chiles, Heider & Company, Inc., represented by Charlie Heider, did an absolutely first-class job from start to finish of the financing.

Unlike most businesses, Berkshire did not finance because of any specific immediate needs. Rather, we borrowed because we think that, over a period far shorter than the life of the loan, we will have many opportunities to put the money to good use. The most attractive opportunities may present themselves at a time when credit is extremely expensive - or even unavailable. At such a time we want to have plenty of financial firepower.

Our acquisition preferences run toward businesses that generate cash, not those that consume it. As inflation intensifies, more and more companies find that they must spend all funds they generate internally just to maintain their existing physical volume of business. There is a certain mirage-like quality to such operations. However attractive the earnings numbers, we remain leery of businesses that never seem able to convert such pretty numbers into no-strings-attached cash.

Businesses meeting our standards are not easy to find. (Each year we read of hundreds of corporate acquisitions; only a handful would have been of interest to us.) And logical expansion of our present operations is not easy to implement. But we'll continue to utilize both avenues in our attempts to further Berkshire's growth.

Under all circumstances we plan to operate with plenty of liquidity, with debt that is moderate in size and properly structured, and with an abundance of capital strength. Our

*We've long felt that the only value of stock forecasters is to make fortune tellers look good. Even now, Charlie and I continue to believe that short-term market forecasts are poison and should be kept locked up in a safe place, away from children and also from grown-ups who behave in the market like children.*

*Warren Buffett*

return on equity is penalized somewhat by this conservative approach, but it is the only one with which we feel comfortable.

Gene Abegg, founder of our long-owned bank in Rockford, died on July 2, 1980 at the age of 82. As a friend, banker and citizen, he was unsurpassed.

You learn a great deal about a person when you purchase a business from him and he then stays on to run it as an employee rather than as an owner. Before the purchase the seller knows the business intimately, whereas you start from scratch. The seller has dozens of opportunities to mislead the buyer - through omissions, ambiguities, and misdirection. After

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the check has changed hands, subtle (and not so subtle) changes of attitude can occur and implicit understandings can evaporate. As in the courtship-marriage sequence, disappointments are not infrequent.

From the time we first met, Gene shot straight 100% of the time - the only behavior pattern he had within him. At the outset of negotiations, he laid all negative factors face up on the table; on the other hand, for years after the transaction was completed he would tell me periodically of some previously undiscussed items of value that had come with our purchase.

Though he was already 71 years of age when he sold us the Bank, Gene subsequently worked harder for us than he had for himself. He never delayed reporting a problem for a minute, but problems were few with Gene. What else would you expect from a man who, at the time of the bank holiday in 1933, had enough cash on the premises to pay all depositors in full? Gene never forgot he was handling other people's money. Though this fiduciary attitude was always dominant, his superb managerial skills enabled the Bank to regularly achieve the top position nationally in profitability.

Gene was in charge of the Illinois National for close to fifty years - almost one-quarter of the lifetime of our country. George Mead, a wealthy industrialist, brought him in from Chicago to open a new bank after a number of other banks in Rockford had failed. Mr. Mead put up the money and Gene ran the show. His talent for leadership soon put its stamp on virtually every major civic activity in Rockford.

Dozens of Rockford citizens have told me over the years of help Gene extended to them. In some cases this help was financial; in all cases it involved much wisdom, empathy and friendship. He always offered the same to me. Because of our respective ages and positions I was sometimes the junior partner, sometimes the senior. Whichever the relationship, it always was a special one, and I miss it.

Warren E. Buffett  
February 27, 1981  
Chairman of the Board

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