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PERSPECTIVES AND ACTIVITIES OF THE NATION'S MOST SUCCESSFUL MONEY MANAGERS.

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LEGG MASON VALUE TRUST'S BILL MILLER
CONVERSATION WITH A MONEY MASTER
" 'AIN'T ONLY THREE THINGS TO GAMBLING:'
THEY'RE ALL YOU NEED TO KNOW ABOUT INVESTING."

Bill Miller is best known for Legg Mason Value Trust's unprecedented 15-year streak of beating the S&P 500. But as we said in our last edition, what we find most fascinating is just how consistent his fund's margin of outperformance has been — looking back over 3, 5, 10 and 15 years.

However, like many other mutual funds and managers who emphasize buying high-quality/high-return businesses,

(continued on page 2)

CENTURY MANAGEMENT'S
ARNOLD VAN DEN BERG ET AL.
"TAKE MY WORD FOR IT. THESE STOCKS ARE CHEAP.
THEY HAVE ENORMOUS GROWTH POTENTIAL, TOO."

Arnold Van Den Berg is used to overcoming the odds. As a member of a Jewish family in Nazi-occupied Holland living just down the street from Anne Frank, Van Den Berg only survived (unlike 39 of 43 family members) thanks to the good judgement of his late father, Hugo, who arranged for a brave 19-year-old Dutch girl he knew was a member of the Dutch resistance to smuggle both the three-year-old and his older brother into a nearby orphanage.

(continued on page 8)

PFIZER'S HENRY MCKINNELL
"THE FOCUS IS ON OUR PATENT EXPIRATIONS TODAY.
LONGER TERM, IT'LL BE ON OUR NEW PRODUCTS."

With many of the investors we follow buying Pfizer and several of them talking about it and/or other pharma stocks in this edition, we thought we should provide you with a bit of perspective about what's really going on at that company and within the industry generally. So we figured who better to provide that perspective than Chairman Hank McKinnell and some of his associates. The excerpts which follow were

(continued on page 46)

OAKMARK FUNDS' BILL NYGREN
"IT MAY BE DIFFERENT THIS TIME,
BUT THAT'S NOT THE WAY TO BET."

For Bill Nygren, it's a case of déjà vu all over again. During the late 1990s, he warned about overvalued techs for so long that "by the time our message was important and accurate, much of our audience had lost patience with us." Having now been saying that high-quality businesses are attractively priced relative to lower quality, more cyclical companies for close to three years, he laments the fact that

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CENTURY MANAGEMENT'S
ARNOLD VAN DEN BERG & JIM BRILLIANT
(cont'd from page 1)

After the war, his parents — who also beat the odds by surviving Auschwitz — took their children to America where they settled in East Los Angeles. Physically underdeveloped as a result of several years of malnutrition in the orphanage (he was barely able to walk at age 6) young Arnie was an all-too-easy target in a neighborhood where weak and skinny kids didn't thrive.

Determined to change the equation, he decided that he would try to overcome his physical shortcomings by taking up rope climbing. In fact, he took up the sport with such commitment that he set a record in the event — climbing 20 feet in 3.5 seconds — a record which lasted until the event was discontinued about 15 years later. And he actually placed ninth in the national *collegiate* event — while still in high school.

After high school, with no other formal education, Arnie became a salesman at a local securities firm which specialized in mutual funds. But he became upset with how poorly those funds had performed in 1969 and 1970. In order to understand why, he became an avid reader of Ben Graham and a student of security analysis.

He soon decided he wanted to manage money. But lacking the background or the credentials to enter the field, he was stymied — until someone suggested that he apply the same commitment that he'd applied to rope climbing nearly 20 years earlier. Then and there, Van Den Berg made the commitment that, however long it might take, he'd begin his own advisory firm. And apply that same commitment he did — converting his tiny studio apartment into a research office, in the process moving everything out except for his desk, his books, and his bed.

Well, so far, so good. During the past 31+ years, clients of Van Den Berg have earned a compound return of 15.6% per year after all fees and expenses (before fees, they've earned 17.1%) versus 13.5% and 12.4% per year for the S&P 500 and the NASDAQ, respectively. By the way, those figures include clients' holdings in cash and bonds. It turns out that the equities portion of his clients' portfolio during that same period have earned a remarkable 21.4% compound annual return before fees and 19.9% after fees. (All performance figures provided by Century Management and, we understand, verified by Ernst & Young.)

We're pleased to bring you the following excerpts from presentations at Century Management's Client Conferences which took place March 4th in Austin and March 25th in Houston and the subsequent question and answer sessions, followed by excerpts from conversations with Van Den Berg and senior research analyst Tom Lewis. We never fail to find Arnie's insights and perspectives to be particularly sharp and colorful, and hope that you will, too.

WE BELIEVE INTEREST RATES WILL REMAIN LOW — AND WE SEE A GREAT OPPORTUNITY.

Interest rates are going to stay low and maybe go lower.

Arnold Van Den Berg: I'd like to just give you a brief outline of what we're going to talk about today. The first thing that we're going to talk about is why we believe that interest rates are going to be low, and could even go lower, why inflation will stay low for quite a while, and why contrary to what everybody believes, we believe the Fed's primary objective is to fight inflation, and that they're continuing a stand of very, very close monitoring of that problem.

Large caps — an outstanding bargain and great opportunity.

Van Den Berg: Next, we're going to talk about why we're buying large-cap stocks, and why we believe that they represent an opportunity we haven't seen in many, many years. In fact, we don't remember a time since 1983 in which we've owned as many large-caps as we do today. That was basically the beginning of this bull market. And they've been going sideways now since 1999 or 2000 — building up, getting lean and mean, and correcting some of their accounting problems.

The result is that they're probably as cheap as we've seen them in more than 20 years relative to interest rates and inflation. And I believe that before this seminar is over, you'll recognize, as we do, that these large-cap stocks are truly an outstanding bargain and a great opportunity.

WE USED TO THINK THE BIGGEST RISK WAS INFLATION. ON FURTHER REFLECTION/STUDY, WE NO LONGER DO.

In 2004, we thought our economy could go either way....

Van Den Berg: In 2004, the economy was coming out of a recession. And for the first time in many, many years, the Federal Reserve was very concerned about us potentially going into a deflationary period....

The ball could have been tipped either way. If the government had decided to print more money, we could have headed into a period of higher inflation. If they kept the money supply too tight, we could have entered a period of deflation. So it was a very critical time. And we weren't sure which way the Federal Reserve was going to go.

And so we laid out the possibilities in our newsletter.

Van Den Berg: In our December, 2004 newsletter, we described four very different, but possible scenarios. And we told you what the stock market would do under each of those scenarios.

We showed you what it would do under the best case scenario of low inflation and low interest rates. We showed you what it'd do in the event of deflation — in other words, in a period of declining prices like Japan experienced over the past 15 years. We showed you stagflation — which is almost the worst of both worlds — where you have very low real returns and very high inflation. And finally, we showed you the worst of all worlds — which we hope we'll never see here, because it's absolutely the worst economic scenario that you can have — and that's high rates of inflation.

Economists worried about deflation. We feared inflation.

Van Den Berg: In fact, at that time, Ben Bernanke, who was not yet Federal Reserve Chairman, was working on a study of the Japanese economy. That's how concerned they were about deflation....

But despite the fact that everybody was concerned about deflation, we thought the most likely scenario was higher inflation and higher interest rates....

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CENTURY MANAGEMENT'S
ARNOLD VAN DEN BERG & JIM BRILLIANT
(cont'd from preceding page)

On further reflection and study, we changed our mind.

Van Den Berg: But six months later, when we really studied the Fed and saw how they were fighting inflation — watching the money supply, etc. — we changed our mind. We concluded that for once the Fed would stay the course, and keep the money supply tight, irrespective of the consequences, and prevent inflation. And when we became convinced of that, we started to purchase long-term bonds, and began to build our models based on that scenario.

INFLATION IS *ALWAYS* WORTH WORRYING ABOUT. CURRENCIES AREN'T THE ONLY THING IT DESTROYS.

We knew how serious a problem inflation could be.

Van Den Berg: And what was it that caused us to change our mind? Well, first of all, we looked at history. We knew that every time a government gets into problems, it's printed money. And that is so automatic that there are very few exceptions. That's how the Roman empire ended. It expanded all over the world and spent well in excess of its tax receipts. And they had to keep depreciating their currency until their empire finally collapsed.

[Editor's note: In fact, in *For Good and Evil: The Impact of Taxes on the Course of Civilization*, Charles Adams says that taxation became so oppressive by the later days of the empire that Roman citizens welcomed the barbarians — in effect, preferring to take a chance on the devils that they didn't know over the devils they knew all too well.]

No society can function without a reputable currency.

Van Den Berg: Now the Romans didn't have a Federal Reserve. What they did have were gold coins. So they shaved the edges in order to produce more gold coins. And therefore, the price of everything went up as more and more coins were put into circulation. Then they switched from gold to silver — and then from silver to base metals. And by the time they went through this whole evolution of depreciating their currency, the Roman empire completely broke down. It could not function — no society can — without a reputable currency.

And so this is the lesson that we've learned from Roman times on: Any time a country has problems and starts printing money, you have a complete disintegration of the society.

So it's understandable why people worry about inflation.

Van Den Berg: With that in mind, I would like to read you a quote from Diocletian in 310 AD in which he talked about the situation in the Roman empire. He said,

(continued in next column)

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"Who is so hardened of heart and so untouched by a feeling of humanity that he can be unaware, nay that he has not noticed, that in the sale of wares which are exchanged in the market, or dealt with in the daily business of the cities, an exorbitant tendency in prices has spread to such an extent that the unbridled desire of plundering is held in check neither by abundance nor by seasons of plenty...."

Diocletian knew that to revive the Roman empire, he had to have a stable currency. He tried to go back to gold, but he wasn't successful because there wasn't enough gold in the Roman empire. So everything crumbled.

So you can see why people are concerned about the government printing money — and why every government has done just that when their back was against the wall.

THOSE WHO EXPERIENCE HIGH INFLATION KNOW JUST HOW SERIOUS IT CAN BE.

I got a taste of high inflation in Century's earliest days.

Van Den Berg: Back when I started in this business, in 1968, the annual inflation rate was running around 2%. Several years later, it was running around 5%. And by the time we started Century Management, in 1974, it had risen to 10% and was completely out of control. When our government decided to print money to take care of its liabilities, the result was one of the greatest financial crises in our history. It was a big, big problem.

The Dow dropped 40% — the average blue-chip stock dropped 65% to 70% — and we were in the worst recession that this country has had since the Great Depression. And although it wasn't a great time to start a business, it was a *wonderful* time to buy stocks, because they were the cheapest they'd been since the Great Depression.

Back then, Franz Pick was sounding the alarm....

Van Den Berg: There was a currency expert at that time named Franz Pick. I studied all of his books, I read all of his newsletters, and I listened to his tapes. And he was truly an incredible individual. He had studied every currency you can imagine in the history of the world. He would get up in his seminars and say, "This currency became toilet paper. This currency became toilet paper." And he would take 350 years of currency history and show how every one of them had declined to where they were worth virtually nothing unless they were backed by gold.

It was at about that time that President Johnson was trying to get the Great Society programs underway and finance the Vietnam War at the same time. And he was in the position, like most Presidents, where he didn't have enough money to go around. So what they usually do is start printing it.

And Franz Pick was just outraged about that. So in his seminars, he would stand up and say, "This government is printing money. We're going to have 10% to 12% inflation. Your money is being depreciated. Therefore, if we stay on this path, in a few years, your currency is going to wind up being worth zilch. It isn't going to be worth *any*thing."

As a young man, Pick had learned what inflation can do.

Van Den Berg: However, that didn't seem to bother the attendees. And so Pick said, "I can't believe that you're just *sitting* here." Finally one person got desperate enough

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CENTURY MANAGEMENT'S
ARNOLD VAN DEN BERG & JIM BRILLIANT
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to ask, "What can we do about it?"

So after thinking about it for a moment, he said in his very heavy Austrian accent, "I don't understand vy there's no revolution in the streets. I don't know vy ve don't take these people, put them against the vall, and *shoot* them."

The reason why he worried about inflation so much was that he'd experienced that type of situation personally. He would tell the story about how his father had worked two jobs to save up enough money to send him to college — and by the time he had saved enough money to send him to college, it was only enough to buy a postage stamp. That's how bad the inflation had been.

THE FEDERAL RESERVE CAN DEBASE THE DOLLAR. HOWEVER, FORTUNATELY, THEY *KNOW* THEY CAN.

The Federal Reserve can print as much money as it wishes.

Van Den Berg: So again, we have to be concerned about inflation, because throughout history, every nation whose currency has not been backed by gold has eventually seen its currency collapse. And of course, the U.S. abandoned the gold standard and its modified versions in full in 1971 when President Nixon "closed the gold window." In other words, the dollar was no longer convertible into gold at the U.S. Treasury. Therefore, the Federal Reserve has the power, if they choose, to resort to the printing press. And that's always been on our minds. We monitor it *very* closely.

However, fortunately, they *know* it....

Van Den Berg: And just to show you that the present Federal Reserve Chairman, Ben Bernanke, is aware of it, too, I'm going to give you a quote from one of his speeches. Bernanke said: "Like gold, U.S. dollars have value only to the extent that they are strictly limited in supply. But the U.S. government has a technology, called the printing press (or, today, its electronic equivalent), that allows it to produce as many U.S. dollars as it wishes at essentially no cost."

So the Federal Reserve is aware that they have the ability to create dollars at will.

The question is whether they're going to *do* it. And in fairness to Chairman Bernanke, he said, "I don't mean to suggest that we're going to print dollars willy-nilly." But in a pinch, they could do that. And history's shown that when governments get into problems, that's the course they take. And when they do, it eventually causes their whole economy to disintegrate along with their currency.

Today, many expect the Fed to take the easy way out.

Van Den Berg: Therefore, that's what people are expecting today. They're expecting more inflation and higher interest rates because they know the debt we have, they know all the financial problems we have, they know that it's important to keep the economy going, and they're expecting the government to resort to the printing press.

THE PRINTING PRESS IS A THEORETICAL OPTION. BUT IT'S AN OPTION THAT THE FED CAN'T USE.

Not only *won't* they print, but they *can't*....

Van Den Berg: Now, here's why we believe that they not only *won't* do that, but that they *can't*. And this is a

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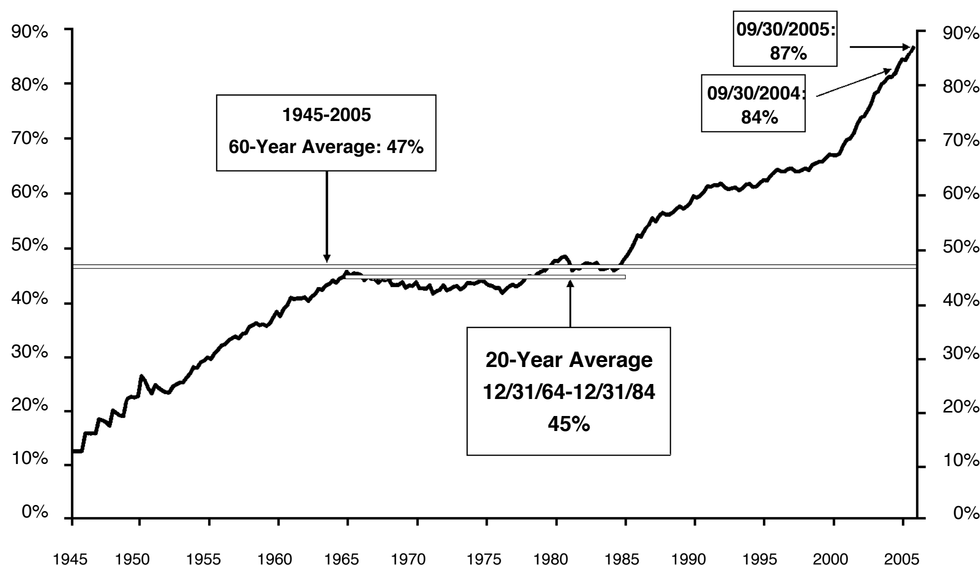
CHART 1

Consumer Debt vs. GDP



Source: Federal Reserve, 3/1945-9/2005

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CENTURY MANAGEMENT'S
ARNOLD VAN DEN BERG & JIM BRILLIANT
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very unusual situation. No nation in the world has ever been in the position that America finds itself in today. And here's why I say that:

In the '70s, when the government was printing money and the dollar started to depreciate, everybody sold dollars. It caused a stock market crash, it caused the economy to go into a terrible economic recession, it caused inflation, and it didn't solve one problem — because all it did was create black markets in commodities, price controls, and a host of regulatory problems.

Foreign investors have learned — as has the Fed....

Van Den Berg: All of the foreign bankers who held American securities — stocks and bonds — got burned. Can you imagine putting your money into America because it was a safe country and watching your purchasing power decline in value from $1 to 85¢? After awhile, you get the idea that that's not a good idea — and so you sell them off. So that created panic in all of these markets.

That's the time that we started Century Management. And I can remember those days very well. There were people who believed that we were at the end of our rope. In fact, the Arabs threatened not to take dollars and instead were going to begin requiring gold for payment of their oil. So it was a real crisis for America.

But the Federal Reserve has learned, too. They know that if they started to print too much money now, with the whole world having learned this lesson and watching them, even if they wanted to, it would be the worst thing that they could do. And that's because it would immediately start a panic in the stock market, the currency market, and the bond market — and it would cripple the economy. So we'd be in *worse* shape....

So this is no longer an alternative. It's something that the Federal Reserve can *technically* do, but it's not something they're *going* to do. And everything we're going to show you today will show you they're not doing that.

Here's another reason why the printing press is out....

Van Den Berg: Here's one of the reasons why they can't do it. Take a look at the consumer debt chart. **(See CHART 1.)**

As you can see, consumers are hocked up to their ears in debt. Over the past 60 years, the average level of consumer debt to GDP has been about 47%. Today, it's about 87%. And what is truly astounding is that it was 65% as recently as June 30, 1998.

Thus, U.S. consumers have continued to borrow against their homes and to use every conceivable technique to maintain their standard of living. So if the government were going to start printing and raise interest rates, every 1% increase on $11 trillion of debt would increase the cost to the consumer by $100 billion, and result in widespread bankruptcies, defaults and so on. Therefore, among other

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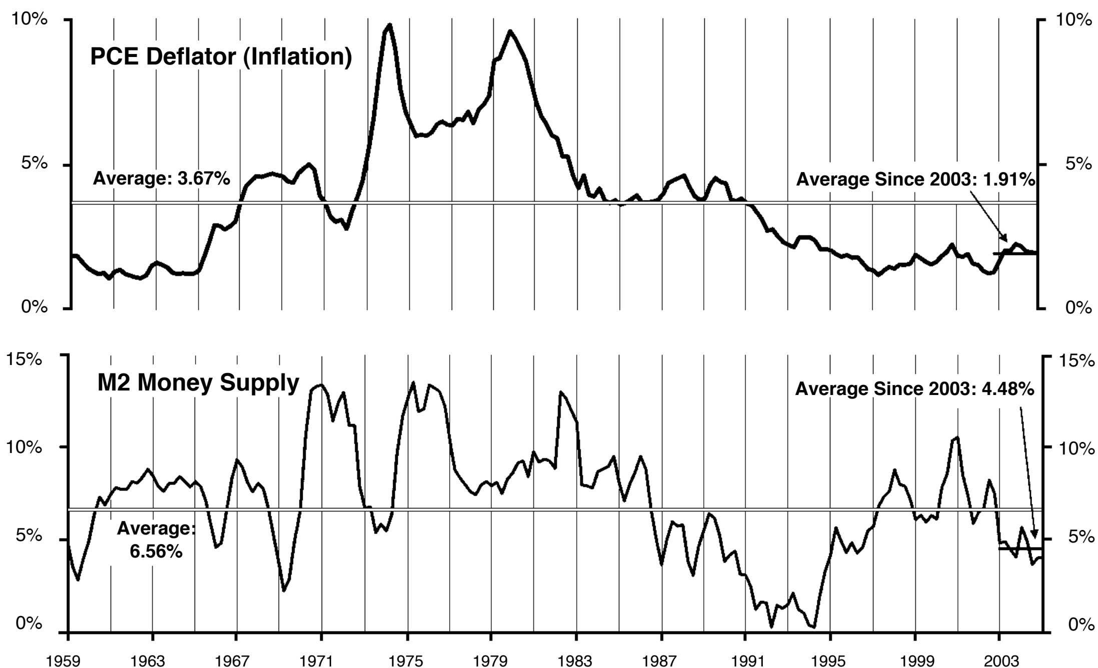
CHART 2

PCE (Excluding Food and Energy) Measure of Inflation: 1959-2005



Source: Federal Reserve and Bureau of Economic Analysis, 12/1959 through 12/2005
M2 Money Supply measures currency, checking, savings, CD's and money market funds.
(See CHART 3 for PCE Core Deflator definition.)

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things, it would cause a recession. So the government can't print — because it would raise interest rates and cripple the consumer.

Higher interest rates would hurt many consumers.

Van Den Berg: And let me give you an idea of the consumer situation. The net worth of the bottom 40% of the U.S. population — that's 45 million households, or about 119 million people — only account for about 1% of the country's wealth, which means they basically don't own *any*thing.

The next 20% of the population account for 5% of the country's wealth. So there you have 60% of the people with very few assets, yet most still have debt. So all it takes is for their costs to go up a little bit, and they are really in deep trouble.

So the worst thing the government could do right now would be to raise interest rates — because that burden on 60% of our population would tip us into a recession....

And it would raise the interest cost on the national debt.

Van Den Berg: And then, when you look at the government debt of $7-1/2 trillion, if they were to raise interest rates 1%, that would be another $70 billion deficit on the budget. So it's not in the *government*'s interest to create higher inflation. And that's why they have gone to such great effort to keep inflation and interest rates down — because that's the only way we'll be able to work out of this situation and keep the dollar strong.

The bottom line of all this printing history, irrespective of what happened in Rome and in all of the civilizations after that time: No country has ever been in this position with their back against the wall, where printing money would absolutely cause the worst type of situation.

BECAUSE THE MONEY SUPPLY'S BEEN TIGHT,
WE EXPECT INFLATION TO REMAIN LOW.

Note the correlation between money supply and inflation.

Van Den Berg: Now let's move on to the next chart — which is the PCE [Personal Consumption Expenditure] price deflator. It's one of the things that the Federal Reserve watches to monitor inflation. It's similar to the CPI. However, unlike the CPI, it adjusts for buying patterns. For example, if the price of oil goes up and people start converting to other types of energy, then it factors in the price of whatever they convert to. Similarly, if the price of beef goes too high and people start substituting less expensive alternatives, it adjusts for that. **(See CHART 2.)**

The line on the bottom represents changes in money supply as measured by M2. So it basically tells you how much the government is utilizing its printing press.

During the 1970s, high M2 growth led to high inflation.

Van Den Berg: Notice how that line moved up during the '70s. And look what happened to inflation as shown in the top chart. The first bump was in the '70s. We printed more — and look what happened to inflation.

Then inflation came down a bit. And in '74, we went into a recession, the Fed pumped up the money supply again, and back we went into a period of high inflation.

So every time we increase the money supply too fast,

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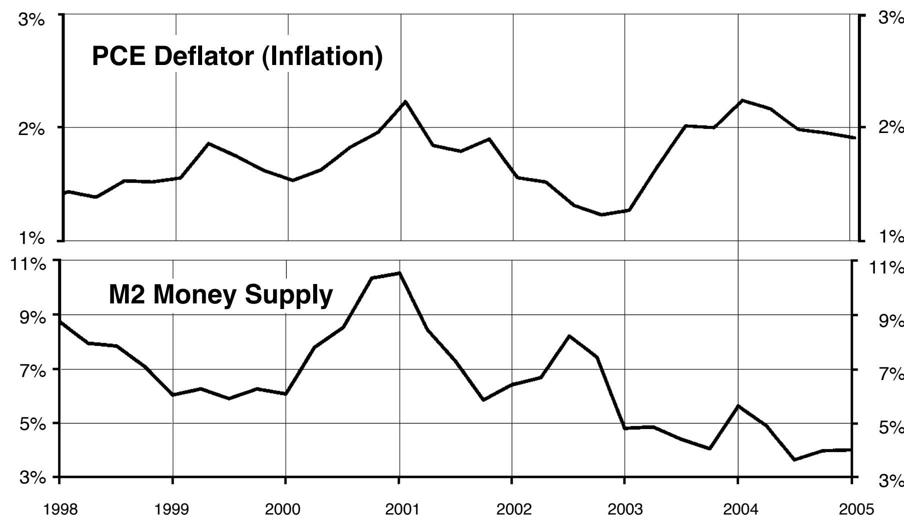
CHART 3

PCE (Excluding Food and Energy) Measure of Inflation: 1998-2005



Source: Federal Reserve and Bureau of Economic Analysis, 12/1998 through 12/2005
PCE Core deflator is a measure of the change in prices of all new, domestically produced, final goods and services in an economy. The basket of goods is allowed to change with people's consumption and investment patterns. Therefore, new expenditure patterns are allowed to show up in the deflator as people respond to changing prices. PCE Core excludes Food and Energy costs.
(See CHART 2 for M2 Money Supply definition.)

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we have inflation; whereas when the money supply grows slowly and the dollar goes higher, you have lower inflation.

Then, under Volcker, low M2 growth led to low inflation.

Van Den Berg: What happened is that things got out of control. So they brought in Paul Volcker. And Volcker was a man who took a stand. He was a man of principles. He said the only way that America can survive is if we have a strong currency and earn back the respect from the rest of the world that we lost in the late '70s.

So he made a commitment that irrespective of the cost, he would drive down inflation. And he said, "Anybody that bets against us is going to *lose*. Inflation is going to come down. We're going to have recessions, and we're going to have defaults — but we have to pay the price to restore the credibility of the U.S. dollar."

And note that for the next 13 years, the money supply kept going back down and down and down. And if you look at the top chart, you see how inflation went down along with it.

In the 1990s, instead of inflation, we got the Tech Bubble.

Van Den Berg: There was only one exception to that — and that was with Chairman Greenspan in the '90s. Because of the Asian crisis, there was a lot of debt being defaulted on in the Asian countries — and their stock markets were panicking. And at the same time, we had an academic experiment by a bunch of professors who started a hedge fund, Long Term Capital Management, that had an incredible reputation. They had two Nobel Prize winners and Ph.D.s as far as the eye could see.

And they thought that all of these wonderful programs that they taught their students in the classroom would just make gobs of money in the real world. But they hadn't been *tested* in the real world. They worked great in the classroom, but they didn't work so well in the marketplace.

They had $1 trillion leveraged out there. And then they started defaulting. What happened is that some of their theories were tested by the merciless frictions of life. And they proved to be somewhat wanting.

Anyway, here was Federal Reserve Chairman Greenspan facing an Asian economic crisis and $1 trillion worth of debts floating around — and he chose to print. And so there again, up went the money supply....

One unfortunate thing: If he hadn't printed, and thus kept that bubble going, we might not have had the bubble in the stock market that we did.

But once again, the Fed learned....

Van Den Berg: I'm speaking in hindsight now, so it's not a criticism of the Fed. But if you look at it, if they had stood firm and let Long-Term Capital default — like they should have — and kept that money supply steady, it might not have spilled into the stock market, and we might not have had quite the technology bubble we did. Those stocks wouldn't have gone as high as they did, but they wouldn't have gone as low either.

But the Fed realized that later. And shortly afterwards, as you can see in this next chart, while the money supply went up until 2000, after that, they've been grinding it down and down and down ever since. As you can see in the lower chart, the money supply as measured by M2 has basically been trending down since 2001. **(See CHART 3.)**

And a tight money policy today means low inflation ahead.

Van Den Berg: And that is very good news for the future — because there is a time lag between growth in M2 and the resulting inflation. Therefore, the inflation we are experiencing today is the inflation caused by the aggressive expansion of the money supply in 2000 and 2001.

From May 31, 2000 through September 30, 2001, the M2 money supply grew at an annualized rate of nearly 9.5%. To put this in perspective, since 2003, M2 has only grown at an annualized rate of about 4.5% — and the 47-year average has been just under 6.6%. The reason we have inflation today at 2%, as measured by the PCE, is due to the time lag that typically occurs from the time that money is printed until it works its way into the economy. In other words, the money has now been fully integrated into the economy.

Over the past three years, the Fed's been withdrawing reserves from the economy, thus creating a tight money supply. So we would expect that after the normal lag time occurs, we should begin to see lower inflation.

UNLESS THERE'S ALSO A LOOSE MONEY SUPPLY,
HIGHER COMMODITY PRICES AREN'T INFLATIONARY.

Commodity prices are running wild? I don't think so....

Van Den Berg: Now here is one of the most important things that I can tell you: People see commodity prices going up, and they say, "Oh, there's going to be inflation".

Well, let me point out a couple of things. First of all, in 1980, the Commodity Research Bureau Index was around 249 — and it hasn't gone anywhere for 23 years. It's only up about 1/2 of 1% a year when annualized.

So while commodity prices have doubled during the last couple of years, that just represents a catch up from this low, low commodity inflation that we've had in the past 23 years — and it's nothing to be concerned about.

And higher commodity prices aren't necessarily inflationary.

Van Den Berg: Let me give you the most important thing that you need to understand as you listen to the news media about commodities. They always say that commodity prices are running wild — and therefore, we're going to have inflation.

Well, that inflation fear is founded on the fear that the Fed is going to continue to print. But I've just shown you that they're *not*. So if you're on a $3,000 a month budget, and the price you pay for gas goes up, but you don't make any more money, what are you going to do? You'll either cut back on your gas purchases, or you'll pay more for gas and spend less on some other things. For example, you might not spend as much on entertainment and clothing.

So as long as no more money is being printed, prices will even themselves out. If the price of oil goes higher, the prices of some other things will go lower — because there'll be less money available for them. So it will equal out.

In fact, without a loose money supply, they're not.

Van Den Berg: The only time rising commodity prices

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CENTURY MANAGEMENT'S
ARNOLD VAN DEN BERG & JIM BRILLIANT
(cont'd from preceding page)

lead to inflation is if they're also printing money — and they're not doing that today. So the difference between today and the '70s is that they were printing money then — and they're not today.

Back in the '70s, when commodity prices went up, people demanded higher wages, and interest rates rose. Basically, the price of everything went up in a vicious cycle. But today, they're holding the reins tight. Therefore, even though commodity prices are going up, they'll eventually go down if the Fed doesn't make more money available.

That said, I do understand why some people see inflation.

Van Den Berg: And I was debating this point with a very good friend of mine — a very sophisticated guy who talks to other very sophisticated people about the economy all day long. And my friend was telling me about this editor at *Forbes* who keeps talking about high inflation and how the government is printing money.

And I said, "That reminds me of a guy who was interviewing a football player. He asked, 'Do you guys prefer to play on grass or Astroturf?' And the football player said, 'I don't know. I've never smoked Astroturf.' "

So my friend asked, "What does that have to do with inflation?" I said, "If this editor can look at these charts — for wages, for the money supply, and for commodities — and see inflation, then he must be smoking something. And I don't think it's Astroturf."

If you don't print money, you're not going to have inflation.

Van Den Berg: Here is the way that inflation starts. It cannot start without the government printing money. That is the first requisite step. If you don't print money, you're not going to have inflation. But once you print money, then it goes into commodities and commodities shoot up.

Then, as commodities go up, and the cost of goods that utilize those commodities goes up, people see their money depreciating. Therefore, they go to their unions and their bosses and they say, "Hey, my money depreciated 5%. I want a 5% raise."

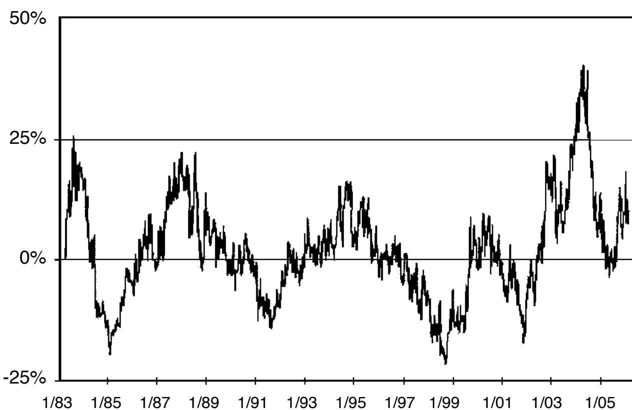
So now you've got the prices of commodities going up, you've got interest rates going up, you've got wages going up, and you've got a cycle that's out of control.

But if you *don't* make that money available, then commodity prices can run up, but the overall price level will eventually even out and price stability will reign.

CHART 4

Median Percentage Change of 21 Commodity Prices Over 52 Week Periods

March 1, 2006



Source: Dr. Wayne Angell of Angell Economics

IF YOU PUT THEM IN THE PROPER PERSPECTIVE,
YOU SEE COMMODITY PRICES HAVE BEEN PRETTY TAME.

This next chart is compliments of Dr. Wayne Angell.

Van Den Berg: Now let's look at this next chart, because this is truly a revealing chart. And it should give all of you who are worried about inflation a lot of peace — because it shows that this commodity bull market is already slowing down. **(See CHART 4.)**

By the way, this is not a chart that we worked up. So I want to be sure to give credit for it to Dr. Wayne Angell. Dr. Angell is a Ph.D. in economics who served on the Federal Reserve Board from 1986 to 1994.

This gentleman was one of the lone voices and the strong believers — along with Paul Volcker — in a strong currency, low inflation, and the integrity of the currency. And I've always admired him for his outspoken ways.

When you read the Federal Reserve's comments, you tend to get a little bit of this and a little of that. So after you read it all, you wonder, "What the hell did they say?!" But Wayne Angell always spoke with clarity and conviction.

It's very simple, but very effective....

Van Den Berg: So when we were struggling with how to resolve our inflation outlook, I had an individual from our staff track Dr. Angell down, we had a long conversation, and I'm pleased to inform you that he's now a consultant to our company.

So when I called him last month before our seminar and we were talking about commodity prices, I told him, "I'd really like to use your charts to help our clients understand why we are not worried about inflation". And he gave us permission to use them. This is what he uses to monitor commodities. And it's such a simple approach, but it's so effective.

Commodity price increases are factored in one time only.

Van Den Berg: Most people, when they're looking at commodities, are looking at the fact that the prices are going up. But that doesn't tell you what future inflation is going to be. For example, if the price of oil goes from $30 to $65, then energy costs are going to go up in your budget. Right? However, if it's now at $65, and it stays at $65, then next year, there's no gain. So this commodity increase is already in the price of the commodity. It's already in the inflation rate — and the inflation figure as measured by the PCE Core Price Deflator is still less than 2%.

So here is this huge run-up in commodities. It's

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already in that inflation calculation. And now we're going forward.

Is this commodity cycle over?

Van Den Berg: So what Dr. Angell does is take the price of 21 commodities from last year, and compare it to prices the next year. And look what's happening:

In 2003, it peaked out. And for the most part, it's been going down. This is a chart as of March of 2006. And as you can see, it's almost at the zero line right now.

In the latest chart that we have, which is 23 days later, it's actually even a little lower. So when I called him, I asked him, "Are you ready now to announce that this commodity cycle is over?" And he said, "I'm not ready to give it a Hallelujah yet, but it's coming very close."

So we are monitoring the money supply and commodity prices. But what these charts show is that the money supply hasn't been going up, and commodity prices are coming down.

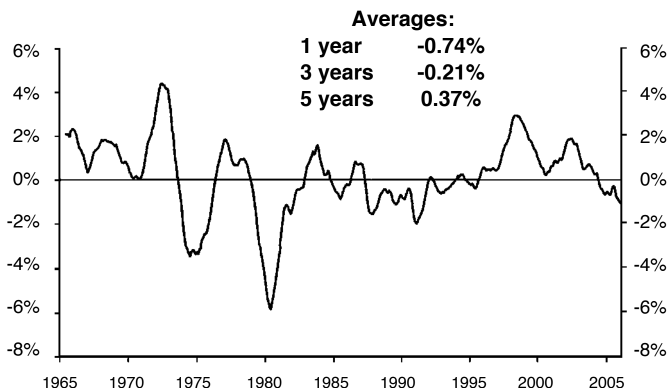
THERE'S NO EVIDENCE OF INFLATION, BUT WE'LL REMAIN DILIGENT....

Nothing is more sensitive to inflation than wages.

Van Den Berg: And now I'm going to give you the most important evidence of all — and that is wages. There's nothing more sensitive to inflation than wages. You may remember how back in the 1970s, the unions had tremendous control over the economy. Why? It was because inflation was going up at 10% a year — and it took a strong union to convince employers to increase those wages the same 10% a year. Well, you can imagine what happens to corporate profits if your costs are going up — including your wages — at 10% a year.

So the real test of whether or not we're going to have inflation is in wages — because everybody is very sensitive to the fact that they've got a very good argument with their employer that if inflation is going up 5%, they should get a 5% raise just to stay even. And as you can see in this chart, in the last five years, there literally has not been any increase in wages after inflation. **(See CHART 5.)**

CHART 5



Source: Bureau of Labor Statisics

There's no evidence of inflation. But we'll stay vigilant.

Van Den Berg: So you've now seen evidence that the rate of growth in the money supply has been very tame, that the money supply's been very tight, that commodity prices are cooling down because of that lack of growth in the money supply, and, finally, that over the last five years, real wages have remained stable. If these things stay in place, we're going to have low inflation and low interest rates into the future. Changes in any one of these things will alert us to the fact that the Fed is starting to print.

And now I'm going to give you the easiest way to monitor it — it's just one simple indicator. All you have to do is watch the U.S. dollar. People who monitor inflation, who are experts about the money supply, the economy and so forth, say that the ultimate test of a currency — whether it's acceptable and has credibility — is whether it remains stable. And the U.S. dollar's been very stable for two years. It ran up a little more than it should have, and came down since. However, the U.S. dollar has been extremely stable over the last couple of years. So there's your proof.

So we've now gone through all of the indicators. And there's no evidence that the Fed is departing from its vigilant stance. If they stick with it, which all of the evidence indicates they're doing, we're going to have low interest rates and low inflation.

So I hope I've convinced you that our evidence of a low inflation/ low interest rate environment is holding up.

ONE OF THE GREATEST OPPORTUNITIES THAT WE'VE SEEN IN A LONG TIME....

We're in a very unusual situation today....

Van Den Berg: An environment of low inflation and low interest rates is *great* for long-term bonds. Today, we believe those bonds have the ability to appreciate between 15% and 25% — which is not exactly a conservative return. And the big-cap stocks, which we're going to talk about next, are going to be the greatest beneficiaries — because their multiples are going to expand.

Mind you, our discipline doesn't tie us to any particular market category. We buy small-caps, mid-caps, and large-cap stocks. However, the problem is that most of the time, the great companies aren't cheap — because they're the ones everybody wants and follows. And therefore, they're rarely available at bargain prices. But this is a most unusual situation. And I'll explain why, but let me give you some history first.

In 2000, the opportunity was in small-cap stocks....

Van Den Berg: In the year 2000, small-cap stocks (the 300 smallest stocks in the Russell 3000) were

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incredibly undervalued. Those are your smaller, less seasoned companies. And they tend to have less seasoned, less sophisticated managements, accounting and so on. They include a lot of good companies — simply not as good as the crème de la crème.

And these small-cap stocks normally trade at a 15% discount to the large-caps. But in 2000, they were actually trading at a discount of *55%*. Why? It was because everybody was chasing the big technology stocks — and nobody cared about these small manufacturing companies. They called 'em the "old economy" stocks — and they were out of fashion.

Small-cap stocks were trading at only 11.4 times earnings in 2000. So these stocks were incredibly cheap. But look what's happened since. Today, small-cap stocks are trading at 26.1 times earnings. So the reason why we've been selling nearly all of our small-cap stocks is that they continue to meet our price objectives.

One of the greatest opportunities we've seen in a long time.

Van Den Berg: And meanwhile, we've been moving into these bigger company stocks because they're so cheap. In fact, we believe this is one of the greatest opportunities that we've seen in a long time.

This is an unbelievable phenomenon. It's kind of like if you went to the best part of town and could buy a house for less than you could in the worst part of town.... In the stock market, most people don't understand value. And there are a lot of people who are buying stocks for reasons other than value. Therefore, you wind up with these valuation discrepancies.

And that's what's happening in the stock market today. Large-cap stocks (the 300 largest stocks in the Russell 3000) had an average P/E multiple of 25.5 in 2000. At that price, they were 35% overvalued relative to interest rates. And one confirmation of that point is that their P/Es have since dropped 27%. Today, the large-caps sell at only 18.6 times earnings. Isn't that hard to imagine?

So homes in the best neighborhood are selling for less than homes in the worst neighborhood. And while we can argue about what they're worth, relative to each other, the difference is dramatic.

Do you notice a pattern here?

Van Den Berg: Consider what happened between 1983 and 1990. In 1983, small-cap stocks — the stock market equivalent of homes in the worst neighborhood — were selling for more than large-cap stocks. They were selling at 17 times earnings, while large-cap stocks were selling at only 12.8 times earnings.

That was an amazing phenomenon — and I want to explain to you why that happened. Any time that things in the stock market get out of kilter, it's due to psychology. By contrast, in 1974, the small-caps got so blistered and beat up that they got to a discount that was unbelievable. I remember having 30 companies lined up — every one of them selling at P/Es of 6-1/2, 6, even 5 times earnings — and I was agonizing over which ones to buy. But looking back, it wouldn't have mattered *what* I bought. I could've thrown a dart. You didn't have to be too smart — because you were buying them at 75% below their intrinsic value.

However, naturally, because these small-cap stocks were so cheap, their prices subsequently went up and up until psychology kicked in the *other* way. People began attributing valuations to small-cap stocks they didn't deserve. They thought, "Look how much better small-cap stocks have performed than large-cap stocks. We want to own *them*." And they kept going up until, by 1983, they got way *over*valued.

[Editor's note: According to *Ibbotson Associates*, during the six-year period from January 1, 1984 through December 31, 1989, small company stocks returned 7.3% on average versus 17.9% for the S&P 500.]

Van Den Berg: And in 1990, they got blistered again. Despite the fact that interest rates went from 11% to 8% — which suggests their prices should have gone up — small-caps fell to 8.6 times earnings while large-caps rose. Now there is an example of a recession sobering people up.

[Editor's note: Again, according to *Ibbotson Associates*, small company stocks returned 24.5% on average for the subsequent five years versus 16.6% for the S&P 500.]

Today, we have a rare opportunity....

Van Den Berg: Similarly, today, the average P/E of the biggest of big-cap stocks has fallen from 25.5 to 18.6. But that's not the whole story. And here's why I say that: Since 2000, the yield on the 10-year Treasury has declined from an average of 6.03% to 4.29%. So the average P/E should actually be *higher*.

However, there's always a psychological reason why valuations temporarily get out of line — and this time is no different. Only in the stock market does the best merchandise occasionally sell cheaper than the lower-grade merchandise. And it just so happens that we're at one of those points in history right now.

In fact, I'd say that such an opportunity only comes along about once every 10 or 12 years — in fact, it may come along only once every *20* years. It's very, very rare....

If you don't believe me, just look at *BusinessWeek*.

Van Den Berg: Incidentally, if you'd like to have some psychological confirmation that what I'm saying is correct, there's an article in the March 13th *BusinessWeek* entitled: "Are large-cap returns really due to pull ahead? Don't bet on it." Well, we *are* betting on it — in part because *BusinessWeek* has now given us a confirmation. They are truly a wonderful contrary indicator. Here's *BusinessWeek* telling people to stick with small-cap stocks — because they've got the greatest future. And that's the problem. When you look at your investments through a rear-view mirror, you see what happened in the past, but you don't see the oncoming truck that you'd see if you were looking through your windshield. So we look through the windshield, not the rear-view mirror, to get investment ideas.

But that's the way we use *BusinessWeek*. We take all their covers and say, "This is what *BusinessWeek* says. What's the best way to do the opposite?" And then we start researching that area — and invariably, we find some very good leads....

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CENTURY MANAGEMENT'S
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AFTER MANIAS, YOU CAN FIND GREAT VALUES.
IT'S THE MOST AMAZING THING I'VE EVER SEEN.

John Kenneth Galbraith had it right....

Van Den Berg: Anyway, there's a psychological explanation of why these *extraordinary* divergences happen. I'll start by reading a quote by John Kenneth Galbraith: "There is nothing unique about the Crash of '29. It is something that happens about every 20 to 30 years, because that is the length of the financial memory. It is about the length of time needed for a new set of suckers to come in and imagine that they have a new and wonderful fix on the future."

Here's what happened in the 1949-1972 bull market. And once we show you that and what happened to the psychology of investors, you're going to understand exactly why these big-cap stocks are so cheap.

First, a bull market; then a mania; then a bad hangover....

Van Den Berg: After World War II, consumers were flush with cash. That's because during the war, they didn't have a chance to spend all the money they were making — because they were all either working or fighting. So they built up this mammoth cash position. And then, all of a sudden, the war was over — and all these consumer products came out, which created one of the biggest bull markets in stock market history. It was truly one of the great bull markets — probably one of the three biggest bull markets in American history, along with those that ended in 1929 and 2000.

And these consumer stocks — like Procter & Gamble, Coca-Cola, McDonald's, and IBM — just became darlings. People decided these companies were "one-decision stocks" — all you had to do was buy 'em and hold 'em. And this was true for 20 years. They were called the "Nifty-Fifty".

Well, what happened? Like all manias, it builds — and it goes higher, and higher, and higher. Soon, valuations lose touch with reality. People start buying these companies because they're going up, not because they're great values. And then something happens, and the bubble bursts — and the result is a terrible, terrible hangover.

After manias, you can find extraordinary values.

Van Den Berg: I want to show you two things in this next chart that I hope you'll remember. **(See CHART 6.)**

First, after the 1973-74 crash, the market went sideways for eight years. This is when it worked off the overvaluation. This is when the pain heals. And it's when companies become lean and mean. It's after this period that you're able to find extraordinary values. And that's exactly what happened after the 1973-74 crash. After an eight-year consolidation, we had the next bull market....

And if you look ahead in the chart, you'll see that we've now been in a six-year consolidation period since the bull market that ended in 2000. I'll come back to that, but I'd like you to take note of that right now.

Nifty-Fifty stocks suffered an average decline of 65.8%.

Van Den Berg: And what happened following the 1973-74 bear market is truly the most amazing thing that I've ever seen or experienced. For two straight years, these major companies got pummeled, and pummeled, and

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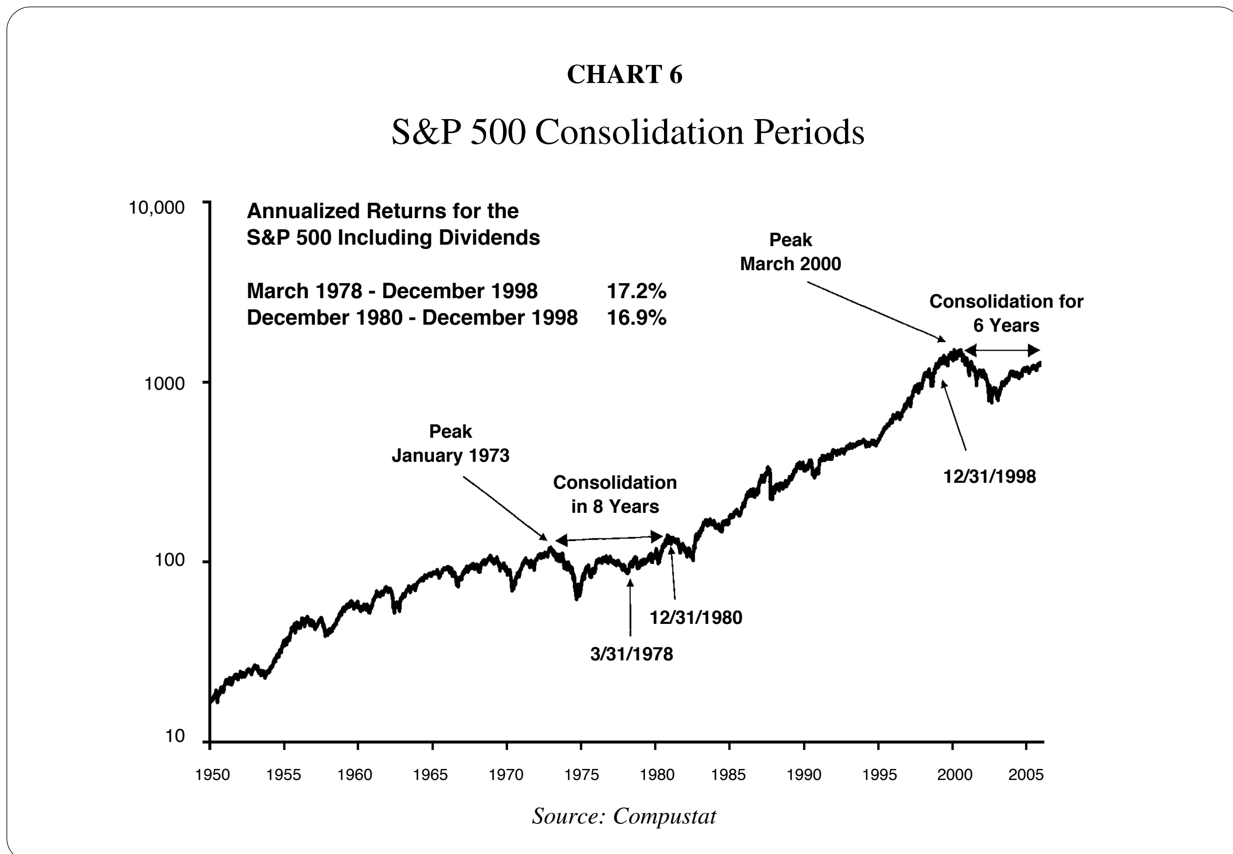
CHART 6



Source: Compustat

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pummeled. On average, they dropped 65%. And they were the crème de la crème.

How did it happen that the world's greatest companies took such a dramatic hit? Well, one of the reasons — and the most important reason — was we had high inflation and high interest rates. And as we all know, a bond trades inversely to interest rates — and so do stocks. Therefore, the higher the interest rates, the more stocks have to go down in order to be attractive relative to their competition.

On average, these stocks suffered a decline of 65.8% — and it took them an average of 12 years just to get back to their 1972/73 highs....

AFTER THE MANIA AND THE CONSOLIDATION, COCA-COLA SHOT UP LIKE A CORK FROM A BOTTLE.

Even Coca-Cola was still down 60% eight years later.

Van Den Berg: This next one is my all-time favorite. It's a classic example. This is without a doubt one of the greatest companies in the history of the world. In fact, I'd say that there's only one other company that rivals it — and we're going to talk about that company in a bit.

But Coca-Cola went public in 1919 and had growth of 15% per year from 1919 until 1972. No other company had ever grown that consistently for that long. So, naturally, it was *the* darling of that era. And look what happened. It went from $75 in '73 to $22 during the '73/'74 bear market — and it was still trading at only $30 eight years later in '82. Just *think* about that — you could have still bought it for $30 eight years later.

And it's not like the company was standing still....

Van Den Berg: And it gets better. Just listen to these numbers — because I think that they explain why we're so excited about the companies we're buying today. From its 1973 peak to its 1981 low, Coca-Cola's stock went from $75 to $30.50. That's a 59% drop in the stock price.

But the company wasn't exactly standing still during those eight years. During that time, Coca-Cola's sales went from $17.94 per share to $47.64 — which is an increase of 166%. Its earnings per share went from $1.80 to $3.62 — an increase of over 100%. And its dividend went from 90¢ to $2.32 — a 158% increase. Meanwhile, its P/E went from 42 to 8 — which is a decline of 80%. Just *think* about that. This company's earnings per share rose 101% and its sales per share rose 166% — and yet, eight years later, its stock was 59% lower.

It wasn't about investment fundamentals, but psychology.

Van Den Berg: Why does that *happen*? Why would people not rush back into Coca-Cola when it was trading at less than half the price and the sales and earnings had doubled or more?

Well, part of the answer is that once people get burned by something, they don't want to *hear* about it. How many of you want to hear about technology stocks? You don't now, but you will in a couple of years. It's been about six years since the technology bubble burst. So in a couple of years, you'll be ready to go again — because enough of the pain will have healed, and their earnings will have doubled. And once their earnings have doubled, you'll start getting interested in 'em again.

So this is not an unusual case. In fact, I could show you *20* examples like that, although I'm only going to show you two. But then I'm going to show you some examples in today's market exactly like these two.

Finally, the stock price shoots up like a cork from a bottle.

Van Den Berg: But first, let me show you what happened *after* that consolidation period. Coca-Cola's split-adjusted average price between '72 and '82 was 81¢. That was the average price of Coca-Cola stock during the 10-year period after its stock had dropped 59% and its sales and earnings had risen 166% and 101%, respectively.

And look what happened to Coca-Cola's stock price in the next two decades. It was up about 66 times. And we're only taking its average price in that 10-year period. We're also only using $53.51 as our sale price — not its peak price of $77.73. So we're being very conservative when we say that for every $1,000 you would've invested in Coca-Cola during that period, you would have wound up with $66,000. That's a compound annual return in excess of 19% per year.

Once a major company's stock has been pummeled, and then it goes sideways for years, and its sales and earnings continue to build up, eventually, the stock price has to shoot up — like a cork out of a bottle. That's exactly what happened with Coca-Cola's stock....

THERE WAS THE SAME PATTERN WITH GE — AND THE SAME STELLAR RETURNS.

We saw the exact same pattern with General Electric....

Van Den Berg: Let's just take a look at one more — and that's General Electric. General Electric's stock hit a peak of $37.90 in 1973. In 1981, it got as low as $25.60. So nearly 8 years later, its stock was still down 32%. Meanwhile, its sales per share went from $31.77 to $59.80 — which is an increase of 88%. Its earnings per share went from $1.61 to $3.63 — which is an increase of 125%. Its dividend went from 75¢ to $1.58 — an increase of 111%. And its P/E declined 70% — from 24 to 7.

So here's the exact same pattern as Coca-Cola....

And your returns in GE would've been equally eye popping.

Van Den Berg: They go down, they consolidate, they heal themselves, they get lean and mean, they grow their sales, they grow their earnings, and *boom* — the stock takes off. And that's what happened with General Electric. Over the next 20 years, its stock gave you a compound annual return of 19.76% per year — from an average price of 47¢ per share split-adjusted all the way up to $35.60. So it was up over 75 times.

And I'm only using $35.60 as the sell target — whereas it actually reached a peak of $53. If I used the $53 price, the result would have been a compound annual return of *25*% per year. So that's the story.

Don't look now, but history seems to be repeating itself....

Van Den Berg: Now I'd like to show you that the

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same thing is happening today right underneath our eyes, with this wonderful lesson from history staring you right in the face. We all know what happened in the year 2000 — the market got carried away because of this tech bubble. Investors drove these stocks way up.

But now they've come down. It's the same thing, even the same names: Abbott Labs, Campbell Soup, Coca-Cola, Disney, Eastman Kodak, Pfizer, Philip Morris (Altria), etc. The crème de la crème of companies declined an average of 49% from their highs to their lows in 2002.... And believe it or not, we've had a consolidation period of six years. We had a consolidation period of eight years the last time. So you can see the pattern holding up. And today we've got another thing that we didn't even *have* in the other era — which is lower interest rates and lower inflation....

INTELLIGENCE ISN'T THE SECRET OF SUCCESS — IT'S HABITS AND DISCIPLINE THAT COUNT.

Don't let your intelligence be overruled by your emotions.

Van Den Berg: Next, let me read you one of the greatest quotes you could ever read when it comes to the stock market. It's by Dr. Karl Menninger, the famous psychiatrist. He said, "The voice of intelligence ... is drowned out by the roar of fear. It is ignored by the voice of desire. It is contradicted by the voice of shame. It is biased by hate and extinguished by anger. Most of all, it is silenced by ignorance."

This is a phenomenon that I've been very interested in from a psychological standpoint. I'm sure that all of you know highly intelligent people who do foolish things. And you've probably wondered, "How in the world could they do such foolish things when they're so intelligent?"

Well, it's because the voice of intelligence gets drowned out by fear and greed and these other emotions — emotions that dominate participants in the stock market. So people, acting as a herd, do some very foolish things because of emotions that block out reason and intelligence.

Of course, that doesn't only apply to the stock market. You've seen it in personal relationships, business dealings and everything else. So intelligence is not the real secret of success. It's discipline and the commitment to principles and so forth that allow you to use your intelligence in the way that it's meant to be used. So intelligence is one thing — but habits and discipline are what enable you to do the things that you need to do in order to be successful.

So don't let your emotions dominate — because that's what creates a lot of pain for people, both in the stock market and elsewhere in their lives.

To earn a great return, you must be willing to stand alone.

Van Den Berg: But let's talk about stockpicking.... First of all, when it comes to buying stocks, you want to buy contrary to the prevailing sentiment. You never feel good when you're buying a great bargain. When you buy a great bargain, you're doing it with sweaty palms, you're leaning against the crowd, engaging in contrary thinking, and you're pretty much alone. And almost everybody in the press is telling you that you're doing the wrong thing.

To buy stocks that are going to provide you with a great return, you have to be willing to buy stocks that are out of favor — and you must be willing to stand alone. And you better believe in what you're doing and be disciplined — because otherwise I can guarantee you that you're going to get shaken out of your position.

IF YOU WANT TO BUY FROM IRRATIONAL SELLERS, HERE ARE THE STATES YOU SHOULD LOOK FOR.

The first great psychological state is apathy....

Van Den Berg: Now there are basically four great psychological states you should look for. And you want to buy stocks that are selling for one of these four reasons. When we've bought stocks for these reasons, they've been the most profitable to us. And the first one is apathy. An example of a stock which became a bargain because of apathy is Coca-Cola. It dropped 50% — and went nowhere for eight years.

Do you know what the thinking was about Coca-Cola when I was telling people that its sales and earnings had doubled by 1982? They said, "Who *cares*? I've owned it for eight years, and I haven't made any money. I just want to sell it."

Well, that's apathy. You're so sick of holding a stock that isn't making you any money that you're just tired of it and you want to try something else. There's a lack of interest and emotion — that's apathy. And apathy is one of the psychological states of investors that creates bargains.

And disgust is nice, but fear and panic are better.

Van Den Berg: The next one is disgust. You find that when investors have lost money, or a stock's gone sideways for a long time, shareholders just want to get rid of it. The stock's disappointed you, the company's earnings have declined, its sales have declined — and you're just disgusted with it. That is truly a deep psychological state. And that's one of our favorite times that we like to buy our stocks — when people are absolutely disgusted.

Fear and panic is the next best state. People own a stock, and they're apathetic about it. Then, all of a sudden, there's bad news and it starts going down. That's the final straw. So they get fearful, they panic, and they sell it. Fear and panic is the third state to look for — because when people are in a state of panic, they're not thinking rationally. They're just selling because they're scared. They're in the same state as people in a theater after somebody has yelled, "Fire!" — where everybody wants to rush out the door at the same time.

So you've got apathy, disgust, and fear and panic.

The most irrational state of all....

Van Den Berg: But the ultimate state is anger. There is no emotion that is more destructive than anger — both to your intelligence and to everything else that you do. As Marcus Aurelius said, "How much more grievous are the consequences of anger than the cause of it."

So anger is the most irrational state. And that's a *wonderful* time to buy a stock — when people are so angry at

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CENTURY MANAGEMENT'S
ARNOLD VAN DEN BERG & JIM BRILLIANT
(cont'd from preceding page)

the stock that they want to get rid of it at almost *any* price. When people have lost a lot of money in stocks, and then have watched 'em go sideways, they're first apathetic. Then they watch 'em go down more — and they get disgusted. And finally, around the time that it hits the bottom, they are so angry that they just want to get out. "Get rid of this piece of you know what." They'll sell it at a lower price when they're driven by anger than they will even when they're driven by fear and panic....

WHEN CLIENTS ARE ANGRY ABOUT A STOCK,
WE KNOW THAT WE'VE GOT A WINNER.

Here's how we know when we've *really* got a winner....

Van Den Berg: When you get angry in the stock market and therefore lose control of your emotions, you will cause yourself some serious problems. In fact, we have a wonderful bellwether in our operation. Whenever we buy a stock that people are angry with, our switchboard lights up. Clients will say, "What are you doing buying that stock?! I don't want that thing in my portfolio!"

Now, why are people angry? Why is anybody angry? When somebody steps on your toe and you get hurt, you get angry. So anger is a result of pain. And when people have lost a lot of money, it creates a lot of pain — which creates a lot of anger. That's why they're acting so irrationally — and that's why you get to buy a stock at a cheap price.

So when people call us up and tell us they're angry about a stock we're buying, we *know* we've got a winner [attendees laugh] — because it's such a contrary indicator. In fact, if we could just buy "angry" stocks, there's no question in my mind that we could provide you a 25% per year return. We just can't get *enough* of 'em. [Attendees keep laughing.]

But over the years, we've had about eight to 10 of 'em that really stand out. And I'd like to briefly give you a few examples....

And everybody knew Murray Ohio didn't have a *prayer*....

Van Den Berg: The first one was Murray Ohio — a bicycle manufacturer that was losing money because of competition from Korean manufacturers. When we began buying that one, all of our clients were calling up saying, "What are you doing buying a bicycle manufacturer? Korean competitors are killing 'em by producing bikes at a quarter of the cost. This thing's losing money, and it's not going anywhere. They don't have a *prayer*. What are you *doing*?!"

But what they had overlooked was that Murray Ohio had 57 acres of land right next to a General Motors plant that GM had begged to buy. And because Murray Ohio was in financial difficulty, they finally decided to sell it. And it was worth twice the price of the stock. So what did I *care* about their bicycles? It was a bargain. And if you understand the value, you can take advantage of it.

Well, it earned a 27% compound annual return.

AND *NOBODY* LIKED COMPUTER ASSOCIATES
— EVEN THE COMPANY'S OWN CLIENTS.

In Computer Associates, we got a *double* confirmation.

Van Den Berg: Then on September 30, 2002, thank God for *BusinessWeek*, their cover story was about massive fraud at Computer Associates — and the president of Computer Associates was featured on the cover. Well, there had been some fraud — some irregularities. However, they also happened to have an income stream that you could count on for the next 10 years.

And when our clients called us... I can remember Jim Brilliant [Head of Research], when he came up with the idea, telling me, "You know, Arnie, a lot of people really *hate* this company."

So our clients were angry — and then we got confirmation from *BusinessWeek*. [Attendees laugh.]

Actually, make that a *triple* confirmation....

Van Den Berg: But we had a *triple* confirmation on that one — because besides our clients and *BusinessWeek* hating it, a lot of times, we'll have a client in the industry who knows more about what we're buying than we do. And that's what we had with Computer Associates — we had a client who worked with a competitor of theirs.

So he called us and said, "Look, this is the first time I've ever questioned you guys, but I'm concerned. I never tell you guys what to do, but I really know this company. This is my industry. I compete against these rascals. And this is a *terrible* company. I don't want it in my portfolio. And I can't believe that you guys are buying it."

And in CA, we earned a compound annual return of 93%.

Van Den Berg: So we said, "Okay, let's talk about it." And we told him about its cash flow and so forth. And he said, "You know what? If you talk to any of their customers, they'll tell you they *hate* the company." So we said to him, "If the customers hate 'em so much, why are they still *with* 'em?" He said, "Well, they're locked in a contract. They can't get out of it." So we said, "Okay. Well, that might be better than having a situation where the customers love you, but they don't want your product anymore. It may not be such a bad deal if people hate you if they're locked in."

For example, at Century Management, we've used a piece of financial software for 14 years that we don't particularly like. But we can't get rid of it because it's the best in the industry, it would cost a lot of money to change, and we wouldn't have anything better to go to. So even though we don't like the company, we're not going to change.

And that was the case with Computer Associates. And a year later, it nearly doubled — and we wound up earning a 93% compound annual return on our money....

ACROSS ALL OF OUR ANGRY STOCKS,
WE'VE AVERAGED A 25% PER YEAR RETURN.

When we bought Salomon, we actually got fired.

Van Den Berg: The one that will always stand out in my mind is Salomon Brothers. We bought that one the day they announced that they'd been playing games in the Treasury market. No doubt, you remember when Salomon

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CENTURY MANAGEMENT'S
ARNOLD VAN DEN BERG & JIM BRILLIANT
(cont'd from preceding page)

was in the headlines because it was embroiled in a bond trading scandal. They were caught misbehaving in the Treasury auction. And the Treasury Department was very upset about it. It was all over the front pages. And Salomon was at risk of losing their approved position at the Treasury auction.

Well, there are two things that can happen when people are angry: They can get very vocal about it, and express their dissatisfaction to you with great emotion, or they can fire you. Well, on this one, we actually got fired. The client said, "If this is the kind of stock you're buying in my pension plan, I don't want you managing my money." And he fired us.

Well, as you may recall, Warren Buffett stepped in and made sure things were cleaned up. And by the time the smoke cleared, our clients had earned a compound return of 19% per year for 6-1/2 years in that one.

I only wish that *all* of our stocks made people angry....

Van Den Berg: And here's my point: During the past 31+ years, our clients have earned a compound return of over 15% per year. Meanwhile, in those angry stocks, we've averaged a compound annual return of about 25%. Can you imagine if we were able to have a portfolio that consisted entirely of stocks that everybody was angry about? That would be *incredible*.

[Editor's note: It appears to us that the 15%+ figure which Van Den Berg references above is quite conservative for several reasons. First, based on verified figures from Ernst & Young, the figure through year-end was 15.6%. Second, it's net of fees. Before fees, it was 17.1%. And third, the portfolios included not only equities, but also cash and bonds. The equity-only figure before and after fees was 21.4% and 19.9% per year, respectively.

So if Van Den Berg wasn't buying only "angry stocks", many of them were, at the very least, quite aggravated.]

Van Den Berg: However, it's not just because people are angry that makes these stocks cheap. It's that an angry emotional state drives these stocks to price levels that are irrational. That's what creates the opportunity.

WHAT MAKES MICROSOFT CHEAP? A CLASSIC CASE OF INVESTOR APATHY.

Please be sure to call in and let us know how you feel.

Van Den Berg: Would you like a couple of leads? Would you like to know a couple of the latest stocks that people are angry about — and one in particular? Well, the switchboard lit up when we bought Wal-Mart. And you wouldn't believe it. I was in a meeting with Jim, and he said, "You know Arnie, our service team is taking tremendous heat for us buying Wal-Mart. I think we should *double* that position." [Attendees roar in laughter.] And I said, "I agree." Therefore, thanks to our clients, our biggest position now is Wal-Mart. So please be sure to call in and let us know how you feel. [Attendees laugh and applaud.]

That was a $50 million decision — and it was one of the easiest decisions we could make. And I'm not saying that you should buy *any* stock that people are angry at. It's also got to have all of the fundamental qualifications. But if it's got all of the fundamental qualifications and people are angry at it, boy, have you got yourself a bargain.

Shades of Coca-Cola and General Electric....

Van Den Berg: Here's another stock that's in today's portfolio — Microsoft. Some of you may have heard about it — probably about six years ago. During the tech bubble, if you were a money manager, you *had* to own Microsoft. It was the best, the leader — the one that was going to make you rich. That's when investors were most enamored with Microsoft — when the stock was $60. It's since gotten as low as $23.80. That's a decline of 60%. Meanwhile, its sales have gone from $1.93 per share to $3.72 — up 93%. Its earnings have grown from 70¢ to $1.16 — up nearly 66%. And its P/E has gone from 86 to 21 — a decline of 76%.

*PORTFOLIO REPORTS** estimates the following were CM Advisers Fund's largest equity purchases during the 3 months ended 5/31/06:

1. MICROSOFT CORP
2. 3M CO
3. GENERAL MILLS INC
4. PAXAR CORP
5. HANDLEMAN CO
6. WAL-MART STORES
7. BRIGGS & STRATTON CORP
8. FOSSIL INC
9. GANNETT CO
10. HUTCHINSON TECHNOLOGY INC

**A sister publication of OID, Portfolio Reports contains the most recent stock purchases of over 75 top managers in over 150 of their portfolios.*

Doesn't this remind you of Coca-Cola and GE? Microsoft's stock is down 60% or more from its peak, it's gone sideways for six years — and its sales and earnings have doubled. This is just an *amazing* situation....

A classic example of a stock selling on apathy....

Van Den Berg: So what I'm showing you is that on a fundamental basis, this stock is selling based on apathy. Nobody's interested.

As a matter of fact, I just got a call the other day from a prospective client. His secretary called me up and said, "Dr. So-and-so wants to know what you think about Microsoft." And I asked, "Why?" She said, "Well, he's a little tired of it. He thinks it's a good company, but he doesn't know whether we should keep it." I said, "Well, tell him to do whatever he wants to do — but we're buying it."

It's a classic example. He could easily be convinced to sell this stock — and not because it isn't a good company, but because he hasn't made any money in it for six years. But it's still a tremendous company. It's just that it got a little pricey. But we believe it's pretty cheap today — and we're buying it.

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CENTURY MANAGEMENT'S
ARNOLD VAN DEN BERG & JIM BRILLIANT
(cont'd from preceding page)

WE THINK PFIZER'S A CLASSIC BARGAIN — THANKS TO APATHY, AND FEAR AND PANIC.

We believe Pfizer's an extraordinary opportunity.

Van Den Berg: Let's take a look at another one — and that's Pfizer. If you look at Pfizer's chart and compare it to General Electric and Coca-Cola, you'll see the identical pattern. People got burned by the stock. Then the stock builds its value. However, the people who got burned by it are just *sick* of it. That's the situation with Pfizer today.

The stock went from $50 to $20. But meanwhile, its sales have gone from $4.21 per share to $6.95 — up 65%. Its earnings per share are up 122% — and its dividend is up 145%. And yet its P/E is down 82%. What else do you need to know? We believe it's an extraordinary opportunity.

With Pfizer, the worst-case scenario wasn't all that bad....

Van Den Berg: But Pfizer was also selling on fear and panic. What was happening with Pfizer is that they have a drug called Lipitor — which represents a *huge* percentage of their sales. And an Indian company, Ranbaxy, was threatening their Lipitor patents. So there was a possibility, albeit very small, that they could lose their patent on Lipitor and an enormous chunk of their sales.

Well, the stock had been drifting down — and people were already feeling apathetic about it. But then people started feeling fear — and right before the ruling on the Lipitor patent case, there was also panic in the stock. So Tom Lewis, our new analyst, got together with Jim Brilliant, undertook a cash flow analysis of the company, and figured, "OK, what is it worth if they lose Lipitor?"

One of the best ways to look at a problem is to look at the worst-case scenario. If the worst-case scenario comes to pass, what would the company be worth? Well, it can lose a lot of sales, but that's okay. Just figure out what the company's worth without the sales — and that's pretty much your worst-case downside.

So they did the analysis and they determined that if they lost Lipitor, the stock would still be worth $19 to $22.

And we believe Pfizer is worth a great deal more....

Van Den Berg: Well, Pfizer prevailed in the lawsuit over the Lipitor patent with Ranbaxy (although, of course, Ranbaxy is appealing the ruling.) But the chances of them losing their patent are remote.... It's an original patent. And Ranbaxy has only been successful once challenging a patent in 30 tries in the past. Therefore, we figured that the chance of Pfizer losing its Lipitor patent was very small. So because we concluded that it was a small risk, we took the position.

Our average cost is around $24. Again, we figured that we had very little downside — maybe to $19-$22. And if it had gotten there, we would've just bought more — and we would have had an even *greater* value. But Pfizer won the case. And we were able to buy a good position in a great company, at an average cost of $24, that we believe is worth a great deal more.

Knowledge and intelligence isn't always enough....

Van Den Berg: And here's another classic example: We just happen to have a friend of our family who is not only a pharmacist, but also a strategic planner for a chain of drug companies. So he knows drugs inside out. And he asked me to handle his portfolio. After looking at his holdings, I said to him, "Gee, you have some interesting stocks." And he asks me, "What's interesting?" I said, "Well, Pfizer, for one."

And he says, "You know, I've owned it for six years. And I know it's good because I handle the products, but I'm about ready to sell it. What do you think?" And I said, "Well, you can go ahead and sell it, but we'll be buying it from you — because we believe it's a great value."

So here's another individual who knows more about a company than we do, who understands its technology, and who knows it's good. Yet he's ready to sell it — because after six years, he figures that something must be wrong.

Well, nothing is wrong. It's just going to take a couple more years of incubation — and then it could *double*. But other than that, there's nothing wrong with it....

TAKE MY WORD FOR IT. THESE STOCKS ARE CHEAP AND HAVE ENORMOUS GROWTH POTENTIAL, TOO.

On the surface, Colgate doesn't look as exciting....

Van Den Berg: Now let's move on to Colgate. As you know, they're a consumer products company. Its stock declined from $66 to $48 — down 28% — so it hasn't declined as much as the others we've talked about. And its sales have gone from $16.51 per share to $22.35 — up 35% — so they're not up as much either. And its earnings have grown from $1.70 per share to $2.63 — up 55%. Meanwhile, Colgate's P/E has gone from 39 to 18 — down 53%.

So even though Colgate's stock is down, and its fundamentals have improved, on the surface, it doesn't look quite as exciting as some of the others we've talked about.

But it's an extraordinary value and opportunity, too.

Van Den Berg: However, Colgate's free cash flow — that is, the money that this company could put in the bank each year after funding their capital expenditures and working capital requirements — has gone from $1.53 per share to $2.85. That's an increase of 86%.

And yet the stock of this global company, with worldwide markets, has gone nowhere for five years — since its peak in 2000. So Colgate-Palmolive is truly an extraordinary value and an extraordinary opportunity, too.

Our timing may be wrong, but we've got the value right.

Van Den Berg: I'm sure that you get the idea from these examples: First there's pain, then there are years of consolidation, and finally, there's a bull market. We may very well be early in these stocks I've mentioned. However, there's no question that we're right about their value.

And our present environment has something going for it that those other periods historically didn't. We have lower interest rates today than we did 30 years ago. So we believe that this combination of factors portends for a great future.

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CENTURY MANAGEMENT'S
ARNOLD VAN DEN BERG & JIM BRILLIANT
(cont'd from preceding page)

THE UNIONS HAVE TAKEN A GREAT COMPANY AND MADE IT ONE OF THE MOST MALIGNED.

The unions have run a very effective smear campaign.

Van Den Berg: Next we're going to talk about a stock that is trading based on anger. This is the ultimate buy. And unless something goes seriously wrong with this company, we have high hopes for it. And that's Wal-Mart. But before I get into its fundamentals, let me explain why people are so angry at this company.

Here's the problem in a nutshell: There is a smear campaign that was started by the unions that is one of the most effective campaigns I've ever seen. They've taken a company that is probably one of the greatest contributors to this economy — and turned it into one of the most maligned companies in the world.

And so you don't have to take my word for it, consider that Wal-Mart was the #1 most admired company, according to *Fortune*, in 2003 and 2004 — two years in a row. Now here we are, two years later, with the unions having gone at 'em, and they've fallen all the way down to 12th. And it's not based on some change in their operations. You have no idea of the power of the press that these unions have orchestrated.

Now a lot of people feel that because I'm talking about the unions, I'm making a political statement. Well, we try not to make political statements in these seminars. We just want to give you the reason why this stock is so cheap — and why it's selling on anger.

And the unions are being hypocrites....

Van Den Berg: And to give you an idea of the campaign underway by the unions, let me give you a quote from Joe Crump, who's a long-time UFCW leader. He said: "After a three-year struggle, the battle of Family Foods is over. Do we represent the employees? No. The company went out of business. But perhaps even more important is the message that has been sent to non-union competitors — that there is no free lunch in our jurisdiction."

The unions say Wal-Mart puts the small businessman out of business — but here they are, deliberately putting this company out of business just because it didn't want to unionize. So it's a very, very powerful campaign which the unions are launching against this wonderful company.

For some clients, it's like we committed a mortal sin....

Van Den Berg: When we bought Wal-Mart, we got more calls on it than almost any stock we've owned. Now it's true that we have more clients now, but it was *really*, *really* bad. And just to give you an idea of the kind of reaction we get, there's a wonderful, spiritual woman, who's been a client of ours for 25 years, who called me up and said to me with a quiver in her voice, "Arnold, I'm *so* disappointed in you — that you'd buy Wal-Mart." She sounded as if I'd just committed some terrible sin.

And to avoid identifying her, let me just call her Mary. So I said, "Mary, we bought Wal-Mart for the same reason we buy *all* of our stocks — because it's a value, and because we believe it contributes to the economy."

And she said, "But Wal-Mart gives all this business to China." I said, "I know that they give business to China. In 2004, they purchased about $18 billion worth of merchandise from China. But Wal-Mart spent $150 billion with 61,000 U.S. suppliers buying merchandise and services here at home. In addition, they also support over 3 million supplier jobs in the U.S."

But for many, emotion rules over facts....

Van Den Berg: So I laid it all out for her. And she finally said, "But you know, Wal-Mart is taking jobs away from Americans and giving it to people overseas." So I said, "Mary, I thought that *all* people were God's children — not just Americans. [Attendees laugh.] What's wrong with giving people overseas a job — especially since nobody here wants to run to China or Thailand to be a greeter at a Wal-Mart?"

There are people in Thailand who, because of poverty, are sold into sex slavery. So how bad can Wal-Mart be? It may be hard to believe — but if you've ever been hungry, anything can happen. And I know, because I was hungry during World War II. I can tell you that it *does* something to you. So anyway, I said, "I know Wal-Mart may not pay the highest wages, but don't you think these girls would be better off working at Wal-Mart than in some brothel?"

So finally she said, "Okay." But she still had us sell the stock. She just could not live with the fact that we bought Wal-Mart. That's the kind of irrational thinking that we're seeing from wonderful, well-meaning people. And it's all because they don't know the facts — or understand the value.

IT'S THE POOR WHO BENEFIT FROM WAL-MART MOST — MILLIONS OF EMPLOYEES AND CONSUMERS ALIKE.

It's the poorest segment that benefits most from Wal-Mart.

Van Den Berg: Wal-Mart has *$300* billion in sales. They've created 1.8 million jobs worldwide — 1.3 million of which are here in the U.S. — many of them opportunities for people with very few skills. It's truly extraordinary how a wonderful company like this, that was the most admired company two years in a row only two years ago, has become the most maligned company today. I mean, if you didn't know better, you would think that they were running a concentration camp.

Here's something else: A UBS/Warburg study found that Wal-Mart grocery prices are 17-29% less than other supermarkets. So they've been able to save the average household $2,300 a year to help them keep their costs down. And that's significant, because a lot of their customers have lower incomes. Even when you're talking about $2,300 on a $50,000 income, that's significant. But when you're talking about $2,300 on $10-12,000, it's *really* significant. That's a very big deal. So the poorest segment of the population are the people who benefit the most from Wal-Mart.

Wal-Mart's compensation package ain't all that bad....

Van Den Berg: And Wal-Mart pays its full-time hourly employees nearly double the federal minimum wage — $10.11 per hour on average. By comparison, H&R Block pays $8, Foley's pays $6.50, RadioShack pays $5.25,

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CENTURY MANAGEMENT'S
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Seven-Eleven pays $7.35, and McDonald's pays $6.25. So why aren't the unions complaining about *those* companies?

They've singled out Wal-Mart because they believe that if they can succeed in unionizing it, they can drive prices up and their grocery union can stay competitive. But that would be a total disservice to the U.S. economy and to the consumer.

And Wal-Mart provides health insurance to 1 million of their people in the U.S. They offer 18 different plans — and they recently began a new program for $11 a month.

Full-time employees are covered by health insurance after six months, and all part-time employees are covered after two years. There are few retailers that provide as many benefits. And in addition to health insurance, they also have a stock option program, and a 401(k) plan.

If Wal-Mart unionized, they would say goodbye to low prices.

Van Den Berg: Just look what happened in Canada. The union drug up some barmaid who left a bar to work for Wal-Mart. And she was unhappy with Wal-Mart — and she started organizing with the union. And I keep asking myself, "Did she have a stock option or 401(k) program at the bar? Did she have health insurance at the bar?" And they were mistreating her at Wal-Mart? This is the kind of nonsense the union promulgated.

So do you know what Wal-Mart did? They said, "Fine. If you're going to unionize, we'll close the store." And that's exactly what they did. They closed the store, and all those people lost their jobs — because Wal-Mart knows that if the union gets in there, they can forget about their low prices.

WMT contributes greatly to charity and people's welfare.

Van Den Berg: Wal-Mart makes a 3% profit on sales. Is that too much for a successful business? I don't think so. I don't think that a company can *survive* on anything less than that. This company produces jobs, and creates opportunities. In 2004, Wal-Mart paid $1.4 billion in state taxes and $4.1 billion in federal taxes. So they're certainly a contributor to our government. And in 2005, they donated $200 million to charity. That's an incredible contribution to charity — and more than a lot of companies have in sales.

Wal-Mart has won every conceivable award from minorities — from black and Hispanic foundations, among

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others — because of the number of Hispanics and blacks they employ in their stores. They have a work force of approximately 775,000 females, 139,000 Hispanics, 208,000 African-Americans, and over 220,000 seniors. Now if that isn't diversity... I'd like to see any company in America that has this kind of record. It is truly amazing.

At one time, this was one of the most admired companies. And quite frankly, given the contributions to the world that Sam Walton has made, I've long felt that he should have won a Nobel Prize — because 50 years ago, this man took $6,000 and started one of the most successful companies that's ever existed. Thanks to Sam Walton, people have the chance to own their stock, they have 401(k) plans, and they have health insurance. And consumers truly have lower prices.

Wal-Mart employs many who'd otherwise be unemployable.

Van Den Berg: But here is the most important thing that I love about Wal-Mart: They give people with literally no skills, who would normally be on welfare and on the unemployment lines, an opportunity to work.

My wife, Eileen, and I have done some work with the homeless. And I can tell you that the homeless are not just people who are drunks and who've given up on life. There are a lot of homeless people who are good people, but they just can't get a job because they don't have any skills. And when you don't have any skills these days, you're in trouble. So you can see what a wonderful contribution Wal-Mart makes to this economy — because without them, *more* people either would be homeless, unemployed, or unable to get a job.

My point is that there are a lot of people employed by Wal-Mart who could not get a job anywhere else. They take people off welfare, they take 'em out of the unemployment line, and give 'em a new start in life. And most of Wal-Mart's managers started in entry-level positions and worked their way up. Now for somebody who doesn't have good skills, that's a pretty appealing situation. And it just amazes me that Wal-Mart can integrate these people in their company — and have such an incredible operation. And to see this company so maligned when they do so much for this economy is truly appalling.

Current and potential employees are voting with their feet.

Van Den Berg: Again, Wal-Mart employs 1.3 million people in the U.S. alone. And you know that free markets sort everything out. Well, we've heard stories about the huge lines of people applying for jobs when Wal-Mart has opened stores. For example, when they opened a store in Oakland, California, there were *12,000* people applying for 350 jobs. If they were abusing people as bad as the media claims, do you think that there would be 12,000 people applying for these jobs? Do you think they're *stupid*? No, those people understand what's going on. They like the opportunity.

At a store they were opening in Chicago, there were 25,000 applicants — that's right, *25,000* — for 400 jobs. And that's the real test. No matter what *anybody* says about Wal-Mart, if you have that many people applying for jobs, you know that they're offering something of real value to these people....

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CENTURY MANAGEMENT'S
ARNOLD VAN DEN BERG & JIM BRILLIANT
(cont'd from preceding page)

WE NEVER BET OUR LIFE ON ONE STOCK.
BUT IF WE HAD TO, WAL-MART WOULD BE IT.

If I had to choose one opportunity, this would be it.

Van Den Berg: So you now know why good people are angry at Wal-Mart — because of this vicious campaign being run by the union. But let's review the actual numbers. Wal-Mart is selling at a totally irrational price. This is truly astounding.

When Wal-Mart was the most admired company, its stock was at $70. It fell to $42. That's a decline of 40%. Meanwhile, its sales per share have gone from $37 to $76 — up 105%. Its earnings per share have gone from $1.28 to $2.63 — so they're up 105%. Its dividend, from its peak stock price in 1999 to its 2005 low, has increased from $0.19 to $0.58 — up 205%. And its P/E is down from 55 to 16 — a decline of 71%.

It's hard to believe that one of the greatest companies in the world — with *incredible* growth potential all over the world — is selling for almost half the price, despite an increase in earnings and sales and opportunity.

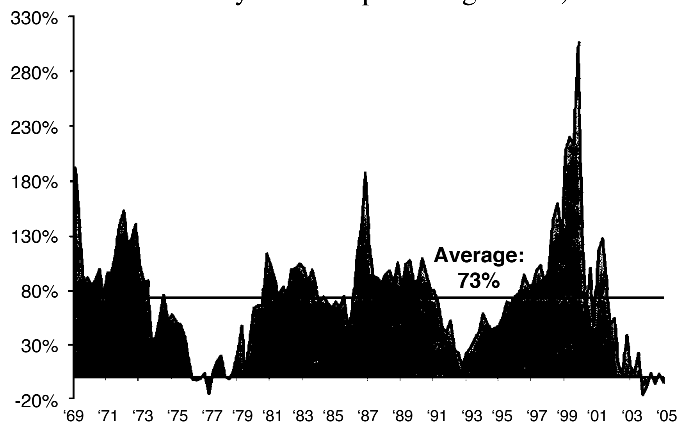
So that's the story on Wal-Mart. And that's why it's our third largest position. We can't guarantee you results on any one stock — and we don't bet our life on one stock. But if I had to choose one extraordinary opportunity — absent something *really* bad happening — this would be it.

People will only be bamboozled about Wal-Mart for so long.

Van Den Berg: This just shows you that a smear campaign — whether it's political, a union, or any other campaign of propaganda — can literally create a situation where a company that has made an enormous contribution to this economy, to consumers and to its employees, can become irrationally priced and sell at a bargain level.

Let me close on Wal-Mart by telling you it's like the old saying: There are three things you can't hide — the sun, the moon and the truth. People will eventually see through the smear campaign and understand what this wonderful company is really about.

CHART 7



Source: Compustat and The Leuthold Group

WE JUST GO WHERE THE VALUE IS —
AND TODAY, THE VALUE'S IN BIG-CAPS.

Opportunities like today's don't come along every day....

Van Den Berg: This last chart is a compilation of everything we've said in this seminar so far. And I think that it should sum up the opportunity in big-cap stocks. **(See CHART 7.)**

We've compared the earnings yield [i.e., earnings divided by stock price] on the top Blue Chip stocks to the yield on 10-year Treasury Bonds. I got the Treasury yields from Compustat. Then we estimated the earnings yields of the top 33 stocks in the Leuthold Group's Royal Blue Index — which is the crème de la crème of American companies. And when we did, we determined that, on average, historically, those Blue Chips have sold at 73% above par. In other words, on average, historically, they've been priced to yield over 40% less.

Why is that? Why does a stock usually sell for more than a bond? It's because the interest payment on a bond doesn't grow. For example, you may get a 5-6% yield on a bond, but the interest payment on that bond doesn't grow. With a stock, you can typically get growth of 6-7% — and sometimes even 10-11%.

So when a big-cap stock offers the same yield as a Treasury Bond, you've usually got a huge bargain — because not only do you get the same initial yield as a bond, but you also get the company's growth for free. So when you can buy a great company at the same yield as a bond, it's generally a great opportunity.

And as you can see in this chart, that's only happened three times during the last 30 years. So it's not something that you see every day. But that's the situation today.

Blue Chips at Treasury yields are great bargains.

Van Den Berg: And if you look at the '72 period that we talked about earlier, the Nifty-Fifty got up to about 150% of par before they went down. And when were they the real bargain? The real bargain was when they sold below the 10-year Treasury Bond level in 1977. It took five years for that consolidation. They bumped up a little bit, and then came back down. And in 1979, they were, again, a bargain when they hit a level equal to the Treasury Bond.

Do you know why that's such a great value? Think about it. If a top crème de la crème company gives you the same yield as a Treasury Bond, and then you're getting the 8-11% return from growth on top of that, it's a no-brainer. Look how much better off you are. So when these Royal Blue stocks provide the same yield as a Treasury Bond, they're a tremendous bargain.

And if you look at the next 25 years, you see that in 1987, the Royal Blue stocks got up to about a 180%

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CENTURY MANAGEMENT'S
ARNOLD VAN DEN BERG & JIM BRILLIANT
(cont'd from preceding page)

premium before they came crashing down. And in 1993, after the recession, they got within a few percent of par.

All the stars are aligned. It's an extraordinary opportunity.

Van Den Berg: Then in the tech bubble, they got to *280%* of par. If any of you would have been looking at this simple chart, you'd have known, without question, that these stocks were *grossly* overvalued. They were selling at a 280% premium to the Treasury Bond, when the greatest premium at which they'd ever sold before had been 180%. So you can see what an extraordinary overvaluation it was.

And the premium's been coming down ever since. And after six years, the yield is once again equal to the Treasury Bond. Just think about that. If you look back at a 35-year history of this index, there have been only *three* times when big-cap stocks had earnings yields equal to the Treasury Bond. And right now, they're even cheaper than they were in '77 and '93 — and those were during bear markets. That's not in absolute terms, but relative to interest rates and inflation.

So everything is now aligning — low interest rates, low inflation, 6 or 7 years of consolidation, and an increase of 100% in earnings. All of the stars are aligned today. That's why this is such an extraordinary opportunity.

We go where the value is. And today, it's in the big-caps.

Van Den Berg: The last time we had this many big-cap stocks in the Century Management portfolio was 23 years ago, when we were almost completely in big-caps. If you go through our 1983 portfolios, you'll see that we were loaded up to the gills. So we're not small-cap, mid-cap, or large-cap managers — we are *value* managers. We just go where the value is. And today, the value is in big-caps.

And as I showed you, we have a lower interest rate today than at almost any time during these years. So we've got a lot of cushion in our thesis.

The owners of these stocks have been suffering a long time.

Van Den Berg: The only other thing I can say about this situation is that we may be a little early. But it's so extraordinary, we'd rather be too early than too late. And so right now, we're in the zone of being able to buy a very small segment of the market owned by people who've suffered great pain since 1998 or 1999 and have had to go seven years with no gains. So these people are tired of these stocks — and they're selling 'em.

And do you know who the *biggest* sellers of these are? What was the biggest fad in 2000? Indexing. All you had to do was buy an index. You didn't need a money manager, or an actively-managed mutual fund. All you had to do was just buy an index and hang on.

Well, indexing is a great concept. I believe in indexing, but I believe in buying it when it's *cheap*. It doesn't matter whether you manage your portfolio or you buy an index — you've still got to buy it cheap. But lots of people bought indexes at the top of the market. And now, when they're selling an index, they're selling all of these stocks — and they're selling 'em to *us*. This is the most unloved sector of the market — and that's why we love it.

These stocks are extremely cheap, and have great futures.

Van Den Berg: I believe we've demonstrated that there are many times when markets can swing from extremes of optimism to extremes of pessimism. And three conditions have combined to create a situation where you're truly able to buy a house on the lake today for less than you can buy a similar house in a lesser neighborhood. This opportunity only comes along once every 15 or 20 years. We believe that these stocks are extremely cheap....

We may be a little bit early, the journey may be a little bit bumpy, but I think you're going to enjoy the ride. All aboard.

—OID

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