

Graham & Doddsville

The investment newsletter of Columbia Business School

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“The Belt & Suspenders Guys”

- Tweedy, Browne

Tweedy Browne has a legendary reputation in value investing, uncovering undervalued securities since 1920. The firm provided brokerage services to Ben Graham, Walter Schloss, and Warren Buffett before transitioning to a direct investment management role in the late 1960's. On February 8th, we interviewed the four managing partners of the firm, Thomas Shrager, Bob Wyckoff, William Browne, and John Spears.

G&D: Let's start with some background for each of you, how you came to Tweedy, and how you got interested in value investing.

Thomas Shrager: I went to Columbia undergrad at the school of International Affairs. I worked myself through college – I went to school full-time and worked full-time. After Columbia, I joined Arthur B. Little, where I did valuation for about two years. Subsequent to that, I started working at Bear Stearns where I got the bug in investment banking. I joined in 1987 on Black Monday – my first day! I received encouraging remarks like the world is coming to an end. What I learned as an associate at Bear Stearns was how investment bankers value companies. I think that experience was helpful for me getting a position at Tweedy, because after three years there, I realized I didn't want to be a banker. I wrote a letter to Will – a cold letter; he invited me over and I was offered a job.

Bob Wyckoff: I attended Washington & Lee University and I have a law degree from the University of Florida. I practiced law for a few years before getting into the investment business in 1980. I got my start in the investment business at Bessemer Trust Company, where I was for about five years before I moved on to a couple of other companies. When I first got in this business in 1980, one of the first books I read was Money Masters by John Train. In the book, there was a chapter on Ben Graham and a sub-chapter on Tweedy Browne

where Train referred to Tweedy Browne as the pawn broker of Wall Street – a place where desperate sellers went to get a bid on stocks.

His description of Tweedy sounded very interesting to me. Here was a firm that owned, at least in those days, smaller-capitalization companies. They diversified with under-covered, under-researched issues. I thought that just sounded right; it made sense. A little bit later I read Buffett's article – the Super Investors of Graham and Doddsville – and it was like turning on a light bulb.

One day I tried to refer a client to Tweedy Browne, and unfortunately, Tweedy didn't get the client – they got me. That was in 1991 and I've been here ever since. I had started talking to John, Will, and Chris and I think they thought that I was interested in this approach. As I think with most people who end up joining Tweedy, if we run into people that we think are interesting and would make a good addition to the firm, we don't have to be in the middle of a formal employment search to take them on.

William Browne: I probably have a more checkered path in terms of experience prior to Tweedy Browne. Obviously I had been somewhat marinated in the value investing approach to the world by virtue of who my old man was. One of the places where I worked prior to coming here was for a guy named Jerry Tsai, who was one of the famous go-go fund managers

back in the 60's. He ran the funds up at Fidelity and made a huge name for himself. Afterwards, he went out and started a mutual fund and raised an absolutely staggering sum of \$200 million. He would run from the ticker to the order room and I would run behind him, jotting down the justification for what he was going to do. I used to come over to Tweedy at lunch time, and I insinuated my way in over here and the rest is history. To paraphrase Buffett, “what you need in life is a good idea” and this firm has a good idea.

John Spears: I started investing at a very young age – I think about 11 or 12 years old. I saved up about a \$1000 mowing lawns and selling Christmas cards door-to-door. My grandfather introduced me to the financial pages; he taught me what an eighth was. He was an investor in stocks and I thought this was just an easy way to make money without physical effort. So, I started investing and I hung around brokerage firms. I recall spending a lot of time with the worst performing salesman – he would spend time with me and answer my questions. The first few investments that I made worked out pretty well, even though I didn't know what I was doing. My first investment went up 50%. That was fun, but I had a few losers too.

I started reading Security Analysis and taught myself accounting in high school. I could grasp that it made sense to buy into companies selling below their net cash and you get the business for free. So, I started looking around for stocks at \$5 or less, trading below net-cash and did pretty well. I felt like a rich-kid in high school and really didn't want to finish high school, but my parents insisted on it. I got impatient and bored with it.

I learned that at the Drexel Institute of Technology, you could design your own curriculum; you didn't have to take all the liberal arts courses – you could just specialize. I set out a curriculum for myself to just take accounting and finance courses and took each one that they offered. I also went to some summer school courses at Wharton and at St. Joseph's night school, where I took a course in cost accounting. So, I basically took all the accounting and finance courses offered, primarily at Drexel.

I didn't have to go to Vietnam and I took a job as a trainee at a New York brokerage firm. I stayed at it for nine months and I got a few clients, putting them into closed-end funds, selling at 60 or 70 cents on the dollar and just realized I didn't like selling, I didn't like the ethics of it. Anyway, I quit, but I probably would have been fired if I hadn't.

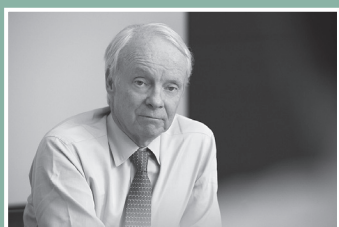
After that, I started up a little investment partnership, where I put in \$3,000 of my own money and other people put in \$30,000. I drove an airport limousine at night to support myself. The fund specialized in Ben Graham type stocks – all below net-cash and way below net current assets. It did pretty well and it led to a job as a junior analyst at a firm called Berger, Kent Associates, run by the late Bill Berger of Berger funds. I worked there for three years and learned about Tweedy Browne from Bill Ruane, who ran Ruane Cunniff, who I had met through my job as a junior analyst.

He asked what I did with my own money and I mentioned this little partnership I was running and he said, “you should really meet those people at Tweedy Browne.” And, I said, I see that name all the time in the pink sheets and the blue book – they own the same stocks that I'm interested in. That led to meeting one of our retired partners Ed Anderson and then I got a job working for Tweedy Browne in 1974 for maybe three years. Then, I got the great, great blessing to become a partner the following year – at the same time that Chris Browne became a partner. It's really been a blessing and a stroke of enormous good luck in my life.

G&D: We'll move to investment approach now. Clearly, Graham & Dodd have been a huge influence, but I'm sure there have been other influences as well – Walter Schloss or Warren Buffett. Can you talk a little bit about your investment philosophy and how you view value investing?

WB: An awful lot of ink has been used in order to find a multitude of ways to expand upon what is a simple idea that when you invest, what you are doing is buying an interest in the business. If you accept that framework and that lens, that will drive everything that you do in terms of analysis or figuring out what the business is worth if you accept the simple concept that the value of the investment is the business and not the price at which the stock is marked at on any given day. It's that concept and that drives everything else you do; you try to analyze a business. There are lots of good things that flow from that.

My personal point of view is that you accept that investing is not a natural science but rather a social science. So, it's never purely empirical; what you are trying to do is everything you possibly can to enhance your probabilities of being right more often than being wrong.



William Browne has been with Tweedy, Browne since 1978. Mr. Browne received a B.A. from Colgate University and an M.B.A. from Trinity College in Dublin, Ireland.

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By focusing on a business, I think that you have a better chance of being right because a business, like many other things in the world, has a value. Graham originally used a statistical approach looking at net-nets or a liquidation framework. Warren Buffett's approach may have a longer look into the future, but you are essentially trying to buy the business and figure out what the business is worth.

You can look, as we do, at comparables and in order to improve your chances of being right, there are lots of different things that different people do. One of which, from our perspective is to avoid highly leveraged businesses because at points of strain in an economy, it's the leverage that takes you down. It all comes from this basic, simple idea: figure out what the business is worth and then see if you can buy into it at a discount. Be diversified – we accept the idea of being diversified, because I think we have a very healthy sense of humility about being able to predict the future. It's not terribly complicated. I think the more difficult part of it is either you accept it or you don't.

G&D: Has your approach changed over time? You referred back to Graham's statistical approach.

WB: We were net-net guys. Going back, that's basically what we did.

JS: In the mid 70's, we had a lot of stocks that were two-thirds or less of current assets, net of all debt. A lot of those were turning up – you didn't have to do much analysis of the business. If the price of inventory for a bunch of electronic vacuum tubes or ladies dresses, plus the cash and the receivables checked out, you didn't even need to make a call to the management.

WB: We had a treasure chest of those things that had been accumulated over time. We would go around and vacuum up all these cheap stocks. Lo and behold, in the mid-to-late 70's a lot of guys, and I won't mention their names, who eventually blossomed into the big leveraged buyout people in the late 70's and 80's start showing up at our door to see if they could go through the files.

JS: We did some consulting with those people.

WB: John started saying, “what are you guys doing?” Tell us how you do it – what's going on here; what's the arithmetic? They sort of laid out the process and how you go about valuing a business as an operating entity and the capital structure of it. What the income stream is and what that can support.

They walked us through their process – everyone knows what it is now; it's basically what private equity guys do – it's very simple.

JS: But, at that time, looking at a business in terms of its whole capital structure, where it's not just simple-minded price/earnings ratio, which is after interest expense. You could have a very, very leveraged company that would be at a low price/earnings ratio. But, if you looked at enterprise value, adding in interest-bearing debt to the value of all the shares – looking at that as a multiple of operating profits after taxes, it would be a very high multiple. So, the LBO people and some of these young tycoons that we were dealing with were very instructive about that.

WB: The other thing we had early on in those years, again I won't mention their names, were some very successful investors implementing this idea of buying a good business using the business valuation approach to it. They were generally partnerships and a couple of them would show up; you would actually be able to sit there and listen to the two of them go back and forth with some of our old partners. They would sit there and debate, asking why would you want to own this piece of junk when this one actually earned something on its capital. It was very interesting to sit there and listen to that discussion.

JS: I remember Chris Browne coming up with Binny & Smith, the crayon producer – Crayolas. I think it was selling at under book value, with almost no debt, and was around 5x earnings. So, it was maybe 20% return on debt-free equity and a very steady earner. We looked at some deal values and it looked cheap, so we bought into that one.

G&D: So has your investment philosophy and investment characteristics evolved over time? Have you gone from the net-net stocks and the net-current assets to focusing more on good quality companies?

WB: I would say no, not entirely. I'd say that it is still some of both. But, today, the bulk of the assets are in good quality, pretty steady earning, and high return on capital businesses that do have a tendency to grow a bit. But, the business has evolved from simply being more of a statistical process in the late 1970's/early 1980's into a somewhat larger view of how you go about looking at things.

TS: It was first that the net-nets disappeared and the second thing, because we learned from a number of people how to



Thomas Shrager has been with Tweedy, Browne since 1989. Previously, he worked in M&A at Bear Stearns and as a consultant at Arthur D. Little. He received a B.A. and Masters in International Affairs from Columbia University.

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value these businesses that trade at a premium to book or net current assets.

WB: And that has resulted in us taking this approach to a global, world-wide model.

TS: But the framework stayed the same. There are two prices to stocks: the one using the stock market and the one you would get in a private market transaction. You still want a 30% discount from that intrinsic valuation.

BW: It’s a mix, and that may be one way that we are a little bit different from some of our competitors. You will still see net-nets in our portfolio when they are available. Today, you can buy them in Japan in small-cap stocks and you will see some of those in our portfolio. You’ll see very high quality businesses like a Novartis, J&J or a Nestle, which are pretty attractive, high quality long-term growers, and then you’ll see some so-so businesses in the portfolio – sometimes it’s a full-blown business appraisal, sort of LBO-type of analysis that they’ve been talking about. Sometimes it’s a net current assets type of analysis.

Sometimes we are buying cyclical companies at a deep discount to book value and letting them go at book. The Tweedy portfolio tends to be a few variations on the value theme, but with a deep value orientation coupled with diversification.

G&D: You were talking earlier about the LBO model and you mentioned learning the tools of an investment banker at Bear Stearns. That is typically a very DCF-type approach, but then a lot of value investors will then say DCF is actually very tricky to actually implement.

TS: We don’t use DCF – there are too many variables.

WB: When you look at the multiples people have paid for businesses, I’m willing to bet that there has been, amongst all the analyses these guys do when they buy a business, there is probably a DCF analysis floating around in there somewhere, which comes and backs its way into these multiples that you are paying for businesses. But, as sort of a handy tool, a handy measure of what people have been paying, you can look at multiples.

JS: If an LBO buyer has a five-year time horizon, they’ll make a guess about the terminal number and multiple that they expect. They will guess that in year five, EBIT or EBITDA will be “x” and they’ll slap some sort of a multiple on it and there is your blast exit cash flow. That’s your discounted cash flow

model and then you’ve got the years in between. However, it’s still human beings doing all this stuff and multiples can change in the business acquisition market.

G&D: I’ve read that you focus on buying companies with good capitalization and balance sheets. Is that an important part of the investment framework?

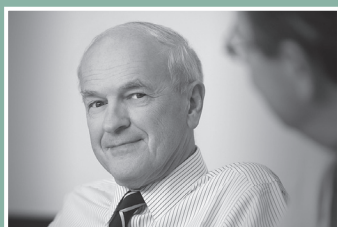
JS: On average, in my view, looking at screens over the years a fair amount, I think that leveraged companies can be on a total enterprise basis, sometimes more expensive, in addition to being riskier. Let’s say you have a debt-free value of \$100 per share, but you have debt of \$50 per share. So, you’ve got a net value of \$50. So, let’s say you buy that at two-thirds of the \$50. That’s roughly \$30, so you’ve got \$20 as your value spread. But, that’s only 20% of \$100 total. So, if you have a leveraged capital structure and you are buying things at a one-third discount after subtracting the debt, your gross margin of safety on the debt-free amount is reduced.

WB: The other thing too is that if you’re in the business and again, predicting the future is always hard, but if your business goes limp so to speak and you are not too hocked up, you’ll get through that period. If you’re all hopped up, particularly if you are a high fixed-cost, low variable-cost sort of business, we all know where the shareholders stack up in terms of the guys with the claim on the company and you’ll end up with the short end of the stick. So, yes, leverage is important to us because that’s what can lead to real problems for you.

TS: Let me clarify something. The fact that we learned from people who are involved in LBO’s, which is part of what we know, doesn’t mean that we like leveraged companies.

JS: That’s a very critical point. The margin of safety idea is very important. You lose 50% on something and you’ve got to go up 100% to recoup it, and we are investing our own money in our portfolios that are combined with our clients and separate stocks that are owned by those portfolios. So, it’s real.

BW: I would just add that when you think of us and the community of value people, I tend to think of us as the belt and suspenders guys in terms of valuation. We tend to value businesses cautiously. Thus, regardless of what we observe being paid, if it seems to be escalating and seems unreasonable, we are going to haircut it. In doing our valuation work, you’ll see the diversification that we use, the avoidance of overleveraged businesses for the most part. You don’t see concentration.



John D. Spears joined Tweedy, Browne in 1974. He previously worked at Berger, Kent Associates, Davic Associates, and Hornblower & Weeks-Hemphill, Noyes & Co. Mr. Spears studied at the Babson Institute of Business Administration, Drexel Institute of Technology, and the University of Pennsylvania—The Wharton School.

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These days, what seems to be more common in the investment world and Buffett speaks of it – is putting your eggs in just a couple of baskets and watching them very closely. More and more value investors are running more and more concentrated portfolios and we are not doing that. So, when you think of us, the culture here is extremely price sensitive, a cautious approach to valuation, coupled with diversification.

JS: I think you can also say sometimes that we maintain skepticism about acquisition valuations. An interesting exercise is to take a deal multiple of EBIT or EBITDA and then convert that to the yield on the total purchase price. Take the operating profit or EBIT and then apply a tax rate to it and get your operating profit after-tax and look at that as the yield on the total purchase price. Then you can say to yourself, in terms of common sense, was this really a great price? Do I want to slap an after-tax 4% yield on everything? Is that sustainable as a multiple?

WB: The ownership arithmetic.

JS: Yes, the ownership arithmetic. So, during the height of easy credit of 2006/2007 when deal multiples were expanding at 20-25% of what they had been typically in prior years, if you did some of that owner’s yield arithmetic, and you knew what was going on with the lending standards and easy money, easy covenants, all that stuff, it makes you a little bit cautious about slapping on these new high deal multiples. You have to look at reality, you have to look at what the market is. If we were selling a business, we would push for the highest price. You need to use common sense.

TS: So, what that results in as a practical method for the vast majority of companies is EBIT multiples between 9x and 11x.

G&D: We’ve talked a lot about valuation, but can we talk more about how you judge the quality of a business and what are the characteristics that you would like to see if you are willing to pay 11x EBIT for, versus 9x EBIT or lower?

TS: It’s really tough to put it into neat boxes. But, what you are trying to do when you are looking at the business is you are trying to understand the competitive advantage. Who are the competitors? Are there any disruptive competitors coming into the market? What is the mix between pricing and volume; do you have volume increases, followed by big price declines – what’s the math there? What’s the history of gross margin and why has it gone up or down? Are these things sustainable over long periods of time?

Then you look at the operating costs and you are trying to understand how efficient the company is in terms of running the business. You are trying to look at fixed to variable costs ratio. In other words, you are trying to find out if a 5% drop in sales would wipe out profitability or whether there is much more flexibility in the cost base. In order to understand all these things, you talk to the company, you talk to analysts, and you sometimes talk to customers and suppliers. So, it’s like putting a puzzle together.

WB: Most of our businesses are differentiated in the mind of the customer and some businesses just aren’t differentiated in the mind of the customer. If you two guys were in here selling copper, from two different companies, all I care about is who can sell me copper at a penny a pound less. It’s that simple. It’s a crummy, crummy business. You try to think about businesses where there may be some characteristics to it that will enable you to compete on some basis, other than you can just bring it to me cheaper than the next guy. Whether there is a concept about it, whether there is a habit that is embedded in the customer; and, of course, whether you could open the newspaper and read that you are out of business essentially because someone has leapfrogged you.

We like to think that we’ve developed a level of sustainability about the business over extended periods of time. By and large, that kind of leads you in one direction, versus the other. On average, you would prefer to be in something other than a raw commodity. But, we’ll buy a raw commodity if you really think it’s cheap enough. On the other hand, we prefer things that you burn, smoke, eat, drink; wear out kinds of businesses.

G&D: Does management make a major impact? Are you closer to Graham, or are you closer to Buffett on management?

BW: Closer to Graham.

TS: We are concerned with whether the reputation of the business will stay intact. However, this is a broad spectrum. We make a point in every single investment we make, to talk to somebody at the company.

BW: And we try to avoid getting into bed with people who we think are going to hurt us in some way. And over the years, we have paid a lot of attention to patterns of insider buying. We like to see CEO’s and CFO’s in particular, buying shares right along with us. Those kinds of things interest us. But, sitting down across the table from a media trained CEO, who



Bob Wyckoff joined Tweedy, Browne in 1991. Prior to joining the firm, he held positions at Bessemer Trust, C.J. Lawrence, J&W Seligman, and Stillrock Management. He received a B.A. from Washington & Lee and a J.D. from the University of Florida School of Law.

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is impeccably dressed and more articulate than we are. Are we going to learn a lot from that?

WB: You are going to learn what you want to.

G&D: How often do you consider the macro or secular picture when you are looking at new investments?

BW: We read and we are aware, but it doesn't play a large role in our analysis. We tend to start at the bottom. We tend to start with price and relationship to value. We start with screenings of securities all over the globe. It's rare that we come up in our heads with some macro theme and decide we are going to go fish in that pond because of some idea we may have of where the world is heading or what this particular innovation might mean for a specific industry.

WB: We certainly don't build a macro thematic framework. One, we don't do that. Two, I suppose at the end of the day, you could probably conclude that we are optimists. We don't think that the world is going to end. I do take a certain level of comfort in the fact that we invest around the world. So, we are not locked into any particular marketplace. Now, I think inevitably you are impacted by the macro world to some extent. Businesses operate in a macro world and they are impacted. Predicting which way it is going to go at any given point in time is very difficult. I think that in sort of an indirect way, we address a lot of that by the nature of the things that we end up investing in.

We tend to be invested in, as we said, businesses that have fairly sustainable demand characteristics and have the wherewithal to get through difficult periods of time. And when they come out the other side of it, businesses that will have prospects that we expected. We are on average right, more often than we are wrong. We understand the nature of the business. While those businesses are, no question about it, impacted to a degree by macro developments, depending on the severity of them, they aren't going to be knocked out of the game by it.

Also, if it's a pretty good business, maybe there are some guys who are knocked out of it and maybe you'll end up with a slightly better edge. Now, volatility is something that always wears a lot of people down. That's one of the reasons you see markets do what they do. But, you can't escape it.

JS: We're in the macroeconomic boat. If there is going to be inflation, we're going to have inflation. If interest rates are going to rise, they're going to rise. If P/E ratios are going to come down because interest rates are going up, we're all in that.

WB: I had a friend a while ago and he was up to his eyeballs in gold and platinum and other precious metals and he was really feeling good – he had made a lot of money. He says, I want to own hard assets. But, the fact of the matter is that when you own a business, it is a fairly hard asset. This is sort of a silly analogy, but I'm going to take you over to corporate headquarters at Diageo and bang your head against the door. I think you'll find that to be pretty hard. It's organic. There are guys waking up every day – they've got assets, they've got capital, they're deploying it, they're making things, they're selling things, they're doing all sorts of things. To me, those are very tangible and hard assets. However, they are not inert assets. To me, that's a much better hard asset than storing away copper bars or oil in a boat, in the straits of Malacca.

JS: You get a yield on it. If someone buys Johnny Walker scotch, we make some money on every drink. People have to buy insurance every year, and we own some businesses in that field. To me, it's great to have things that produce stuff that people really need every day.

WB: There may be a corporate CEO, who wakes up one morning and looks at his wife and bursts into tears and says, “Honey, I just can't take it!” But most guys are going to wake up and say, “I've got a pile of assets. I've got a pile of capital. I've got these assets that are earning capital. I have to think about what I am going to do with them to stay ahead of the game.” So, it's real; it's organic.

BW: As Will likes to say – business adapts much more quickly than governments to problems that are out in the marketplace. He also made another good statement that I think is important, that we are generally optimists. I think that the key to being successful as a value investor is this willingness to accept the near-term randomness that goes on in our markets. And to be able to emotionally deal with that and accept that that is something that goes along with investing. If you are willing to do that and able to do that and accept that kind of volatility, then the spreads that we can make and the kind of investing that we can do are much, much larger than the spreads these quants are trying to make in the short run, where they have to use a whole lot of leverage for it to make sense.

Ultimately, what we are doing, I think is a lot safer and we sleep a lot better at night, knowing that our whole business is not built upon a foundation of leverage. But emotionally, and I think this has been happening over the last 10-15 years, emotionally people are drawn to what they think they can control and that's typically something in the short run. Something they think they can see an immediate result from.

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WB: But one of the things that gives us an edge is that when we come into the office in the morning, we know what we are going to do. We've got a framework. A lot of these books about how we are wired as creatures are very interesting to read. And people are not well wired for investing in many respects – we suffer from anchoring on recent news, confirmation bias, etc. and these all work against you in stress periods.

It's very important to have an anchor. You've got a shot at being objective as opposed to being tossed into the panic pot. Then it's all up for grabs – that's when you are really going to get it wrong. Whatever it is, you've got to get a process where you can anchor your thinking because all of this external stuff grinds away at your objectivity – every single day in down markets. Up markets, you all just walk around thinking you are smart. But from our point of view, you've got to have the objectivity too, because sometimes valuations just get foolish and you've got to be willing to walk away.

G&D: You mentioned time horizon and how that was critically important and how it sets you apart from other investors. What is your time horizon?

BW: I don't think we would put a number on it, but typically we own stocks for three to five years or longer. Sometimes stocks get taken away from us in takeovers. If it's a compounder, one of these better businesses we've talked about where the intrinsic value is compounding over time, we can own it indefinitely. We've owned Novartis, in one form or another, for 20-25 years. We've owned J&J for a very, very long period of time. Because these businesses are compounding their intrinsic value, right along with their stock price over time. But, if it's a cyclical business like we've talked about, we are typically buying it at a big discount to book and then trading it out at book. If it's a net-current assets stock, we're buying it at a discount to net-current and trading it out at net-current. But, I'd say if you made a general statement about turnover in our portfolio, its averaged over time about 20% or less.

WB: There is an anomaly with average mutual fund turnover. The highest turnover is typically found in the growth fund category, which you would think, just as you go through it logically would be lower because those companies are growing and wouldn't need to be traded out of.

BW: You're confusing growth with momentum!

WB: No, they don't say anything about that! The ideal stock, if you are in the unenviable position of being a taxpayer, is that you buy a stock and own it forever. Now, I'll put words in John's mouth – John's time-horizon is his funeral – Buffett's is eternity. But we don't have a time horizon. That goes back to

something I always found interesting. The problem with a lot of people – individual investors and I've seen it with nieces and nephews and cousins – is that they'll own four or five stocks and they'll have a stock that sits around there and it doesn't do anything for a year-and-a-half and then they'll sell it. I'll ask why, and they'll say because it hasn't done anything!

My friends are making money in all these other stocks. Regardless of what the considerations were for going in and that they haven't changed, this emotional dimension comes back in. I think one of the nice things about being diversified is that we own enough stocks – we have about 67% of the portfolio in 25 names and it sort of trails off from there. You've got enough stocks with stuff going on that you don't have to obsess over the ones where nothing is going on as long as you think the rationale for being there hasn't changed. But, with individuals, it's very amusing – “Oh, I'm sick of that stock. I want to get out of it and I'm going to get out of it right away as soon as it gets up to what I paid for it.”

JS: When you have a lot of holdings in your portfolio, you can compare things to what you already own and be reminded of the integrity of the story and why you went into something. Or when you are considering something new, you can go through and say which ones you like. You can say you like this coke bottler at 9x earnings. It's debt-free, it's in Mexico, and they've got 85% of the market, and they have a great delivery system going to all of the bodegas, which is hard to compete with. You compare that to some cell phone company in a lesser developed country where prices go down at a rapid rate. You've got political instability and funny insider trading. Which one seems simpler? What grabs you more? You can do those sorts of comparative judgment exercises.

BW: I would make just one point, though. A lot of people think that if you diversify, you are the market. So, how do you add value? If you look at our portfolios – despite the fact that we may own 50 or 60 stocks and sometimes even more depending upon where value is showing up, the portfolios tend to not look anything like the market index. Its multi-cap, and the weightings and industries are vastly different. So just because you are diversified by issue doesn't mean that you have a portfolio that looks like the market. And you can't simply assume that because you own a lot of stocks, you can't do well. The S&P 500 over long periods of time has beaten 80-85% of professional money managers. Probably the greatest mutual fund investor we've known or heard of over the years is Peter Lynch of the Magellan Fund and he had 1,000 or 1,500 stocks in his fund. So, don't confuse diversification by issue with a portfolio that looks like a market.

“Emotionally, people are drawn to what they think they can control and that's typically something in the short run. Something they think they can see an immediate result from.”

G&D: We would like to talk a little bit about your portfolio. One of the things we noticed was that you have a lot of capital invested in Consumer Products companies. Maybe you could talk about one of the names you own or about the industry in general and how that fits the framework that you all find attractive?

TS: I think it is much more important when you look at consumer products companies, is to understand what is attractive. If you are talking about food, beverage, and personal care companies, which represent a big part of our portfolio, where you have to look is how many billion dollar brands they have. Because once a brand becomes big, it gets economies of scale. Your marketing may be less than it would otherwise be. You get economies of distribution. You get a number of advantages.

Second, you would have to look at categories. There are certain categories that grow and ones that don't grow. You want to have your products in those categories that grow faster than the market. These food, beverage, and personal care products grow below GDP in the developed world. For example, if you are in pet care, that grows much faster than GDP. Water, at least until a year ago, grew much faster. And it shows that things can change within the categories. Then, things like ketchup are not growing faster than GDP. So, the categories are very important.

Three, the geography – the more emerging market exposure you have, where you have a rising middle class, the better off you are going to be. Having a strong emerging market exposure is not an easy thing to achieve, because you have to overcome the same issues with distribution, marketing, packaging – all those kind of things that are important to those markets. A very good example is Nestle, which gets more than 30% of its income from developing countries. It has more than 30 billion dollar brands, and it is generally in categories that grow a little bit faster than the market. It has tremendous market share because of those brands in the categories in which it operates.

BW: I might just add that a number of these companies are reasonably priced. They tend to be steadier. Many of them are underleveraged. And I want to emphasize Tom's point that they sell products that these aspiring middle classes that are coming up in emerging markets want to own. Companies like Coca-Cola FEMSA, which is selling coke, water, and beer to people in Latin America. Companies like Philip Morris International that is selling tobacco all over the world. You've got Novartis selling pharmaceuticals; you've got Nestle and Diageo, and if you went right on down the list and looked at the percentage of revenues that are coming from these faster

growing parts of the world, it's surprising. We often like to say that if Nestle wasn't headquartered in Vevey, Switzerland, but was headquartered in Shanghai, it probably would sell at twice the current multiple. But, interestingly enough, it's benefitting significantly from growth in these emerging markets. So, it's often a cheaper and safer way to get the benefit of those markets.

WB: Generically, if you think about it, they tend to have multiple sources of income, multiple products, and they are constantly coming out with iterations of products to maintain their market share. Most of them tend to be big companies, which already have very strong holds on shelf space, which is always a hard thing for a new product to get. You couldn't come out with Shrager ketchup tomorrow and expect to get into A&P or Kroger.

BW: Again, they are products that are typically less discretionary. And, one of the things we do during these tough economic times is have endless discussions about trade-downs, and when people trade down, will they trade back up? Sometimes the companies will come out with various price points to sell. But, I'm telling you that the trade-down/trade-up issue was as vibrant in 1976 as it is today. People do, I think, on average want to buy what is perceived as a symbol of a better product. While nothing is given, on average they seem to have, from our point of view, better probabilities about the future than other types of businesses. As a group, they tend to have better returns on capital. They are reinvesting the capital. They have, albeit in an uneven fashion, businesses that grow. They grow with the world, they grow with the population. They find ways to squeeze costs out. There is just a multiplicity of things that they are tapping on to try and keep the business going.

G&D: One of the things we noticed in the portfolio is that there are a few businesses that are sort of in a secular decline that you own, such as Philip Morris, Reynolds, and Axel Springer. We are curious about those types of businesses and what has led you to some investment there.

TS: The Roman Empire disappeared after the split over 1200 years. It split in 300 AD and then the Byzantine Empire disappeared in 1500 AD, which was a relatively long period of existence before the time of decline. You have to look at it company by company. There is no question in my mind that we held certain media stocks too long. Some of them were too illiquid to get out of. But, I think that we are in relatively good shape with the media companies that we own now.

“Don't confuse diversification by issue with a portfolio that looks like a market.”

I would start with Schibsted in Norway. It's a monopoly situation where there are a couple of television stations, but the most important thing is that more than 50% of operating income coming from the internet. So, they have made a transition. They have a site that is more popular than Google; they have some destination sites, including a financial website that is extremely popular in the Nordic countries. They have been able to achieve that because they started investing in the mid-1990's and because people in the Nordic countries are much more internet savvy than other regions of the world. So, they capitalized on that in order to build a very profitable internet business.

In the case of Axel Springer, its main asset is a national newspaper called *Bild*, which is sort of a tabloid newspaper that gets sold all over Germany with local editions and they don't have any competition for that. So, it's a very unique newspaper where the circulation declines have been very, very moderate for a long period of time. They can reach a larger audience than the most popular TV program that you have in Germany by a factor of three or four. So, advertisers value that. So, it's not the number-four newspaper in a market that is already declining; it's the number-one with nobody else behind it, except some serious national newspapers that people increasingly don't read.

They also have the biggest magazine business and that by itself wouldn't be such a good business, but they are increasing the access of their magazines online. For example, they have the *Auto Bild*, which is the car magazine that they have. They have the *Auto Bild* site, which is the most viewed automotive site. If someone wants to buy a car, they are much more likely to go to their site. They have the second best real estate online site, which they developed from their newspaper pages. So, they have successfully expanded outside of Germany, where they have done very well, unlike other companies. Overall, it's a very special type of situation.

G&D: And, you are compensated in the form of the price?

TS: Yes! You are buying at a big discount; these businesses will generate a lot of cash, they will pay dividends of 5-6% in some of the instances. So, you are getting well compensated. With a dividend of 5%, you need to compound at just another 5% to get double-digit returns.

G&D: It also seems that there are a number of pharmaceutical names in the portfolio and that's certainly a space where there is potential governmental interference. How much does that play into your analysis and what are your thoughts around that?

TS: There has been governmental interference around this industry forever. The question is whether there will be more in the future or not. The election in Massachusetts has made it less likely. That's the only thing I would say. On one hand, when you are investing in the pharmaceutical or health care industry, you have the wind at your back because the population is getting older. For someone who is 85 years old, you are going to spend six-or-seven times more than on someone who is 55 years old. Thus, as the population is aging, the demand for medical services and pharmaceutical products will grow. The question is in what way will the government try to limit cost increases.

This is a very, very complex issue because there are so many vested interests that are trying to protect themselves. With rational reform, pharma companies should see an impact but only a small impact in a purely rational environment. However, doctors groups are very powerful. Nurses unions are very powerful. And a number of different interest groups within this entire system want their little piece of the pie. Union companies want their piece and pharma companies want their slice. How all this plays out is going to be interesting. All I know is that the products of these companies will be needed in the future and you need to have a way in which you still give them an incentive to produce.

BW: I would just add that the death of health care and pharmaceutical companies has been announced many times in the past. Thinking back to when the Clintons proposed health care – that drove down the stock price of the pharmaceutical companies and we got a chance to buy Johnson & Johnson around 1993 or 1994 at about 12x earnings, which was a terrific price. Today, you are being given another opportunity to buy these pharmaceuticals at attractive prices. There are all these patent roll-offs that you have to pay attention to and understand, but one of the characteristics of at least two of the pharmaceuticals that we own is that they have significant consumer products businesses attached with their drug business. That's the case with J&J and that is becoming the case with Novartis. That part of the business is steadier.

TS: But it is a lower margin business – so you are not getting the 30%-40% margin that you are getting with pharmaceuticals.

G&D: Are there any recent investments you would like to talk about or an investment idea that you are thinking about? It would be great to hear your thoughts on the analytical approach you use and comments on the thesis.

BW: We have a dividend fund here. It uses the same valuation approach that we practice, but we have a portfolio that

“People do, I think, on average, want to buy what is perceived as a symbol of a better product.”

couples our valuation work with stocks that pay above average dividends. One of the recent stocks we purchased about three months ago was Exelon, which is the nuclear utility company.

Dave Krasne: It’s the nation’s largest merchant nuclear fleet in the country and nuclear is among the large sources of electricity and the lowest-cost source of power. There was a transaction in December 2008 with EDF purchasing a 50% interest in Constellation’s nuclear assets. This gives a very interesting post energy bubble deal multiple – it was an all-cash deal, knowledgeable buyer, arms-length transaction. They bought 49.99% because the government won’t let any nuclear entity be more than 50% owned by a foreign corporation.

The price paid would imply roughly \$55 per share for Exelon’s nuclear assets. Pile onto that, Exelon’s two regulated utility businesses, which given that they are allowed to earn a regulated rate of return, should be approximately book value. But if you use a 20% haircut to book value, that adds another \$11 per share, which gets you to \$66. It was essentially a more than 20% discount to intrinsic value on what seemed to be a very conservative and reasonable valuation.

BW: For the dividend portfolio, we don’t require as deep of a discount as we do for the traditional portfolio. For the traditional portfolio, we want at least a 30%-40% discount off of our cautious intrinsic value calculation. But, for the dividend portfolio, something that is trading at 15%-20% off its intrinsic value, with a really attractive yield that is growing over time is sufficient. In this case, Exelon is not a traditional deep discount, but then Exelon also has a kicker associated with it.

DK: If there is any type of a carbon regime, because nuclear power does not have any exposure to carbon, it would essentially be all additive and go straight to the bottom line, straight to margins. It would increase the cost to their competitors and because of that, the price to consumers. The price increases, but the costs associated with the new policy wouldn’t increase for Exelon. That would potentially add another \$15 per share of incremental value if there is some type of carbon regime and even if no carbon regime gets implemented by the legislature, the EPA is also pursuing its own path that would also regulate CO₂. Thus, even if Congress cannot get its act together, the EPA can essentially do it itself.

G&D: Are Exelon’s assets similar to the nuclear portfolio that was bought from Constellation in 2008?

DK: You can argue about location. Probably about 40% of their assets are in comparable, desirable locations, and then there is another 60% of their assets that are in Illinois, which don’t have the same market characteristics in terms of power pricing

that they have in the Mid-Atlantic. But, as far as purchasing unencumbered nuclear assets, the value per kwh of assets that you are buying are actually at a discount to what they can spend to uprate the capacity at the plants. So what they spend on maintenance capex, and to some extent growth capex, that increases the capacity of the plant, which is very economic to them at about \$2,500/kwh. The current price of Exelon’s stock – especially now – is at a pretty steep discount to that. The dividend yield is close to 5%. When the market looks at it, they see earnings staying essentially flat for the next several years, so from the market’s standpoint, there is nothing to get excited about. It’s also a utility, which typically has its own investor base.

BW: We typically don’t own a lot of utilities in the dividend portfolio, but this was a special situation.

DK: Power is a commodity business and generally we don’t like commodity businesses. But, it has a structural competitive advantage as the lowest-cost producer of that commodity that no one else can match.

G&D: What does Tweedy think about the current market?

BW: There is no question that the number of opportunities that we see has slowed pretty dramatically over the past several months. We still see opportunity and we are looking at about a half-dozen things right now. But, if you went back a year-or-so ago, there were two-dozen things in the hopper that we were working on. And, there have been significant changes to the portfolio over the last year or year-and-a-half, but not as many over the past several months with the markets doing what they’ve done.

We ended up exiting pretty early in a number of instances in late 2007, early 2008 in a number of financial stocks that we owned, where as Tom likes to say “as the onion was being peeled” and disclosure became clearer. Things became murkier and we let go of almost all the bank stocks. We then took that money and redeployed it and bought some high-quality industrial companies here in the US that we had not had a chance to buy in 20 years – companies like 3M or Emerson Electric. These stocks have come up pretty dramatically, but we were buying these things in 4Q08 and 1Q09. We bought the railroad stocks, such as Burlington Northern, Union Pacific, Norfolk Southern.

For the first time in a long time, we bought oil stocks as oil prices came down – we bought Conoco Phillips, Devon Energy, Total in France. We bought some quality growth companies that we had not been able to buy in the past – companies like Henry Schein, which is the dental distributor and a great company; one of the most recession resistant businesses ever.

“For the traditional portfolio, we want at least a 30% - 40% discount off of our cautious intrinsic value calculation.”

We bought some Cintas and we also own some other uniform businesses. We had a chance at some Ben Graham statistical type bargains, we had a real estate holding company in Hong Kong, which was trading below cash.

We also bought some European companies that we had owned in the past and sold. But when the crisis hit, these things came back down in price and we had a shot to get back in. These were companies like Linde, the German industrial gas company, a company called Krones, which makes beverage equipment for the beverage and beer industry, a terrific company. So, we did a lot, but many of those stocks have risen and bargain hunting has slowed.

TS: But in the last couple of weeks there are more ideas coming.

JS: We are doing a few net-nets in Japan or Korea most of which are two-thirds or less of net current assets and 3x-5x peak earnings, although earnings are depressed. Two of them are priced around net-cash. Great balance sheets and there is tremendous optionality in these things. They once sold at more than book value and I think if you put together a bunch of them and look out five years, I bet you'll get a chance to sell some of them at book or more.

G&D: Considering your view that opportunities are slowing down, what is your position on cash?

BW: Cash is residual, but we typically have some cash. We tend to think of ourselves as fully invested when we get up around 95% invested. Today we are about 90% invested.

TS: We've had 20% cash, but it's not as if we are waking up one day in the morning and saying “we should go into cash.” This is not what's happening. If we have more companies that reach intrinsic value, then we sell, and if we have fewer opportunities to invest, then we wind up with more cash.

JS: The great thing about these companies that you think are going to grow while you sleep at night, is that when they get up to what you thought they were worth, maybe they'll chug along. So you may not have another thing to buy when you sell it. So, it gives you a bit of a luxury, owning some of these things that seem like they are going to increase in value while you sleep even if they're not beautifully and cheaply priced.

BW: One thing that is characteristic in this market is that the bounce that we had since March last year – and I'm being very general in what I'm about to say – all of the stuff that cratered the worst in 2008 and early 2009 are the stocks that came roaring back in late 2009. So, to a certain degree, when you have a bounce off of a recession low like we've had, the

leveraged companies, non-dividend paying companies, the crummier businesses have gone straight to the moon and the higher quality businesses, companies that are globally diversified, that may have stronger balance sheets, that may pay a dividend, haven't participated to the same degree as these lower quality businesses.

So, we took a look at that and one of our young fellows here took a look at the S&P 500 for instance and looked at the World Index and took a simple metric – do you pay a dividend or you don't pay a dividend. And, in the S&P 500, there were roughly 370 companies in the S&P 500 that paid some form of a dividend last year and 130 that did not. The 370 that paid a dividend were up, on a weighted-average basis, about 27%, which is pretty attractive rate of return. The 130 companies that didn't pay a dividend were up on average 82%. For the global index, you ended up with comparable statistics. When you look at your top 25 holdings at Tweedy, the P/E for the top 25 names are anywhere from 14x-16x current run-rate earnings. But, at lower multiples, is where we think underlying earnings power is, even though current multiples are higher. So, as John was saying, we like what we own and we are comfortable with our holdings.

JS: We liked them better when they were cheaper!

BW: We closed to new business in 2005 and we re-opened in 2008 and we'll probably stay open here for a while.

G&D: Do you have any parting words for MBA students?

JS: Persevere! Just persevere and realize that when you get rejected, it's not personal. Many money management firms only occasionally, and very randomly, hire people. Our turnover has been so low and I couldn't tell you when we will add to the analyst heap.

BW: We just did! I would just add that there seem to be huge headwinds out there. The macro picture looks pretty bleak, but it's been that way in the past often and we've just gone through ten years of flat-to-negative returns in every market. So, that doesn't happen very often. If you're optimists like we are, then you think the next ten years have to be better than the last ten years. We don't know that obviously, but I think if you can get in now, if you can find your way into a shop that does something you're interested in, it's probably going to be a decent future.

JS: I think small-cap and neglect – less liquid – that's an area of opportunity. As you manage more and more money, there tends to be some abandonment of that.

G&D: Thank You.

“If you're optimists like we are, then you think the next ten years have to be better than the last ten years.”

Notes

Current and future portfolio holdings are subject to risk. Investing in foreign securities involves additional risks beyond the risks of investing in US securities markets. These risks include currency fluctuations; political uncertainty; different accounting and financial standards; different regulatory environments; and different market and economic factors in various non-U.S. countries. In addition, the securities of small, less well-known companies may be more volatile than those of larger companies. Value investing involves the risk that the market will not recognize a security's intrinsic value for a long time, or that a security thought to be undervalued may actually be appropriately priced.

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