MARTIN J. WHITMAN MARTIN SHUBIK

THE AGGRESSIVE CONSERVATIVE INVESTOR



John Wiley & Sons, Inc.

MARTIN J. WHITMAN MARTIN SHUBIK

THE AGGRESSIVE CONSERVATIVE INVESTOR



Table of Contents

INTRODUCING WILEY INVESTMENT CLASSICS Title Page Copyright Page Dedication Acknowledgments Epigraph Foreword Introduction CHANGES IN TERMINOLOGY PERFORMANCE DATA THE DISCLOSURE EXPLOSION OUR CHANGED, OR MODIFIED, BELIEFS THE CHANGED ENVIRONMENT TROUBLESOME REGULATORY PROBLEMS CONCLUSION

SECTION ONE - THE APPROACH

<u>Chapter 1 - An Overview</u> <u>Chapter 2 - The Financial-Integrity Approach to Equity</u> <u>Investment</u>

<u>THE FINANCIAL-INTEGRITY APPROACH</u> <u>THE BENEFITS AND USES OF THE FINANCIAL-INTEGRITY</u> <u>APPROACH TO THE NONCONTROL INVESTOR</u> <u>THE SHORTCOMINGS OF THE FINANCIAL-INTEGRITY</u> <u>APPROACH</u> SECTION TWO - THE USES AND LIMITATIONS OF FUNDAMENTAL ANALYSIS AND TECHNICAL ANALYSIS

<u>Chapter 3 - The Significance of Market Performance</u>

THE "IDEALISTIC" VIEW OUTSIDERS, INSIDERS AND MARKET PRICE MARKET PERFORMANCE AND OVERALL PORTFOLIOS MEASURING MARKET PERFORMANCE PROFESSIONAL MONEY MANAGERS AND BEATING THE MARKET

PERSPECTIVE ON BAILOUTS AND THE SIGNIFICANCE OF MARKET PERFORMANCE

Chapter 4 - Modern Capital Theory

THE COMPUTER AND MATHEMATICAL ANALYSIS ON SYSTEMS FOR PLAYING THE MARKET ON ARBITRAGE PORTFOLIO BALANCING FUNDAMENTAL SECURITY ANALYSIS AND CORPORATE FINANCE CALCULATION OR EVALUATION

Chapter 5 - Risk and Uncertainty

ASSESSING THE INVESTMENT ODDS: RISK AND REWARD QUALITY OF THE ISSUER PRICE OF THE ISSUE FINANCIAL POSITION OF THE HOLDER PORTFOLIO DIVERSIFICATION VERSUS SECURITIES CONCENTRATION CONSIDERING THE CONSEQUENCES RISK AND INVESTMENT OBJECTIVES **SECTION THREE - DISCLOSURES AND INFORMATION**

Chapter 6 - Following the Paper Trail

A SUMMARY OF A PORTION OF SEC REGULATION 10 (B)5 AS IT PERTAINS TO DISCLOSURE THE DOCUMENTS AND HOW TO READ THEM OBTAINING THE DOCUMENTS WHAT THE PAPER TRAIL DOES FOR THE OUTSIDE INVESTOR WHAT THE PAPER TRAIL DOESN'T DO HOW GOOD IS THE PAPER TRAIL?

Chapter 7 - Financial Accounting

TYPES OF ACCOUNTING HOW TO UNDERSTAND FINANCIAL ACCOUNTING

Chapter 8 - Generally Accepted Accounting Principles

MYTHS AND REALITIES ABOUT THE MEANING OF GENERALLY ACCEPTED ACCOUNTING ... UNDERLYING GAAP ASSUMPTION 1 UNDERLYING GAAP ASSUMPTION 2 UNDERLYING GAAP ASSUMPTION 3 UNDERLYING GAAP ASSUMPTION 4 UNDERLYING GAAP ASSUMPTION 5 UNDERLYING GAAP ASSUMPTION 6 UNDERLYING GAAP ASSUMPTION 7 UNDERLYING GAAP ASSUMPTION 8 UNDERLYING GAAP ASSUMPTION 8 UNDERLYING GAAP ASSUMPTION 9 UNDERLYING GAAP ASSUMPTION 10 UNDERLYING GAAP ASSUMPTION 10 <u>MYTHS ABOUT THE SHORTCOMINGS OF THE CORPORATE</u> <u>AUDIT FUNCTION AND THE ETHICAL ...</u>

SECTION FOUR - THE FINANCIAL AND INVESTMENT ENVIRONMENT

<u>Chapter 9 - Tax Shelter (TS), Other People's Money (OPM),</u> <u>Accounting Fudge ...</u>

TAX CONSIDERATIONS OTHER PEOPLE'S MONEY SOMETHING OFF THE TOP (SOTT): SOME PRELIMINARIES SOME PRELIMINARIES ON THE ACCOUNTING FUDGE FACTOR (AFF) HOW IT ALL MESHES

Chapter 10 - Securities Analysis and Securities Markets

REASONS FOR ACQUIRING AND HOLDING SECURITIES PROFIT MARGINS SIZE LIBERAL ACCOUNTING POLICIES ADVANTAGES OF A LOW NET ASSET VALUE WALL STREET SPONSORSHIP THE TRADING ASSUMPTIONS VERSUS THE INVESTMENT ASSUMPTIONS CONVERTIBLE SECURITIES LIMITATIONS ON COMPARATIVE ANALYSIS

Chapter 11 - Finance and Business

HEAVY DEBT LOAD LARGE CASH POSITIONS DIVERSIFICATION VERSUS CONCENTRATION MANAGEMENT INCENTIVES ADVANTAGES OF HIGHLY CYCLICAL COMPANIES IN COMPETITIVE INDUSTRIES GOING PUBLIC AND GOING PRIVATE GOVERNMENT REGULATION WHO RUNS MOST COMPANIES? CONSOLIDATED VERSUS CONSOLIDATING FINANCIAL STATEMENTS NEGATIVE VAUES IN OWING ASSETS

SECTION FIVE - TOOLS OF SECURITIES ANALYSIS

Chapter 12 - Net Asset Values

THE USEFULNESS OF BOOK VALUE IN SECURITY <u>ANALYSIS</u> <u>BOOK VALUE AS ONE MEASURE OF RESOURCES</u> <u>BOOK VALUE AS ONE MEASURE OF POTENTIAL LIQUIDITY</u> <u>BOOK VALUE ANALYSIS AS A COMPETITIVE EDGE</u> LIMITATIONS OF BOOK VALUE IN SECURITY ANALYSES

Chapter 13 - Earnings

WEALTH OR EARNINGS? THE LONG - TERM EARNINGS RECORD "PARSING" THE INCOME ACCOUNT

<u>Chapter 14 - Roles of Cash Dividends in Securities Analysis</u> and Portfolio Management

<u>THE THREE CONVENTIONAL THEORIES</u> <u>CASH DIVIDENDS AS A FACTOR IN MARKET</u> <u>PERFORMANCE</u> <u>THE PLACEBO EFFECT OF CASH DIVIDENDS</u> CASH DIVIDENDS AND PORTFOLIO MANAGEMENT CASH DIVIDENDS AND LEGAL LISTS CASH DIVIDENDS AND BAILOUTS THE GOALS OF SECURITIES HOLDERS

<u>Chapter 15 - Shareholder Distributions, Primarily from the</u> <u>Company Point of View</u>

CASH DIVIDENDS OR RETAINED EARNINGS STOCK DIVIDENDS DISTRIBUTION OF ASSETS OTHER THAN CASH LIQUIDATION STOCK REPURCHASES

Chapter 16 - Losses and Loss Companies

QUALITY CONSIDERATIONS AND TAX - LOSS COMPANIES ON ACCOUNTING AND INCOME BE WARY OF ACQUIRING EQUITY SECURITIES OF THE ENCUMBERED FIRM COMMERCIAL BANKS' PORTFOLIO LOSSES THE "TURNED THE CORNER" THEORY

Chapter 16 - Losses and Loss Companies

QUALITY CONSIDERATIONS AND TAX-LOSS COMPANIES ON ACCOUNTING AND INCOME BE WARY OF ACQUIRING EQUITY SECURITIES OF THE ENCUMBERED FIRM COMMERCIAL BANKS' PORTFOLIO LOSSES THE "TURNED THE CORNER" THEORY

<u>Chapter 17 - A Short Primer on Asset-Conversion Investing:</u> <u>Prearbitrage and Postarbitrage</u>

POSTARBITRAGE

SECTION SIX - APPENDIXES—CASE STUDIES

Introduction to Appendixes I and II

Appendix I Appendix II Appendix III Appendix IV ABOUT THE AUTHORS INDEX

INTRODUCING WILEY INVESTMENT CLASSICS

There are certain books that have redefined the way we see the worlds of finance and investing—books that deserve a place on every investor's shelf. *Wiley Investment Classics* will introduce you to these memorable books, which are just as relevant and vital today as when they were first published. Open a *Wiley Investment Classic* and rediscover the proven strategies, market philosophies, and definitive techniques that continue to stand the test of time. MARTIN J. WHITMAN MARTIN SHUBIK

THE AGGRESSIVE CONSERVATIVE INVESTOR



Copyright © 1979 by Martin J. Whitman and Martin Shubik. All rights reserved. Foreword copyright © 2006 by John Wiley & Sons, Inc. All rights reserved. Introduction copyright © 2006 by Martin J. Whitman and Martin Shubik. All rights reserved.

> Published by John Wiley & Sons, Inc., Hoboken, New Jersey. Published simultaneously in Canada. Originally published in 1979 by Random House.

No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means, electronic, mechanical, photocopying, recording, scanning, or otherwise, except as permitted under Section 107 or 108 of the 1976 United States Copyright Act, without either the prior written permission of the Publisher, or authorization through payment of the appropriate per-copy fee to the Copyright Clearance Center, Inc., 222 Rosewood Drive, Danvers, MA 01923, (978) 750-8400, fax (978) 750-4470, or on the web at www.copyright.com. Requests to the Publisher for permission should be addressed to the Permissions Department, John Wiley & Sons, Inc., 111 River Street, Hoboken, NJ 07030, (201) 748-6011, fax (201) 748-6008, or online at <u>http://www.wiley.com/go/permissions</u>.

Limit of Liability/Disclaimer of Warranty: While the publisher and author have used their best efforts in preparing this book, they make no representations or warranties with respect to the accuracy or completeness of the contents of this book and specifically disclaim any implied warranties of merchantability or fitness for a particular purpose. No warranty may be created or extended by sales representatives or written sales materials. The advice and strategies contained herein may not be suitable for your situation. You should consult with a professional where appropriate. Neither the publisher nor author shall be liable for any loss of profit or any other commercial damages, including but not limited to special, incidental, consequential, or other damages.

For general information on our other products and services or for technical support, please contact our Customer Care Department within the United States at (800) 762-2974, outside the United States at (317) 572-3993 or fax (317) 572-4002.

Wiley also publishes its books in a variety of electronic formats. Some content that appears in print may not be available in electronic books. For more information about Wiley products, visit our web site at <u>www.wiley.com</u>.

Library of Congress Cataloging-in-Publication Data

Whitman, Martin J. The aggressive conservative investor / Martin J. Whitman, Martin Shubik. p. cm. Originally published: New York: Random House, c1979. Includes bibliographical references and index. ISBN-13: 978-0-471-76805-0 (pbk.) ISBN-10: 0-471-76805-7 (pbk.) 1. Investments. I. Shubik, Martin, joint author. II. Title.

> HG4521.W474 2006 332.67'8—dc22 2005051067

To Lois, Jim, Barbara and Tom Whitman, and to Julie and Claire Shubik

ACKNOWLEDGMENTS

This book had a lengthy gestation period, during which we were helped by numerous people who read the manuscript, or portions of the manuscript, and made many invaluable suggestions. The names are too numerous to mention but our thanks go to them all—family members, friends, students, Wall Street practitioners, accountants, tax lawyers, securities lawyers and academic colleagues at Yale and other universities.

Two people worked especially diligently in bringing this book to fruition—Albert Erskine, our editor, and Marilyn Hainesworth, administrative vice-president of M. J. Whitman and Co. Inc., who oversaw the many housekeeping chores involved in preparing the manuscript.

Errors and shortcomings, of course, belong to us alone.

The difficulty lies, not in the new ideas, but in escaping from the old ones, which ramify, for those who have been brought up, as most of us have been, into every corner of our minds. J. M. KEYNES

FOREWORD

I first met Marty Whitman and Martin Shubik while we were students at Princeton Graduate School. We played poker together on a regular basis, often well into the night. I doubt if any real money ever changed hands, probably because we had none to wager, but when we reminisce about that time we each remember being the big winner. While we may have been gamblers at the time, Marty and Martin have taken few gambles since, either with their own money or with the money entrusted to them by investors. I didn't recognize it then, but they were starting to exhibit the tendencies that would make them successful investors. They knew when to take the calculated risk, when the payoff merited exposure, when to cut their losses, and when to raise the ante. I guess it proves the old adage "If a dog is going to bite, he's going to do it as a pup."

Obviously I have known the authors for a long time, Marty Whitman in particular. I know he is smart, honest, and successful, three characteristics I admire not only in business associates but also in friends. That he is successful should come as no surprise and would be a given for anyone who proposes to write a book on investing. After all, who would buy a book from someone with a history of breaking even? But Marty has taken success to levels most portfolio managers are hard-pressed to imagine. For example, since 1984 he has been the principal at Equities Strategies Fund and Third Avenue Value Fund, while Martin served the same two firms as an independent director. During that time, directed by the investment strategies outlined in this book, these funds on average vastly outperformed any relevant market index on a long-term basis, and for a majority of the time.

I can also speak from personal experience. Marty has served on the boards of both public companies of which I have been chief executive officer and today is the lead director on the Nabors Industries board. He is a man of extraordinary wisdom and insight, and I can honestly say I never make a major move without his input. He is the king of due diligence, spending an enormous amount of time collecting and analyzing information before pulling the trigger on any transaction. I have heard it said that he has been extremely fortunate in some of his investment decisions, but I have observed that the harder he works the luckier he gets.

His counsel has served me well on many occasions and in a broad range of situations. For instance, he advised me on a passive investment in a Japanese company called Tokio Marine, which netted the first serious money I ever made. I subsequently sought his counsel on my very first acquisition. I had let my ego usurp my good sense, agreeing to personally guarantee a note we had issued to the seller. Marty told me to get out of the guarantee or get out of the deal, and that if I didn't take his advice I should never ask for it again. I did, and I still look back on that as representative of the kind of nononsense, pragmatic perspective that has characterized his investment history.

More recently Marty's financial acumen and market savvy were invaluable in the issuance of a \$700 million convertible debenture with zero coupon and zero accrued interest. He recommended that Nabors take advantage of this low-cost capital even though we didn't need the money at the time. We followed his advice, and it gave us much greater financial flexibility. So what makes this book unique? It certainly goes against conventional wisdom. For instance, the philosophy of safe and cheap investing ignores price fluctuations for securities and other market risks, guarding only against investment risk, something going wrong with the company, or with the interpretation of securities covenants. Likewise, relying on the "Nifty Fifty" or the top 100 common stocks of large, wellorganized companies as the only source of high-quality investments has been abandoned. Discarded also is the notion that a concept of general risk is useful for analysis. Macro data, such as predictions about general stock market averages, interest rates, GDP, and consumer spending, have been abandoned as irrelevant as long as such investments are undertaken in countries marked by political stability and an absence of violence in the streets.

But this book is not about what the authors don't believe. The nuggets in this book are what they do believe, like the principle of "good enough," which encourages investors to content themselves when a good return has been realized, even if it is not perfect. Adhering to a long-term philosophy is also bedrock investment advice, which the authors personally subscribe to and encourage, regardless of the age of the investor. Another key principle involves taking advantage of the era of expanded corporate disclosure, closely scrutinizing a company's public communications to direct or influence investment decisions. Of course, the principle of buying stocks that are safe and cheap is at the heart of this book and is a philosophy every serious investor should embrace.

Who should read this book? The obvious answer would be anyone looking to develop a sound investment strategy, or anyone striving to incorporate into a portfolio some useful ideas that bring value long-term. However, it is equally valuable for anyone who runs a business, or aspires to run one. Many of the principles that direct the Nabors operating philosophy, and that are responsible for the success we have achieved in spite of the cyclical nature of our markets, are direct parallels to personal strategies espoused by the authors. There are many examples. Like the authors, we downplay the macro, refusing to overly concern ourselves with the price of commodities. When prices are up the company has impressive earnings, but when they are down we use our liquidity to make acquisitions, or grow organically if conditions are favorable. We also understand that access to capital is critical for companies in a growth mode, following the authors' recommendation to gain that access before we need it. Simply stated, the time to borrow is different from the time to spend.

The Aggressive Conservative Investor is a must-read for any investor looking to develop a sound, long-term growth strategy and should be a fixture in every business library. The authors have the ability to take complex financial concepts and articulate them in terms that virtually anyone can understand. They describe this as the bridge between Wall Street and Main Street. I think you will find it a bridge worth crossing.

Eugene M. Isenberg Chairman of the Board Nabors Industries July 2005

INTRODUCTION

Dramatic changes have occurred since *The Aggressive Conservative Investor* was published in 1979. The basic thesis of the book—emphasizing financial integrity—remains at least as valid today as it was then, and because of subsequent developments, may be even more valid now. Moreover, changes since 1979 in the disclosure area, it seems to us, have made it easier for a diligent person to become a successful aggressive conservative investor than was possible in the late 1970s.

The Aggressive Conservative Investor includes six major areas that warrant review today:

- Changes in terminology
- Performance data
- The disclosure explosion
- Our changed, or modified, beliefs
- The changed environment
- Troublesome regulatory problems

CHANGES IN TERMINOLOGY

When we initially wrote *The Aggressive Conservative Investor*, we named our strategy "the financial-integrity approach." We now like to think of it as "the safe and cheap approach" (which sounds less pompous and is more direct).

For a common stock to be an attractive investment, *The Aggressive Conservative Investor* outlined four essential characteristics:

- The company ought to have a strong financial position that is measured not so much by the presence of assets as by the absence of significant encumbrances, whether a part of a balance sheet, disclosed in financial statement footnotes, or an element that is not disclosed at all in any part of financial statements.
- The company ought to be run by reasonably honest management and control groups, especially in terms of how cognizant the insiders are of the interests of outside security holders.
- There ought to be available to the investor a reasonable amount of relevant information that is akin to full disclosure, though this will always be something that falls somewhat short of the mark.
- The price at which the equity security can be bought ought to be below the investor's reasonable estimate of net asset value.

These four characteristics describe common stock investment under both a financial-integrity approach and a safe and cheap approach. Especially since there have been quantum improvements in the quantity and quality of information available, these four concepts hold as firm today as in 1979.

The other terminology change is the use of the acronym OPMI (outside passive minority investor) to describe outside investors and passivists as well as non-control and unaffiliated security holders. OPMIs run the gamut from day traders to most institutional investors to safe and cheap investors who do not seek elements of control over the companies in which they hold securities positions. The reason for using the term *OPMI* rather than *investor* is that the word *investor* is one of the most misused and misunderstood words on Wall Street. Most of the time it seems as if those using the term *Investor* really mean shortrun speculator—either individual or institutional—so we've mostly discontinued use of the word *investor* in favor of *OPMI*.

PERFORMANCE DATA

Since 1984, the authors have been either the principal, or an independent director or trustee of two mutual funds— Equities Strategies Fund and Third Avenue Value Fund whose modus operandi has been to follow the safe and cheap approach in investing in securities.

How have the two funds fared from 1984 through mid-2005? They have vastly outperformed any relevant market index on a long-term basis, on average, and for a majority of the time. Efficient market theorists will carp that the funds have not outperformed relevant indexes consistently. *Consistently* is really a dirty word meaning all the time. In investing, *consistently* should have relevance only for day traders, not long-term buy-and-hold investors.

A comparison of the Equity Strategies Fund's performance with that of the Standard & Poor's 500 Index is contained in <u>Table I.1</u>. We took over management of Equity Strategies in April 1984. Prior to that, the fund was invested in options. In 1994, Equities Strategies Fund was merged into Nabors Industries on a basis where each one share of Equity Strategies received 5.84 shares of Nabors Industries common. An investor investing \$10,000 in Equity Strategies in April 1984 would own Nabors common stock with a market value of over \$286,000, in April 2005. This equals a compound annual return for the 21 years of 17.2%.

Before the Nabors merger, Equity Strategies was a unique mutual fund in that it always was fully taxed as a subchapter C corporation, and never qualified, like all other mutual funds, as a subchapter M corporation. M

corporations do not pay federal income tax as long as they distribute all their income and net capital aains to shareholders. Despite being required to accrue a liability for deferred capital gains taxes on unrealized appreciation, a \$10,000 investment in Equity Strategies had a market value of \$38,643 as of April 30, 1994. A comparable \$10,000 investment in the S&P 500 Index had a market value of \$23,163 as of April 30, 1994. If Equity Strategies had reported its net asset value the same way M corporations reported theirs, the Equity Strategies market value would have been approximately \$52,000 in April 1994 after adding back to net asset value the liability for deferred capital gains taxes on unrealized appreciation. At that point in 1994, the compound annual returns on the Equity Strategies investment was approximately 16.2% before deducting the reserves for capital gains taxes on unrealized appreciation.

Third Avenue Value Fund came into existence on November 1, 1990. Since then its performance has tracked that of Equity Strategies with a compound annual return since inception of 16.8%. The annual performance of Third Avenue Value Fund compared with the S&P 500 Index is shown in <u>Table I.2</u>.

TABLE I.1 EQUITY STRATEGIES FUND V. S&P 500

Return Investment Value of Investment Return Investment Value of Investment Value of Investment				Equity Strategies Fund	pun		S&P 500 Index	
4/30/84 \$10,000.00 \$10,000.00 \$10,000.00 4/30/85 5.08% \$10,000.00 \$10,508.00 \$10,000.00 4/30/86 24.69% \$10,000.00 \$13,102.43 \$10,000.00 4/30/87 18.87% \$10,000.00 \$13,102.43 \$10,000.00 4/30/87 18.87% \$10,000.00 \$15,574.85 \$10,000.00 4/30/88 3.02% \$10,000.00 \$15,574.85 \$22,435% \$10,000.00 4/30/80 17.28% \$10,000.00 \$15,574.85 \$22,435% \$10,000.00 4/30/90 29.64% \$10,000.00 \$15,574.85 \$22,689% \$10,000.00 4/30/91 21.12% \$10,000.00 \$24,395.43 \$10,658% \$10,000.00 4/30/92 29.64% \$10,000.00 \$22,547.74 \$17.541% \$10,000.00 4/30/93 41.25% \$10,000.00 \$22,547.74 \$17.541% \$10,000.00 4/30/93 41.25% \$10,000.00 \$23,547.74 \$17.541% \$10,000.00 4/30/93 41.25% \$10,000.00 \$23,547.74 \$17.541% \$10,000.00 4/30/93 41.25% \$10,000.00 \$38,642.98 \$10,000.00 \$10,000.00 10.55% 41.25% \$10,000.00			Return	Investment	Value of Investment	Return	Investment	Value of Investment
4/30/85 5.08% \$10,000.00 \$10,508.00 -0.094% \$10,000.00 4/30/87 18.87% \$10,000.00 \$13,102.43 -1.126% \$10,000.00 4/30/87 18.87% \$10,000.00 \$15,574.85 \$24,35% \$10,000.00 4/30/88 3.02% \$10,000.00 \$15,645.21 \$4,39% \$10,000.00 4/30/89 17.28% \$10,000.00 \$18,817.83 \$22.435% \$10,000.00 4/30/90 29.64% \$10,000.00 \$18,817.83 \$22.689% \$10,000.00 4/30/91 21.12% \$10,000.00 \$234,395.43 \$10,658% \$10,000.00 4/30/92 29.64% \$10,000.00 \$22,435.43 \$10,658% \$10,000.00 4/30/92 -2.61% \$10,000.00 \$235,4774 \$17.541% \$10,000.00 4/30/92 -2.61% \$10,000.00 \$235,4774 \$17.541% \$10,000.00 4/30/93 41.25% \$10,000.00 \$38,642.98 \$10,000.00 \$38,642.98 \$10,000.00 * 4/05/94 -4,93% \$10,000.00 \$38,642.98 \$10,900.00 \$13,9000.00	1 YEAR	4/30/84		\$10,000.00	\$10,000.00		\$10,000.00	\$10,000.00
4/30/86 24.69% \$10,000.00 \$13,102.43 -1.126% \$10,000.00 4/30/87 18.87% \$10,000.00 \$15,574.85 \$21,435% \$10,000.00 4/30/88 3.02% \$10,000.00 \$15,045.21 -8.439% \$10,000.00 4/30/89 17.28% \$10,000.00 \$18,817.83 22.689% \$10,000.00 4/30/90 29.64% \$10,000.00 \$24,395.43 10.658% \$10,000.00 4/30/91 21.12% \$10,000.00 \$24,395.43 10.658% \$10,000.00 4/30/91 21.12% \$10,000.00 \$23,547.74 17.541% \$10,000.00 4/30/92 -2.61% \$10,000.00 \$23,547.74 17.541% \$10,000.00 4/30/93 41.25% \$10,000.00 \$23,547.74 17.541% \$10,000.00 4/30/93 41.25% \$10,000.00 \$23,547.74 17.541% \$10,000.00 4/30/93 41.25% \$10,000.00 \$38,642.98 \$10,000.00 \$38,642.98 \$10,000.00 * 4/05/94 -4,93% \$10,500.00 \$38,642.98 \$13,93% \$10,000.00	1 YEAR	4/30/85	5.08%	\$10,000.00	\$10,508.00	-0.094%	\$10,000.00	\$9,990.60
4/30/87 18.87% \$10,000.00 \$15,574.85 22.435% \$10,000.00 4/30/88 3.02% \$10,000.00 \$16,045.21 -8.439% \$10,000.00 4/30/89 17.28% \$10,000.00 \$18,817.83 22.689% \$10,000.00 4/30/90 29.64% \$10,000.00 \$24,395.43 10.658% \$10,000.00 4/30/91 21.12% \$10,000.00 \$224,395.43 10.658% \$10,000.00 4/30/92 -2.61% \$10,000.00 \$224,395.43 10.658% \$10,000.00 4/30/92 -2.61% \$10,000.00 \$224,395.43 10.658% \$10,000.00 4/30/92 -2.61% \$10,000.00 \$238,776.55 13.980% \$10,000.00 4/30/93 41.25% \$10,000.00 \$38,642.98 \$5.320% \$10,000.00 * 4/05/94 -4.93% \$10,000.00 \$38,642.98 \$5.320% \$10,000.00 * 200 Index is as of April 30, 1994. \$10,94.298 \$5.320% \$10,000.00 \$10,94.20	1 YEAR	4/30/86	24.69%	\$10,000.00	\$13,102.43	-1.126%	\$10,000.00	\$9,878.11
4/30/88 3.02% \$10,000.00 \$16,045.21 -8.439% \$10,000.00 4/30/80 17.28% \$10,000.00 \$18,817.83 22.689% \$10,000.00 4/30/90 29.64% \$10,000.00 \$24,395.43 10.658% \$10,000.00 4/30/91 21.12% \$10,000.00 \$24,395.43 10.658% \$10,000.00 4/30/91 21.12% \$10,000.00 \$22,547.74 17.541% \$10,000.00 4/30/92 -2.61% \$10,000.00 \$28,776.55 13.980% \$10,000.00 4/30/93 41.25% \$10,000.00 \$38,642.98 \$5.320% \$10,000.00 * 4/05/94 -4.93% \$10,000.00 \$38,642.98 \$5.320% \$10,000.00 * 200 Index is as of April 30, 1994. \$10.94. \$10.94. \$10.94. \$10.94.	1 YEAR	4/30/87	18.87%	\$10,000.00	\$15,574.85	22.435%	\$10,000.00	\$12,094.26
4/30/89 17.28% \$10,000.00 \$18,817.83 22.689% \$10,000.00 4/30/90 29.64% \$10,000.00 \$24,395.43 10.658% \$10,000.00 4/30/91 21.12% \$10,000.00 \$23,547.74 17.541% \$10,000.00 4/30/92 -2.61% \$10,000.00 \$28,776.55 13.980% \$10,000.00 4/30/93 41.25% \$10,000.00 \$23,547.74 17.541% \$10,000.00 4/30/93 -41.25% \$10,000.00 \$23,776.55 13.980% \$10,000.00 * 4/05/94 -4.93% \$10,000.00 \$33,642.98 \$5.320% \$10,000.00 * 200 Index is as of April 30, 1994. \$1994. \$10,994. \$10,994. \$10,994.	1 YEAR	4/30/88	3.02%	\$10,000.00	\$16,045.21	-8.439%	\$10,000.00	\$11,073.62
4/30/90 29.64% \$10,000.00 \$24,395.43 10.658% \$10,000.00 4/30/91 21.12% \$10,000.00 \$29,547.74 17.541% \$10,000.00 4/30/92 -2.61% \$10,000.00 \$28,776.55 13.980% \$10,000.00 4/30/93 41.25% \$10,000.00 \$240,646.87 9.193% \$10,000.00 * 4/05/94 -4.93% \$10,000.00 \$38,642.98 \$5.320% \$10,000.00 P 500 Index is as of April 30, 1994. P 500 Index is as of April 30, 1994. \$10,000.00 \$10,000.00 \$10,000.00	1 YEAR	4/30/89	17.28%	\$10,000.00	\$18,817.83	22.689%	\$10,000.00	\$13,586.12
4/30/91 21.12% \$10,000.00 \$29,547.74 17.541% \$10,000.00 4/30/92 -2.61% \$10,000.00 \$28,776.55 13.980% \$10,000.00 4/30/93 41.25% \$10,000.00 \$40,646.87 9.193% \$10,000.00 * 4/05/94 -4.93% \$10,000.00 \$38,642.98 5.320% \$10,000.00 P 500 Index is as of April 30, 1994. P P P P P P	1 YEAR	4/30/90	29.64%	\$10,000.00	\$24,395.43	10.658%	\$10,000.00	\$15,034.13
4/30/92 -2.61% \$10,000.00 \$28,776.55 13.980% \$10,000.00 4/30/93 41.25% \$10,000.00 \$40,646.87 9.193% \$10,000.00 * 4/05/94 -4.93% \$10,000.00 \$38,642.98 5.320% \$10,000.00 P 500 Index is as of April 30, 1994. P 500 Index is as of April 30, 1994. P 500 Index is as of April 30, 1994. P 500 Index is as of April 30, 1994.	1 YEAR	4/30/91	21.12%	\$10,000.00	\$29,547.74	17.541%	\$10,000.00	\$17,671.26
4/30/93 41.25% \$10,000.00 \$40,646.87 9.193% \$10,000.00 4/05/94 -4.93% \$10,000.00 \$38,642.98 5.320% \$10,000.00 500 Index is as of April 30, 1994. 5.320% \$10,000.00 \$38,642.98 \$33,642.98 \$10,000.00	1 YEAR	4/30/92	-2.61%	\$10,000.00	\$28,776.55	13.980%	\$10,000.00	\$20,141.71
4/05/94 -4.93% \$10,000.00 \$38,642.98 5.320% \$10,000.00 500 100 500 100 100 100 100 100 100 1	1 YEAR	4/30/93	41.25%	\$10,000.00	\$40,646.87	9.193%	\$10,000.00	\$21,993.33
S&P 500 Index is as of April 30, 1994.	1 YEAR	4/05/94	-4.93%	\$10,000.00	\$38,642.98	5.320%	\$10,000.00	\$23,163.38
	*S&P 5(00 Index is as of	April 30, 1994.					

Besides Equity Strategies and Third Avenue Value Fund, other investment vehicles following a safe and cheap approach also have outperformed relevant indexes. Three of these funds are sister funds to Third Avenue Value: Third Avenue Small Cap, Third Avenue Real Estate, and Third Avenue International Value. Professor Louis Lowenstein of Columbia University Law School in an October 11, 2004, article in *Barron's*, reviewed the performance of 10 wellregarded value funds from 1999 through 2003. All 10 outperformed the S&P 500 for the period. The other funds compared were FPA Capital, First Eagle Global, Legg Mason Value, Longleaf Partners, Mutual Beacon, Oak Value, Oakmark Select, Source Capital, and Tweedy Brown American. In short, very good performance results have been obtained a majority of the time by those funds that have followed a safe and cheap approach or a reasonable facsimile thereof.

Consequently, during the last 26 years, the efficient market hypothesis (EMH) and efficient portfolio theory (EPT) have been increasingly discredited insofar as EMH and EPT purport to describe a generalized stock market behavior. EMH and EPT just do not describe value investing—never have, never will. Rather, EMH and EPT describe a very narrow special case. EMH and EPT describe financial markets populated solely by day traders vitally affected by immediate price movements in securities. These market participants are strictly top-down speculators devoid of virtually any bottom-up knowledge about a company or the securities it issues. This just isn't most markets and it probably isn't most investors. Not only do EMH and EPT fail to describe the safe and cheap investor, the theories also are utterly devoid of any realistic explanations about the operations and techniques of control investors, a group that heavily influences the dynamics of most financial markets.

TABLE I.2 THIRD AVENUE VALUE FUND V. S&P 500

		Third Avenue Value Fund	pu		S&P 500	
	Return	Investment	Value of Investment	Return	Investment	Value of Investment
					\$10,000.00	\$10,000.00
1990	8.60%	\$10,000.00	\$10,860.00	9.43%	\$10,000.00	\$10,943.00
1991	34.41%	\$10,000.00	\$14,596.93	30.46%	\$10,000.00	\$14,276.24
1992	21.29%	\$10,000.00	\$17,704.61	7.62%	\$10,000.00	\$15,364.09
1993	23.66%	\$10,000.00	\$21,893.52	10.08%	\$10,000.00	\$16,912.79
1994	-1.46%	\$10,000.00	\$21,573.88	1.32%	\$10,000.00	\$17,136.04
1995	31.73%	\$10,000.00	\$28,419.27	37.58%	\$10,000.00	\$23,575.76
1996	21.92%	\$10,000.00	\$34,648.77	22.96%	\$10,000.00	\$28,988.75
1997	23.87%	\$10,000.00	\$42,919.43	33.36%	\$10,000.00	\$38,659.40
1998	3.92%	\$10,000.00	\$44,601.88	28.58%	\$10,000.00	\$49,708.26
1999	12.82%	\$10,000.00	\$50,319.84	21.04%	\$10,000.00	\$60,166.87
2000	20.76%	\$10,000.00	\$60,766.23	-9.11%	\$10,000.00	\$54,685.67
2001	2.82%	\$10,000.00	\$62,479.84	-11.88%	\$10,000.00	\$48,189.01
2002	-15.19%	\$10,000.00	\$52,989.15	-22.10%	\$10,000.00	\$37,539.24
2003	37.08%	\$10,000.00	\$72,637.53	28.69%	\$10,000.00	\$48,309.25
2004	26.60%	S10.000.00	\$91.959.12	10.88%	\$10,000.00	\$53.565.30

THE DISCLOSURE EXPLOSION

The improvements in the disclosure scene since 1979 have been dramatic and far-reaching. This has happened in two areas—substantive disclosures and improved delivery

systems. As a consequence, there is a vast improvement in and quality of disclosures, especially the amount documentary disclosures, available to those using the safe and cheap approach. The Aggressive Conservative Investor seems to have understated the degree of knowledge one can obtain about a company and the securities it issues by relying solely on the public record. The book, however environment disclosure for the accurate in 1979. inadequately describes the guantity and guality of disclosures available in 2005.

The role of disclosure ought to be to provide outside investors the same level of disclosure that is provided to an investor with clout (e.g., commercial bank lenders) who are able to undertake due diligence. The Securities and Exchange Commission (SEC) and the Financial Accounting Standards Board (FASB) seem to have done a pretty good job from the point of view of the safe and cheap investor.

For the vast majority of issuers—excluding Enron and Worldcom—disclosure documents seem to be prepared on the basis that companies, their officers, and their directors do not want to be sued, and especially not sued successfully. Thus, there is a tendency in public documents to disclose all admissions against interest, however remote. Such laundry lists give safe and cheap investors an unweighted for probabilities inventory of what could conceivably go wrong. Almost the first question any safe and cheap investor asks is what could go wrong. Having a carefully prepared list of risk factors helps answer that guestion. This laundry list of risk factors is contained for U.S. issuers in Form 10-K, Form 10-Q, Form 8-K, prospectuses for the cash sale of securities, merger proxy statements, exchange of securities documents, and cash tender offers. They are also contained in the footnotes to financial statements that comply with GAAP.

Chief executive officer letters and other communications to stockholders seem to have become more comprehensive. more complete, and, in many ways, more honest in terms of what management thinks about long-term promises and problems. Admittedly, most management communications do seem to focus on the immediate earnings outlook, something not of much interest to the safe and cheap investor. Nonetheless, communication seems to have vastly improved since 1979. Top management communications are contained in annual reports to stockholders, quarterly stockholders, teleconferences. to investor reports conferences, and one-on-one meetings.

Principal new disclosures since 1979 that have been a boon to safe and cheap investors both as put forward by the SEC and FASB include the following:

- Integrated disclosure between the Securities Act of 1933 and the Securities and Exchange Act of 1934.
- Disclosure of earnings forecasts under rules that provide forecasters a safe harbor from liabilities for forecasts, which while honestly made, turn out to be wrong.
- Expanded proxy statement disclosures that include (1) existence and functions of various committees; (2) attendance record of directors and committee members; (3) expanded transactions detailing relationships between the company and its insiders; (4) resignations of directors and top officers.
- Environmental disclosures.
- Reserve recognition accounting (RRA) for exploration and production oil and gas issuers.
- Management discussion and analysis of financial condition and results of operations (MDA) implemented and eventually expanded. This is a quarterly filing.

- Expedited use of Form 20-F for foreign issuers (equivalent of a Form 10-K for a U.S. domiciled issuer).
- Summary sections in prospectuses and merger proxy statements.
- Shelf registrations.
- Disclosure of rating agency ratings.
- New real estate guidelines.
- Edgar and other electronic communications—a virtual revolution in delivery systems mightily benefiting safe and cheap investors. In 1979, obtaining documents filed with the SEC but not mailed to securities holders (Forms 10-K, 10-Q, 8-K) tended to be cumbersome or relatively expensive.
- Electric and gas utility guide.
- Financial reporting requirements for banks and bank holding companies.
- Consolidating financial statements distinguishing between guarantor subsidiaries and nonguarantor subsidiaries.
- Increased disclosure of management backgrounds.
- Sales and income by industries sector disclosures.
- Sales and income by geography disclosures.
- Basis for accounting estimates disclosures.
- Cash flow reporting.
- Expanded Form 8-K reporting.
- Reporting comprehensive income.
- Disclosure of information about capital structure.
- Accounting for income taxes.
- Accounting for leases.

Increasingly there has been disclosure of non-GAAP financial measures regulated by the SEC under Regulation G. Non-GAAP financial measures include periodic cash flow data and various appraisal values. Hopefully, disclosures of non-GAAP financial measures, used as a supplement to GAAP, rather than as a substitute for GAAP, will continue to