

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 November 2010 edition of Leyland Lines.

Once again – another flat month. Macro concerns surrounding Ireland, Greece and Korea have been offset by some positive indicators from the USA on the employment front, and many strategists are forecasting a positive 2011.

We know it is folly to predict the market, but when we find a plethora of opportunities it normally means the market is cheap, and vice-versa. This time last year we were able to find a few opportunities and therefore thought the market was fairly priced. Please take a look at this interview with CNBC from December 2009.

<http://www.youtube.com/watch?v=1Mpput24OYU>

In this edition of Leyland Lines we have found a fantastic article titled "The markets hate uncertainty" which succinctly discusses some of

the well intentioned but factually incorrect clichés which dominate the news and broker reports at various stages of the market. This article is important in reiterating the importance of looking closely at the business you are purchasing, and ignoring wider market commentary.

We also discuss Bluescope Steel which is now below \$2.00 per share and Fairfax Group which is out of favour – and therefore on our radar.

Warren Buffett's 1967 letter to shareholders is also included in this edition of Leyland Lines. These letters are very educational and highlight that the same issues surrounding investment choices are as relevant now as they were in the 1960's, and thus why the value investment philosophies are as relevant now as they have always been.

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The markets hate uncertainty

If you wandered anywhere near a television in advance of the midterm elections, the Federal Open Market Committee meeting or October's employment report, that cliché was unavoidable. It was the pundits' preferred proverb.

Wall Street has a sweet tooth for such investing maxims. They infect the trading community like influenza in December. Repeat mindless dictums ad nauseum, and they soon become the accepted wisdom.

The problem with these supposed truisms is they are no more accurate than the flip of a coin. A closer look at this uncertainty meme reveals it to be a false-ism – one of those emotionally appealing phrases that ping around trading desks. The lack of evidence supporting their premise seems to matter very little.

To recognize how meaningless these statements are, consider the opposite: Could markets function without uncertainty? It takes only a little thought to realize that markets actually thrive on doubt, imperfect information and a lack of consensus.

Uncertainty drives the market's price-discovery mechanism. Investing requires there to be differences of opinion. When there is broad agreement as to an asset's fair value, trading volume falls. Without any uncertainty, who would take the opposite side of your trade?

History teaches that whenever the opposite occurs – when certainty overwhelms uncertainty – the herd tends to be wrong. In rare instances, when there is a near-total lack of uncertainty in the market, the outcome is usually a spectacular disaster.

When Certainty Rules

Recall the dot-com era, when everyone knew that profits no longer mattered. Uncertainty seemed to be banished. An epic crash followed.

After the Internet implosion, the opposite extreme was operational: Profitable, debt-free tech companies were being traded for less than

book value. In a few rare instances, they were being sold for less than cash on hand. Investors had become certain that a dollar was worth only 75 cents.

There was little uncertainty heading into the March 2009 stock-market lows. Almost everyone was sure the world was falling into the abyss. In that massive and indiscriminate selling, it seemed almost certain that no one was ever going to buy another house or car, or send their kids to school, or for that matter, clothe or feed them. How did the consensus work out in that instance?

No Reward

When we discuss uncertainty, what we are really discussing is risk. All unknown outcomes contain risk, and therein lies the possibility of loss. Risk is inherent in the concept of uncertainty. However, anyone looking for performance must embrace risk, for without it, there can be no reward.

Uncertainty is what makes alpha, or market-beating gains, possible. Smart traders know that uncertainty is where the money is. No uncertainty, no risk; no risk, no possibility of outperformance.

Since July, when the Era of Uncertainty began, the Morgan Stanley Cyclical Index – those businesses most closely tied to this uncertain economy – is up 26 percent.

Want some certainty? Go buy yourself Treasuries. You can pick up a very lovely two-year bond yielding 0.41 percent. (Good luck charging two and 20 on that!)

Track Record

The future, by definition, is unknowable. Investing involves making our best guesses about the value of an asset at some point after this moment in time. There will always be an element of uncertainty involved. We can discount various outcomes, engage in probabilistic analysis, but no one knows for certain what tomorrow will bring.

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The markets hate uncertainty cont'd

Those who claim to know fail to understand the most basic workings of markets. We need only consider the track record of Wall Street's prognosticators to know the truth in this statement. As much as the future is uncertain, the most likely outcomes are well understood.

As an example, consider the uncertainty of tax rates. The 2001 and 2003 Bush tax cuts will either be eliminated, or they won't. Marginal rates will go up by three or four percentage points, or not; capital gains rates might revert to 20 percent from 15 percent, or not.

The impact on the economy isn't all that difficult to discern, even for Wall Street economists. Thus,

uncertainty is far less uncertain than you might have been led to believe if you paid any attention to the chattering classes. Even the tax on dividends – which might rise from 15 percent at present to a 39.6 percent rate in the worst-case scenario – is less uncertain than it looks. Many dividend-paying stocks are held in tax-free or tax-deferred accounts, or are owned by non-taxable pension plans, foundations and trusts. This mutes the impact of even this uncertain tax change.

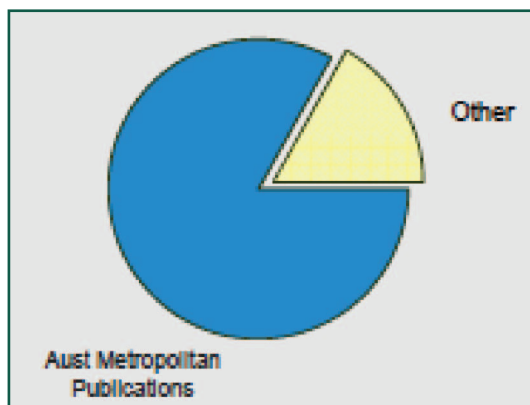
Pundits may hate uncertainty – it tends to make them look foolish – but markets harbor no such bias. In fact, markets thrive on uncertainty. It is their reason for being.

Fairfax Media Limited (FXJ)

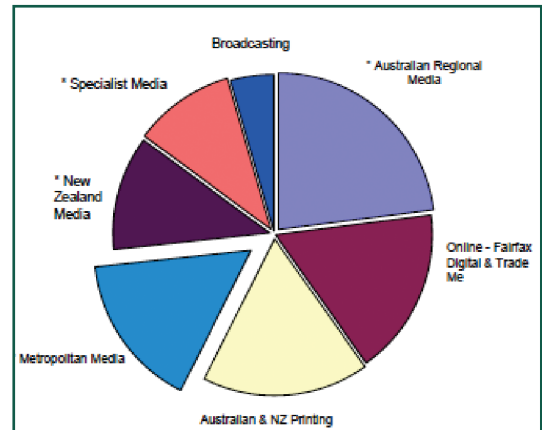
Fairfax is a diversified media company, with its main publications being The Sydney Morning Herald, The Age and The Australian Financial Review.

Central to the strategy of FXJ is to improve the range of distribution platforms. The company has achieved diversification across a number of revenue streams.

2000 EBITDA



2010 EBITDA



Online media makes up 12% of revenue and 17% of EBITDA. Key to the success of FXJ is a sustained improvement in advertising conditions, whilst further deterioration is a clear risk.

Fairfax aims to drive revenue growth and reduce the cyclical nature of earnings through improved digital earnings, reduced capital expenditure and focusing on subscription revenue models. Further non-core asset sales could add further shareholder value.

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Fairfax Media Limited (FXJ) cont'd

Print	Web	Mobile	Tablet
 <p>Total daily readership SMH/Age:</p> <ul style="list-style-type: none"> • 1,389,000 (M-F) • 1,864,000 (Sat) 	 <p>Total UA's for the four news sites:</p> <ul style="list-style-type: none"> • 5,546,000 (monthly) 	 <p>Total UB's for the four mobile sites:</p> <ul style="list-style-type: none"> • 104,000 (daily) 	 <p>SMH downloads = 16,000</p>

The company enjoys one of the strongest positions in digital media of any newspaper globally. The digital media assets have outperformed traditional media businesses during the downturn, and should also participate in any cyclical upturn.

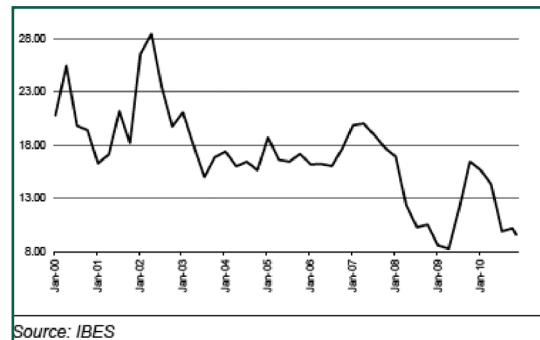
FXJ returned to positive EPS in 2H F2010, which can be expected to continue into 2011 and beyond.

Valuation

FXJ is a 'value' media stock trading on an undemanding forward PE of 9x, a discount to the 14.7x for the broader media sector. It appears that the market is not ascribing value to the fact that FXJ has a significant and profitable digital media business.

The recent Investor Update highlighted that the New Zealand based online auction and classified business, 'Trade Me' is one of FXJ's most valuable assets, with a stand alone valuation of ~\$0.56 per share. This being the case, the remainder of FXJ is trading on a PE of 7x.

FXJ PE Chart



FXJ \$1.34	2009 A	2010 A	2011 E	2012 E	2013 E
EPS (cps)	11.83	11.63	13.88	15.20	16.15
PE (x)	11.33	11.53	9.66	8.82	8.30
DPS (cps)	2.00	2.50	4.65	8.75	10.68
Yield (%)	1.49%	1.87%	3.47%	6.53%	7.97%
Franking (%)	75%	56%	75%	75%	75%

The dividend in 2010 was 2.5 cents due to a low pay-out ratio of 25%, equating to a yield of only 1.8%. The company has the objective of increasing the pay-out ratio in the medium term.

Other Key Numbers

Debt/Equity	: 28%
Return on Equity	: 5.3%
Price/Book Value	: 0.7

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Fairfax Media Limited (FXJ) cont'd

Online Pay-Walls

The Australian Financial Review has been successful in erecting an expensive 'pay wall' for access to online content. This has driven users to subscribe to both the print and online content.

Evidence from overseas suggests that online pay-walls simply result in a reduction of users, rather than a shift in subscriber numbers. However, News Limited has announced that they will implement pay-walls in 2011 leaving readers with little option should Fairfax do the same.

Online and outdoor advertising continues to deliver above market growth, TV and radio remains in line, whilst printed media is lagging.

Fairfax may pursue a large-scale migration of metro publications onto iPad and e-reader

formats at the expense of print. This strategy is untested, and as such is high risk. However, technology is progressing and Fairfax is cognisant of the fact that people are changing the way they access information.

Risks

Whilst FXJ shares appear to be cheap, the new initiatives represent both structural and operational risks.

- Decline in the economic and advertising cycles
- Earnings pressure from migration of advertising to online
- Competition and margin pressure
- Fall in readership and/or circulation

BlueScope Steel (BSL)

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

On the 11th of November 2010 the company held its Annual General Meeting (AGM) and advised the market that due to tough trading conditions, they would likely report a breakeven Net Profit After Tax for the first half financial year 2011. This would be before any potential write downs in

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BlueScope Steel (BSL) cont'd

inventory which may lead to a small loss. The company identified four key drivers that were continuing to impact earnings namely:

- 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.)
- The Australian dollar (A\$) has appreciated by approximately 20% since July 1, which reduces both export prices in A\$, and reduces earnings from offshore operations when translated into A\$.
- There has recently been a softening in Australian domestic demand, particularly in the industrial market segment.

On a regional basis, BlueScope expects another solid performance from its Asian business. The company remains on track to open its second metallic coating line in the second quarter of 2011. In the US, growth remains weak and as previously mentioned, the Australian business continues to suffer from compressed margins.

Operationally, the company is focusing efforts on reducing costs and maintaining a strong balance sheet. According to management, cumulative permanent cost reductions of \$340 million have been achieved since 2008.



Outlook

The flat guidance provided by the company at the AGM was largely anticipated. Indeed the general view was one of relief that BlueScope looks to be able to break even in the face of the significant challenges they have faced this year. Global economic growth will be key to drive global steel capacity utilisation which will enable the industry and BlueScope to pass on the raw material price increases to customers and earn an appropriate return on capital.

The main risks to earnings include continuing \$A strength, high iron ore prices and the fact that the company is leveraged to key cyclical industrial sectors, including construction (dwellings, non-dwellings, infrastructure) and automotive/ transport.

Conversely, to the upside BlueScope have a strong balance sheet and generally strong cashflows. Gearing levels reduced to 12% during 1st half 2010 as a result of a massive capital raising and debt repayment in 2010. The previously mentioned cumulative total permanent cost savings, in excess of A\$340 million, should provide somewhat of a buffer against the impact of raw material price pressures and increase cyclical recovery leverage.

The market appears to be focusing on short-term problems which does create a buying opportunity. Given the historic earnings (which are known to be volatile), sound management, strong balance sheet and possibly oversold share price, BlueScope looks attractive for growth investors with a medium –term time frame.

BSL \$1.915	2009 A	2010 A	2011 E	2012 E	2013 E
EPS (cps)	6.20	6.41	7.47	18.98	27.10
PE (x)	30.88	29.89	25.65	10.09	7.07
DPS (cps)	5.00	5.00	4.29	10.54	16.80
Yield (%)	2.61%	2.61%	2.24%	5.50%	8.77%
Franking (%)	100%	100%	100%	100%	100%

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Warren Buffett – January 25th 1967 Letter to Partners

The First Decade

The Partnership had its tenth anniversary during 1966. The celebration was appropriate - an all-time record (both past and future) was established for our performance margin relative to the Dow. Our advantage was 36 points which resulted from a plus 20.4% for the Partnership and a minus 15.6% for the Dow.

This pleasant but non-repeatable experience was partially due to a lacklustre performance by the Dow. Virtually all investment managers outperformed it during the year. The Dow is weighted by the dollar price of the thirty stocks involved. Several of the highest priced components, which thereby carry disproportionate weight (duPont, General Motors), were particularly poor performers in 1966. This, coupled with the general aversion to conventional blue chips, caused the Dow to suffer relative to general investment experience, particularly during the last quarter.

The following summarizes the year-by-year performance of the Dow, the performance of the Partnership before allocation (one quarter of the excess over 6%) to the general partner, and the results for limited partners:

Year	Overall Results From Dow (1)	Partnership Results (2)	Limited Partners' Results (3)
1957	- 8.4%	+10.4%	+ 9.3%
1958	+38.5	+40.9	+32.2
1959	+20.0	+25.9	+20.9
1960	- 6.2	+22.8	+18.6
1961	+22.4	+45.9	+35.9
1962	- 7.6	+13.9	+11.9
1963	+20.6	+38.7	+30.5
1964	+18.7	+27.8	+22.3
1965	+14.2	+47.2	+36.9
1966	-15.6	+20.4	+16.8

(See next page for footnotes to table.)

- (1) Based on yearly changes in the value of the Dow plus dividends that would have been received through ownership of the Dow during that year. The table includes all complete years of partnership activity.
- (2) For 1957-61 consists of combined results of all predecessor limited partnerships operating throughout the entire year after all expenses, but before distributions to partners or allocations to the general partner.
- (3) For 1957-61 computed on the basis of the preceding column of partnership results allowing for allocation to the general partner based upon the present partnership agreement, but before monthly withdrawals by limited partners.

On a cumulative or compounded basis, the results are:

Year	Overall Results From Dow (1)	Partnership Results (2)	Limited Partners' Results (3)
1957	- 8.4%	+10.4%	+ 9.3%
1957-8	+26.9	+55.6	+44.5
1957-9	+52.3	+95.9	+74.7
1957-60	+42.9	+140.6	+107.2
1957-61	+74.9	+251.0	+181.6
1957-62	+61.6	+299.8	+215.1
1957-63	+94.9	+454.5	+311.2
1957-64	+131.3	+608.7	+402.9
1957-65	+164.1	+943.2	+588.5
1957-66	+122.9	+1156.0	+704.2
Annual Compounded Rate	8.3	28.8	23.2

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Warren Buffett – January 25th 1967 Letter to Partners cont'd

Investment Companies

On the following page is the usual tabulation showing the results of the two largest open-end investment companies (mutual funds) that follow a policy of being, typically, 95-100% invested in common stocks, and the two largest diversified closed-end investment companies.

Year	Mass. Inv. Trust (1)	Investors Stock (1)	Lehman (2)	Tri-Cont. (2)	Dow	Limited Partners
1957	- 11.4%	- 12.4%	- 11.4%	- 2.4%	- 8.4 %	+9.3%
1958	+42.7	+47.5	+40.8	+33.2	+38.5	+32.2
1959	+9.0	+10.3	+8.1	+8.4	+20.0	+20.9
1960	- 1.0	- 0.6	+2.5	+2.8	- 6.2	+18.6
1961	+25.6	+24.9	+23.6	+22.5	+22.4	+35.9
1962	- 9.8	- 13.4	- 14.4	- 10.0	- 7.6	+11.9
1963	+20.0	+16.5	+23.7	+18.7	+20.6	+30.5
1964	+15.9	+14.3	+14.0	+13.6	+18.7	+22.3
1965	+10.2	+9.3	+19.0	+11.1	+14.2	+36.9
1966	-7.7	-10.0	-2.6	-6.9	-15.6	+16.8
Cumulative Results	+118.6	+101.6	+138.9	+122.8	+122.9	+704.2
Annual Compounded Rate	8.1	7.3	9.1	8.3	8.3	23.2

(1) Computed from changes in asset value plus any distributions to holders of record during year.

(2) From 1966 Moody's Bank & Finance Manual for 1957-1965. Estimated for 1966.

These investment company performance figures have been regularly reported here to show that the Dow is no patsy as an investment standard. It should again be emphasized that the companies were not selected on the basis of comparability to Buffett Partnership, Ltd. There are important differences including: (1) investment companies operate under both internally and externally imposed restrictions on their investment actions that are not applicable to us; (2) investment companies diversify far more than we do and, in all probability, thereby have less chance for a really bad performance relative to the Dow in a single year; and (3) their managers have considerably less incentive for abnormal performance and greater incentive for conventionality.

However, the records above do reveal what well-regarded, highly paid, full-time professional investment managers have been able to accomplish while working with common stocks. These managers have been favourites of American investors (more than 600,000) making free choices among many alternatives in the investment management field. It is probable that their results are typical of the overwhelming majority of professional investment managers.

It is not true, however, that these are the best records achieved in the investment field. A few mutual funds and some private investment operations have compiled records vastly superior to the Dow and, in some cases, substantially superior to Buffett Partnership, Ltd. Their investment techniques are usually very dissimilar to ours and not within my capabilities. However,

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Warren Buffett – January 25th 1967 Letter to Partners cont'd

they are generally managed by very bright, motivated people and it is only fair that I mention the existence of such superior results in this general discussion of the record of professional investment management.

Trends in Our Business

A keen mind working diligently at interpreting the figures on page one could come to a lot of wrong conclusions.

The results of the first ten years have absolutely no chance of being duplicated or even remotely approximated during the next decade. They may well be achieved by some hungry twenty-five year old working with \$105,100 initial partnership capital and operating during a ten year business and market environment which is frequently conducive to successful implementation of his investment philosophy.

They will not be achieved by a better fed thirty-six year old working with our \$54,065,345 current partnership capital who presently finds perhaps one-fifth to one-tenth as many really good ideas as previously to implement his investment philosophy.

Buffett Associates, Ltd. (predecessor to Buffett Partnership, Ltd.) was founded on the west banks of the Missouri, May 5, 1956 by a hardy little band consisting of four family members, three close friends and \$105,100. (I tried to find some brilliant flash of insight regarding our future or present conditions from my first page and a half annual letter of January, 1957 to insert as a quote here. However, someone evidently doctored my file copy so as to remove the perceptive remarks I must have made.)

At that time, and for some years subsequently, there were substantial numbers of securities selling at well below the "value to a private owner" criterion we utilized for selection of general market investments. We also experienced a flow of "workout" opportunities where the percentages were very much to our liking. The problem was always which, not what.

Accordingly, we were able to own fifteen to twenty-five issues and be enthusiastic about the probabilities inherent in all holdings.

In the last few years this situation has changed dramatically. We now find very few securities that are understandable to me, available in decent size, and which offer the expectation of investment performance meeting our yardstick of ten percentage points per annum superior to the Dow. In the last three years we have come up with only two or three new ideas a year that have had such an expectancy of superior performance. Fortunately, in some cases, we have made the most of them. However, in earlier years, a lesser effort produced literally dozens of comparable opportunities. It is difficult to be objective about the causes for such diminution of one's own productivity. Three factors that seem apparent are: (1) a somewhat changed market environment; (2) our increased size; and (3) substantially more competition.

It is obvious that a business based upon only a trickle of fine ideas has poorer prospects than one based upon a steady flow of such ideas. To date the trickle has provided as much financial nourishment as the flow. This is true because there is only so much one can digest (million dollar ideas are of no great benefit to thousand dollar bank accounts - this was impressed on me in my early days) and because a limited number of ideas causes one to utilize those available more intensively. The latter factor has definitely been operative with us in recent years. However, a trickle has considerably more chance of drying up completely than a flow.

These conditions will not cause me to attempt investment decisions outside my sphere of understanding (I don't go for the "if you can't lick 'em, join 'em" philosophy - my own leaning is toward "If you can't join 'em, lick 'em"). We will not go into businesses where technology which is way over my head is crucial to the investment decision. I know about as much about semi-conductors or integrated circuits as I do

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Warren Buffett – January 25th 1967 Letter to Partners cont'd

of the mating habits of the chrzaszcz. (That's a Polish May bug, students - if you have trouble pronouncing it, rhyme it with thrzaszcz.)

Furthermore, we will not follow the frequently prevalent approach of investing in securities where an attempt to anticipate market action overrides business valuations. Such so-called "fashion" investing has frequently produced very substantial and quick profits in recent years (and currently as I write this in January). It represents an investment technique whose soundness I can neither affirm nor deny. It does not completely satisfy my intellect (or perhaps my prejudices), and most definitely does not fit my temperament. I will not invest my own money based upon such an approach; hence, I will most certainly not do so with your money.

Finally, we will not seek out activity in investment operations, even if offering splendid profit expectations, where major human problems appear to have a substantial chance of developing.

What I do promise you, as partners, is that I will work hard to maintain the trickle of ideas and try to get the most out of it that is possible - but if it should dry up completely, you will be informed honestly and promptly so that we may all take alternative action.

I call investing the greatest business in the world because you never have to swing. You stand at the plate, the pitcher throws you General Motors at 47! U.S. Steel at 39! and nobody calls a strike on you. There's no penalty except opportunity lost. All day you wait for the pitch you like; then when the fielders are asleep, you step up and hit it. - W.E. Buffett

Analysis of 1966 Results

All four main categories of our investment operation worked out well in 1966. Specifically, we had a total overall gain of \$8,906,701 derived as follows:

Category	Average Investment	Overall Gain
Controls	\$17,259,341	\$1,566,302
Generals – Private Owner	1,359,340	1,004,362
Generals – Relatively Undervalued	21,847,045	5,124,254
Workouts	7,666,314	1,714,181
Miscellaneous, including U.S. Treasury Bills	1,332,609	(18,422)
Total Income		\$9,390,677
Less: General Expense		483,976
Overall Gain		8,906,701

A few caveats are necessary before we get on with the main discussion:

1. An explanation of the various categories listed above was made in the January 18, 1965 letter. If your memory needs refreshing and your favourite newsstand does not have the pocketbook edition, we'll be glad to give you a copy.
2. The classifications are not iron-clad. Nothing is changed retroactively but the initial decision as to category is sometimes arbitrary.
3. Percentage returns calculated on the average investment base by category would be understated relative to partnership percentage returns which are calculated on a beginning investment base. In the above figures, a security purchased by us at 100 on January 1 which appreciated at an even rate to 150 on December 31 would have

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an average investment of 125 producing a 40% result contrasted to a 50% result by the customary approach. In other words, the above figures use a monthly average of market values in calculating the average investment.

4. All results are based on a 100% ownership, non-leverage, basis. Interest and other general expenses are deducted from total performance and not segregated by category. Expenses directly related to specific investment operations, such as dividends paid on short stock, are deducted by category. When securities are borrowed directly and sold short, the net investment (longs minus shorts) is shown for the applicable average investment category.
5. The above table has only limited use. The results applicable to each category are dominated by one or two investments. They do not represent a collection of great quantities of stable data (mortality rates of all American males or something of the sort) from which conclusions can be drawn and projections made. Instead, they represent infrequent, non-homogeneous phenomena leading to very tentative suggestions regarding various courses of action and are so used by us.
6. Finally, these calculations are not made with the same loving care we apply to counting the money and are subject to possible clerical or mathematical error since they are not entirely self-checking.

Controls

There were three main sources of gain during 1966 in respect to controlled companies. These arose through: (1) retained business earnings applicable to our holdings in 1966; (2) open market purchases of additional stock below our controlling interest valuation and; (3) unrealized appreciation in marketable securities held by the

controlled companies. The total of all positive items came to \$2,600,838 in 1966.

However, due to factors mentioned in my November 1, 1966 letter, specific industry conditions, and other relevant valuation items, this gain was reduced by \$1,034,780 in arriving at our fair valuation applicable to controlling interests as of December 31, 1966. Thus the overall gain in the control category was reduced to \$1,566,058 for the year.

We were undoubtedly fortunate that we had a relatively high percentage of net assets invested in businesses and not stocks during 1966. The same money in general market holdings would probably have produced a loss, perhaps substantial, during the year. This was not planned and if the stock market had advanced substantially during the year, this category would have been an important drag on overall performance. The same situation will prevail during 1967.

Generals - Private Owner

Our performance here falls in the "twenty-one dollars a day, once a month" category. In the middle of 1965 we started purchasing a very attractive widely held security which was selling far below its value to a private owner. Our hope was that over a two or three year period we could get \$10 million or more invested at the favourable prices prevailing. The various businesses that the company operated were understandable and we could check out competitive strengths and weaknesses thoroughly with competitors, distributors, customers, suppliers, ex-employees, etc. Market conditions peculiar to the stock gave us hope that, with patience, we could buy substantial quantities of the stock without disturbing the price.

At yearend 1965 we had invested \$1,956,980 and the market value of our holding was \$2,358,412 so that \$401,432 was contributed to performance during 1965. We would have preferred, of course, to have seen the market

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Warren Buffett – January 25th 1967 Letter to Partners cont'd

below cost since our interest was in additional buying, not in selling. This would have dampened Buffett Partnership, Ltd.'s 1965 performance and perhaps reduced the euphoria experienced by limited partners (psychically, the net result to all partners would have been a standoff since the general partner would have been floating) but would have enhanced long term performance. The fact that the stock had risen somewhat above our cost had already slowed down our buying program and thereby reduced ultimate profit.

An even more dramatic example of the conflict between short term performance and the maximization of long term results occurred in 1966. Another party, previously completely unknown to me, issued a tender offer which foreclosed opportunities for future advantageous buying. I made the decision that the wisest course (it may not have been) for us to follow was to dispose of our holdings and we thus realized a total profit of \$1,269,181 in February, of which \$867,749 was applicable to 1966.

While any gains looked particularly good in the market environment that ultimately developed in 1966, you can be sure I don't delight in going around making molehills out of mountains. The molehill, of course, was reflected in 1966 results. However, we would have been much better off from a long range standpoint if 1966 results had been five percentage points worse and we were continuing to buy substantial quantities of the stock at the depressed prices that might have been expected to prevail in last year's market environment.

If good ideas were a dime a dozen, such a premature ending would not be so unpleasant. There is something to be said, of course, for a business operation where some of the failures produce moderate profits. However, you can see how hard it is to develop replacement ideas by examining our average investment in the Private Owner category - we came up with nothing during the remainder of the year despite lower

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.

stock prices, which should have been conducive to finding such opportunities.

Generals - Relatively Undervalued

Our relative performance in this category was the best we have ever had - due to one holding which was our largest investment at yearend 1965 and also yearend 1966. This investment has substantially out-performed the general market for us during each year (1964, 1965, 1966) that we have held it. While any single year's performance can be quite erratic, we think the probabilities are highly favourable for superior future performance over a three or four year period. The attractiveness and relative certainty of this particular security are what caused me to introduce Ground Rule 7 in November, 1965 to allow individual holdings of up to 40% of our net assets. We spend considerable effort continuously evaluating every facet of the company and constantly testing our hypothesis

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that this security is superior to alternative investment choices. Such constant evaluation and comparison at shifting prices is absolutely essential to our investment operation.

It would be much more pleasant (and indicate a more favourable future) to report that our results in the Generals - Relatively Undervalued category represented fifteen securities in ten industries, practically all of which outperformed the market. We simply don't have that many good ideas. As mentioned above, new ideas are continually measured against present ideas and we will not make shifts if the effect is to downgrade expectable performance. This policy has resulted in limited activity in recent years when we have felt so strongly about the relative merits of our largest holding. Such a condition has meant that realized gains have been a much smaller portion of total performance than in earlier years when the flow of good ideas was more substantial.

The sort of concentration we have in this category is bound to produce wide swings in short term performance - some, most certainly, unpleasant. There have already been some of these applicable to shorter time spans than I use in reporting to partners. This is one reason I think frequent reporting to be foolish and potentially misleading in a long term oriented business such as ours.

Personally, within the limits expressed in last year's letter on diversification, I am willing to trade the pains (forget about the pleasures) of substantial short term variance in exchange for maximization of long term performance. However, I am not willing to incur risk of substantial permanent capital loss in seeking to better long term performance. To be perfectly clear - under our policy of concentration of holdings, partners should be completely prepared for periods of substantial underperformance (far more likely in sharply rising markets) to offset the occasional over-performance such as we have

Diversification is a protection against ignorance. It makes very little sense for those who know what they're doing.

experienced in 1965 and 1966, and as a price we pay for hoped-for good long term performance.

All this talk about the long pull has caused one partner to observe that "even five minutes is a long time if one's head is being held under water." This is the reason, of course, that we use borrowed money very sparingly in our operation. Average bank borrowings during 1966 were well under 10% of average net worth.

One final word about the Generals - Relatively Undervalued category. In this section we also had an experience which helped results in 1966 but hurt our long term prospects. We had just one really important new idea in this category in 1966. Our purchasing started in late spring but had only come to about \$1.6 million (it could be bought steadily but at only a moderate pace) when outside conditions drove the stock price up to a point where it was not relatively attractive. Though our overall gain was \$728,141 on an average holding period of six and a half months in 1966, it would have been much more desirable had the stock done nothing for a long period of time while we accumulated a really substantial position.

Workouts

In last year's letter I forecast reduced importance for workouts. While they were not of the importance of some past years, I was pleasantly surprised by our experience in 1966 during which we kept an average of \$7,666,314 employed in this category. Furthermore, we tend to ascribe borrowings to the workout section so that our net equity capital employed was really something under this figure and our return was somewhat

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better than the 22.4% indicated on page six. Here, too, we ran into substantial variation. At June 30, our overall profit on this category was \$16,112 on an average investment of \$7,870,151, so that we really had a case of an extraordinarily good second half offsetting a poor first half.

In past years, sometimes as much as 30-40% of our net worth has been invested in workouts, but it is highly unlikely that this condition will prevail in the future. Nevertheless, they may continue to produce some decent returns on the moderate amount of capital employed.

Miscellaneous

Operationally, we continue to function well above rated capacity with Bill, John, Elizabeth and Donna all contributing excellent performances. At Buffett Partnership, Ltd. we have never had to divert investment effort to offset organizational shortcomings and this has been an important ingredient in the performance over the years.

Peat, Marwick, Mitchell & Co., aided for the second year by their computer, turned in the usual speedy, efficient and comprehensive job.

We all continue to maintain more than an academic interest in the Partnership. The employees and I, our spouses and children; have a total of over \$10 million invested at January 1, 1967. In the case of my family, our Buffett Partnership, Ltd. investment represents well over 90% of our net worth.

Within the coming two weeks you will receive:

1. A tax letter giving you all BPL information needed for your 1966 federal income tax return. This letter is the only item that counts for tax purposes.
2. An audit from Peat, Marwick, Mitchell & Co. for 1966, setting forth the operations and financial position of BPL, as well as your own capital account.
3. A letter signed by me setting forth the status of your BPL interest on January 1, 1967. This is identical with the figures developed in the audit.

Let me know if anything in this letter or that occurs during the year needs clarifying. My next letter will be about July 15 summarizing the first half of this year.

Cordially,

Warren E. Buffett

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