Transcript from Front Street Capital Management

Annual Investor Meeting – May 13, 2009

Thanks everyone for coming. We are just going to skip over all of the formalities and dive right into this thing because we have a lot to cover tonight. Last year we talked extensively about the economics of the banking industry. I am just going to reiterate the same theory that we talked about last year. I think it all came to pass one year too early.

There are a lot of complicated side shows that have occurred over the past year. In my opinion, you can break this whole thing down into some fairly simple terms. I think that most things that a lot of people try to make very complicated, if you take a few minutes to peel the onion back, you can get to the core of the matter by understanding the pure supply and demand of the economics of the problem.

The core of the banking business is fairly straight forward; banks borrow money and then they lend it out at a higher rate. There are two determinants as to what the bank's profit margins are on these loans, or what we call spreads. The two determinants are credit spreads and yield spreads. A credit spread is the difference between the rate a BBB borrower would borrow and the rate that an AAA borrower would borrow. The difference between those two is part of the bank's profit margin on their loans. The wider that margin, or spread, the more the lucrative the business while the narrower the margin, the less lucrative the business is. A yield spread, on the other hand, is the difference between what they could get on a one year loan versus a two year loan versus a five year loan versus a ten year loan. The longer the loan is for, the more interest rate risk there is in that instrument. Theoretically, you would think that they should get paid more for loaning the money out for a longer period of time. The steeper the curve is, or the larger the spread between the one year and the five year, the greater the profit margin for the financial institution while the narrower the spread, the less the profit margin for the financial institution. This difference between the yield spreads is called the yield curve.

So the story for tonight begins around 2003 (Slide 3). Both credit spreads and yield spreads began to compress. They continued to compress until about 2006, when they had literally collapsed. This collapse meant that a BBB borrower could get fairly the same rate as an AAA borrower and the yield curve was flat as a pancake. There was no difference between a one year and a five year treasury note; they were almost the same rate. In fact, there were several points in time during that period where short-term rates were actually higher than long-term rates; called an inverted yield curve. The result of this was that financial institutions faced very poor economics on each loan that they made. This is where most public companies get into trouble. There is an enormous pressure, particularly on public companies, to grow year after year, quarter after quarter, even month after month. It causes managers to do strange things. Unfortunately, the world is not linear. So many managers try to force their business to become linear when the world is not. In fact, this is where investors tend to get themselves into trouble. There is a need to have your investments grow in a straight line. And again, the world is not linear. Interestingly enough, investors did not throw their money at Bernie Madoff because he was promising such incredibly high returns. They threw money at Bernie Madoff because he was promising linear returns. So, the banks were faced with this situation.

Why were the credit and yield spreads narrower during this time period? What were the dynamics that led to that happening?
Answer**:** Part of it was due to the fact that the Fed was keeping interest rates artificially low during this time period. I think from the debacle in 2001, it forced the Fed's to lower interest rates and they never brought it up again for a variety of reasons, some political.

Here the banks face this situation where they have very poor economics on each loan that they made. Logic would have it that if you had poor economics on every unit then you would actually pull back and make fewer loans. Some companies did that. We have a company in our equity portfolio, Financial Federal that, for all intents and purposes, quit lending money during this period because the spreads were so terrible. They spent that time building up their capital so that in the future when spreads returned to more attractive levels they would have capital to lend. US Bank and Wells Fargo were also two banks that became more conservative as things got crazier. However, most companies fell into the proverbial trap: If you cannot make money on every unit, then you make up for it by selling more units. That is exactly what they did. As a result, loan volumes exploded and the system became a wash of liquidity. This is what fueled the housing bubble. In fact, it threw gasoline on the fire. I was anticipating that the housing bubble would eventually burst. However, when it did, the ramifications were far worse than I could have ever dreamed. The other problem with anticipating that the housing bubble would actually burst was I became way too anxious to figure out ways to take advantage of it when it did burst. I was mentally way too early in preparing for what the outcome would be. When the bubble burst, both credit and yield spreads immediately widened dramatically and kept widening until, like everything else in this panic, by September or October of 08 they had gotten to extreme levels that most banks thought they would never see. This meant that a BBB borrower was suddenly in a position to have to pay dearly to get any kind of money, if they could get money at all. The yield curve was literally straight up because it started at zero. The short-term interest rates literally went to zero. The flipside of this was that when these spreads widened so dramatically, it meant that the bank's profit margins on their loans had never been better than what they were able to get. In fact, at one point during the middle of the banking crisis, they interviewed Buffett. He made the comment, "What a great time it is to be a bank." At his last annual meeting just a few weeks ago, Buffett was quoted saying, "If I could, I would buy all of Wells Fargo and US Bank right now." There are limits to how much an outside investor can invest in a regulated bank and it is twenty percent of the equity.

Keep in mind, while I am telling this story that as this crisis unfolded the interest rates dropped to very paltry levels. With the accounts that we have that are trying to gain some income, we were faced with a situation where rates had dropped so low that it made no sense to buy bonds. In fact, as we talked about before, the Treasury bill rate got to zero and from time to time, went negative. This means that people were actually paying the government to take their money. (Audience comment: I don't understand negative rates, so I was giving the Government $100 and wanting $90 in return? Because it was safe? What a deal.) At Buffett's annual meeting, he had a slide where he sold a Treasury bill at a positive number and that was the only slide he had for the whole presentation. It is extraordinary what a frightened, panicked mob of human beings will do. Unfortunately, I made the decision instead of putting money in bonds at sub two percent that we would buy some common stocks that pay dividends. Those companies included Coca-Cola, Verizon, AT&T, Pfizer, Kraft, Valspar, Redwood Trust and Three Banks, US Bank, Bank of America, and Wachovia. As I said before with this whole scenario, we were definitely twelve months early on how it would unfold. This caused me more stress and consternation than anything I have seen in my thirty years.

Since I had never bought a bank stock in my thirty year career, I thought it would be best that we looked at the largest AA rated banks. I knew that US Bank was clean going into this. That is a long story you can ask me about later. There is some history there. I actually thought that Bank of America was clean for a number of reasons and it turns out that I was right. Bank of America did not get into trouble until they bought Merrill Lynch. Bank of America's loan losses were at a manageable level. They did not get into all of the crazy stuff and their credit profile was fairly tight. Part of being in banking is losing some loans. These banks had manageable losses in their portfolio. They were high but they were manageable given their equity position. Both banks had strong consumer franchises.

I mentioned before that I had been anticipating this bursting of the housing bubble so as such, I was keeping a list of companies that I would consider to purchase in the aftermath of the collapse. One of those companies was the St. Joe Company, which is an integral part right now of our equity portfolios. I have worked on that company for three or four years at least, and the stock came down from 85 to thirty something when we finally started to make commitments. Another company on the list was a company by the name of Golden West Financial. Let me tell you a couple of reasons why Golden West is on this list. It was brought to my attention by several very credible sources; one being a book I read called "Less is More." It had a criteria they used to select companies that was fairly similar to our kind of eclectic management criteria which I thought was fascinating. They did an extensive search of thousands of companies and narrowed it down. They went and lived with the few companies left for a month or two and documented it in this book. Golden West was one of those companies featured. The stock was owned by several investment managers that I have a lot of respect for. I read hundreds of different letters and portfolios of respected managers around the country, Chris Davis being one of them from the Davis Funds whose expertise is in financials. What was unique about Golden West was that they required twenty to thirty percent down on all mortgages, which is a very high hurdle rate. These stringent requirements enable them to manage through the last horrific downturn in the California Real Estate market with hardly even a blemish. They were one of the only companies, if not the only one, that came out of that mess as clean as can be. This gets a little controversial now in hindsight obviously but a lot of their mortgages were adjustable rate mortgages which actually appeal to me because I always have a little bit of a phobia about the pain that can occur with rising interest rates; it is a real risk. We will talk about that later. With adjustable rate mortgages, as long as you have enough equity cushion in the mortgage, it gives you the ability to eliminate interest rate risk out of your portfolio, which actually appealed to me at the time. They made all of their own loans and kept all of their loans on their own books, which is actually fairly unique. It was founded by a husband and wife team, Herb and Marion Sandler, who continued to run the business well into their late seventies. They lived a very modest lifestyle and took minimal salaries. However before the bubble burst, Golden West was bought out by Wachovia. So, my ability to research this company ceased immediately and I had no access to find out what was going on with their portfolio and did not really care much at that point in time. However, later in the process after the bubble had burst and I was out looking for AA rated banks with sizable dividends, I found Wachovia at very depressed prices primarily because of their exposure to the California Real Estate market through the Golden West purchase. What I knew about this company two years prior was that they had tight lending standards and I felt that Wall Street was overreacting to the loan portfolio that they had bought from Golden West. Hence, the third bank in the portfolio was Wachovia.

Now this is very important. When Congress voted down the first TARP, a panic ensued of biblical proportions. I cannot tell you how much I believe that if they would have passed that first TARP, 2008 would have turned out far differently. In my opinion, the reason for this is that all market participants must believe that the government will do everything in its power to protect the integrity of the financial system. The mere hint of their unwillingness to do that literally sent shock waves around the world. There was a literal run on the system. I did not think that was possible after what we had learned after 1929; that we would permit a run on the system. Secretary Paulson pleaded with Congressional leaders to not create a panic. And, as I mentioned in one of my letters, there was a point in time where the Secretary went on his hands and knees to beg these people to act swiftly and discreetly. It was anything but that. Again, after the first vote failed, there was a massive run on the system and there was a massive run on Wachovia. By the weekend, the Feds were forced to orchestrate a takeover of the bank at the expense of the shareholders. By the way, going into the vote, Wachovia was in the final stages of finalizing a merger with Wells Fargo at a very fair value. In a week and half, the Feds were forced to come in and stop the run on the bank. Wachovia was a tax loss for 2008.

As I stated before, Bank of America was clean. In fact, they were so clean going into this that they decided that it was in their best interest to become very aggressive in buying distressed assets and that they had the ability to do so. Their troubles began when they purchased Merrill Lynch. As this whole thing evolved, suddenly Merrill Lynch becomes the poster child for everything that went wrong up to that point in time. I feared that that position put that bank at a disadvantage and put their business model at a disadvantage going forward. So we sold Bank of America at distressed prices and moved the money into US Bank and Wells Fargo, also at ultra depressed prices. I wanted to ensure that these things were going to recover. They are well on their way to recovery: those transactions now are up a hundred to a hundred and fifty percent from where we made that switch. Both banks, in the first quarter, unveiled the enormous earnings power that we talked about before because of the wide spreads that are available and both banks had huge first quarters in earnings. I think both of these banks will be terrific investments for many years to come. I also think that the large cash flows that they are going to enjoy will once again enable them to produce sizable cash dividends that will benefit us in the future. With that said, I would not blame anybody if they fired me for this particular lapse in judgment.

I would like to make one comment before we move on and that is to reiterate that there is no role more important for the government as important as ensuring the integrity of the banking system. It is essential that nobody loses a nickel on an FDIC-ensured deposit. Although I fully understand that not every decision that was made by our officials was perfect, in fact far from it, I express my deep gratitude to those who were willing to stand up, take the heat under brutal criticism, and follow through with their jobs and their sworn duty. This would include Henry Paulson, Ben Bernanke, Sheila Bair, and Tim Geithner. They had the guts to make the hard choices in real time with no playbook under the most trying conditions imaginable. They stood, took the heat, and did their jobs. I admire that. The good news, in my opinion, is that it worked. I also believe that we are at the beginning of a new era. Any questions?

Ben Graham said that there will be times when a stock will outperform the underlying business and there will other times when the business will outperform the underlying stock. This is very important (Slide 4). Here is a chart of the S&P 500 going back to the 1950s (Slide 5). As you can see, the panic lows here in March, and the S&P 500 was at the same level back here in 1996 which is a full thirteen years. According to Ben Graham, we had just gone through thirteen years where the businesses had outperformed the underlying stocks. The S&P 500 is massively more valuable today than it was thirteen years ago. Everything they earn, they get to compound, keep, and build upon. These businesses are hugely more valuable today than they were thirteen years ago and the stocks are at the same level they were thirteen years ago. So the stocks had been underperforming the business all that time. The flipside was also true, by the way. From 1974-75 until the top in 2000, stocks outperformed the underlying businesses. The S&P actually grew 15.1% during that period. Companies the S&P is comprised of did not grow 15.1%

compounded during that period. These businesses did not accumulate wealth at 15.1% a year for twenty-five years. So we went through this whole period where the stocks outperformed the businesses. Thus, we had to go through some period where that needed to be digested. Unfortunately, I thought that happened here in 2002. Actually, if you look at it, for all intents and purposes from a valuation perspective, it kind of did. It just was not enough time for people's psychology to move on.

Are we going to return to the 'Nifty Fifty?'
Answer**:** This was back in the 1960s when everyone thought that the world was going to change at the hands of fifty companies. Those companies got grossly over-valued. That was back when the market was peaking out in here. When a market has a tendency to peak out, the buying becomes very narrow. It gets focused only on one industry or a few companies. The same thing happened when we peaked out in 2000 where the Internet stocks were driving everything; the new era. Traditional companies were actually selling at fairly low valuations. In fact, if you remember, Bill Dunn was running money for us at the time. Bill Dunn was up during those years where everything had collapsed in here. It is because he owned more companies other than Internet companies or companies that were technology-oriented. When markets peak out, they become very narrow. So that is way at the end of the cycle in my opinion.

Now I am going to try to explain the value of some of the companies. I have picked some companies randomly out of the S&P 500 (Charts 6 – 9). In 1995, Coca-Cola earned $1.19 and in 2008, they earned $3.02. The book value for Coca-Cola in 1996 was $2.48 and in 2008, it was $8.85. Proctor & Gamble had about the same thing. In 1996, their earnings were $1.07 and in 2008, they were $3.50. The book value for Proctor & Gamble in 1996 was $3.59 and in 2008, it was $22.46 a share; dramatically more valuable. Here is Wells Fargo. Their book value in 1996 was $3.98 and in 2008, it was $23.43. In 1996, Verizon had a book value of $8.48 and in 2008, it was $18.00. Again, I just want to reiterate, over this thirteen years these companies have become dramatically more valuable than thirteen years prior. Ben Graham's concept, that the stocks outperform the business and the business outperform the stocks, has been engrained in me for a long time. Back in the early 1980s, I used to go through chart books and look for flat charts, stocks that had gone nowhere for long periods of time, and try to find companies that added a fair amount of value while the stock went nowhere. In my opinion, it was kind of like pumping up a tire, eventually the thing is going to have to blow at some point. Originally, that is how we had found JLG; by rummaging through flat charts. What I thought was fairly interesting was going back to the bottom of 1974 (Slide 10). Generally speaking, what is going to be characteristic of a bottom potentially is that somehow or another, the level of pessimism is at some absolutely unbelievable extreme level. That was certainly true in 1974. When I started the business in 1977 and all I heard about were the stories of 1973-74, I longed just to live through it just because I heard so much about it. The level of pessimism literally could not have gotten any more extreme in 2008 and 2009. It would literally be impossible. (Audience comment: "could you long for something else" (Laughter) "be careful of what you wish for." (Laughter)) It was actually very interesting. I was listening to an interview with Buffett and Munger the other day and they were asking them whether 2009 was as bad as 1974. Just instinctively, their comment back was, "No, it wasn't quite as good." (Laughter) The valuations did not quite get to where they were in 1974; it is just instinctive of these guys. I thought it was interesting looking back at the bottom of 1974, it got to the same level that it did back in 1961, which coincidentally, was thirteen years. I tried to go back further, but they did not have an S&P before this. I would have to go to the Dow Jones Industrial Average which is only thirty stocks and compares apples and oranges. You can kind of make a case; sometimes the Dow and the S&P can look quite different. If you went back twenty-five years, it takes you to 1947 when we were coming out of World War II which was an incredible time span. But, since we are dealing with apples and oranges, you can almost take it back to 1932 where it got a little messier. One thing that you should know is that after this digestion of thirteen years from 1961 to 1974, the market compounded at 15.1% a year meaning that if you had put $100,000 in at 1974, it would have turned into $3.3 million in 2000 (Slide 11) . Long-term investing is not dead. Just to prove this point, I will show you the numerical chart (Slide 12). Here we are starting in 1975: the market went up 37%, up 23%, down 7%, up 6%, up 18%, up 32%, down 5%, up 21%, up 22%, up 6%, up 31%, up 18%, up 5%, up 16%, up 31%, down 3%, up 30%, up 7%, up 10%, up 1%, up 37%, up 23%, up 33%, up 28%, and up 21%. Long-term investing is not dead. It just had a thirteen year hiatus. So my contention is that 2008 and 2009 is an inflection point similar to the inflection point in 1975 and somewhat selfishly should provide a fairly favorable environment for the bulk of the rest of my career. Believe me; we are still going to have dramatic ups and downs. What happened after the bottom in 1974, after that thirteen year hiatus, every time the market jumped, everyone wanted to get out because of the experience that they had gone through.

Audience Question: What do you think about the market slowly going up now?
Answer: I think it is the beginning of a multi-decade trend. It is still going to be this; we are down again this week. I will just refer you back to the chart (Slide 5).

Audience Question: It is different for everyone here as we are all different ages. Is there going to be enough time for us to come back to do any good for those of us that are on the top end of the curve?
Answer: In 1975, we were up 37% and 23%. The majority of it came back in two years. That is why people have been as freaked out as they have but it is sort of remarkable how rapidly things can return to normalcy. The same thing occurred in 2002 and I did not have any answers. Within a year and a half to two years, our Front Street accounts had fully recovered and started to go into the black.

Audience Question: How do the dynamics of now compare to 2002? Have the world dynamics changed much over the past ten years?
Answer: I think valuations are much more understandable than world dynamics. I can understand that Verizon had a book value of $3 in 1996 and now a book value of $13 or so in 2009 and the stock is where it was in 1996. I can sink my teeth into that; it is very understandable. That is what Ben Graham did: he broke things down into more understandable terms so that you did not have to make predictions on things that you cannot predict accurately. There are always things that are different and there are always things that are the same. One thing that always remains the same is human psychology. That doesn't change.

Audience Question: There is probably a pretty fair chance that there will be a storm of regulation coming up. You can probably make a case that it could be good for the system. Do you think that that will have a substantial affect on what happens over the next few years?
Answer: It is normal. We are not capitalism. We are capitalism and democracy. In my opinion, you cannot have one without the other. People seem to think that we can have

this system with an all-knowing czar to make sure that nobody interferes with it. You cannot have Atlas Shrugged - capitalism without a democracy. In a democracy, when things go hay-wire, the populace movement occurs and people begin to vote to bring in more regulations. All of the regulations will come in, things will get tight and, over time, they begin to loosen up again. Some regulations will be good while some regulations will not be so good. Democracy is not very efficient. Capitalism can be, but democracy is certainly not efficient and it never has been. Our system has worked quite well even given the fact that Democracy is a little bit messy. But thank God for it.

Audience Question: You mentioned earlier that we are entering a new era but most of what I have heard so far suggests that we are not entering a new era. What is there about what you see ahead that is a new era or is it just simply a repetition of a cycle?
Answer: It is repetition of a cycle, the cycle being that we have gone through an extended period of time where the businesses had built up a lot of value and it was not reflected in the stock prices. We should be entering a new era now where the stock prices will outperform to what degree the businesses are at building value. That is what I consider a new era. It is not going to be a new planet and we are not going to have a new democratic system. It is all going to be the same hopefully except for the fact that we have gone through too long of a period to where this asset class has underperformed and the value has been building up over the years. The amount of pessimism that occurred in 2008 and 2009 would certainly verify the fact that this should be an inflection point as it was in 1974.

Audience Question: Related to that, do you see any serious structural changes or changes in the relationship between public and private sectors coming out of this?
Answer: There will be all kinds of changes. But the one thing about both democracy and capitalism is that you push something and something else pops out. All of these things will be overshot and then it will come back to the mean again, in my opinion. There will be nothing that will happen that, as Warren Buffett said, will make our kids live less of a lifestyle than we have. As long as we can keep going to the voting booth every other year and the system continues to work, the democratic and capitalistic system will adjust. They are constantly evolving and over-compensating from one side to the other. Occasionally we move through the middle.

This idea that every time something jumps up, people are going to want to get out. That was certainly the case for Peter Lynch (Slide 13). Peter Lynch started the Magellan fund in 1977, which was when I got started in the business by the way. There were scars all over from the 1961 to 1974 period. Peter Lynch's fund was remarkable. He retired in 1991 because he had enough success with his fund. During this period, they averaged 29% a year. No one has ever had a mutual fund that has gone thirteen years in a row with that kind of performance. One hundred thousand dollars invested over that thirteen year period was worth $2.7 million. Peter Lynch's run was absolutely incredible. He took the time to do a study that showed that the majority of the people that owned that fund during that period lost money because they got scared out every time it dipped. Talk about a new era: that is going to be part of the new era. Fear is good. It is when there is no fear in a market that you should be extremely concerned. Fear is good, healthy, and it provides a bottom. We should have a fair amount of fear for a long time to come (Laughter). If this holds true, if you can remind me in 2035 that it is time to get out and move on (Laughter).

Audience Question: So the implication is that equity's performance is going to outperform the market for some time to come?
Answer: Yes, that is my contention. Lord knows we deserve it.

Audience Question: Is it your contention that the last ten to thirteen years money was chasing other assets like real estate or emerging markets or any other place where you could put your money instead of U.S. equities?
Answer: The housing thing really hit the accelerator around 2002 and 2003.

Audience Question: So there will be a reversal of that? U.S. equities will come back into favor or at least be preferred over other asset classes that have sort of stolen the thunder the past thirteen years?
Answer: That is a possibility but I do not really need to go there. I do not need to commit money that says that is going to happen. That could certainly be one of the ramifications but as long as my performance during this period is good and I can retain all of you high-quality people through this whole period going forward, whether other asset classes do well or not is immaterial to where my head is going to be. We owned Nucor; I sold it all and I am not buying it back even though it was one of my favorite companies because I think that that is a real possibility.

Audience Question: One of my pet peeves of the Board of Directors of a lot of these companies is no one puts their feet to the fire. I think they are going to have to be more careful who they put on these boards. Do they know anything or do they just agree to be on each other's boards?
Answer: I think that one of the positive things that has come from this is that there has been a bright light shined on these guys. Again, it is one of those things that will get cleaned up for a period of time and then years down the road it will get sloppy again. But there should be a fairly bright light shined on these folks. We try to make that one of our advantages that we spend a fair amount of time trying to find companies that have a Board of Directors that we actually admire. We have three companies that have CEOs that do not take salaries. I said that a couple of years ago and there was an elderly lady here that is not here tonight. She called me the next day and said, "You have three CEOs that don't take a shower?" (Laughter) It is actually somewhat of an advantage if you can identify companies that have more admirable characteristics but it will ebb and flow.

There is one asset class that clearly is not going to perform well moving forward and it is crystal clear: the bond market (Slide 16). Let me read to you a piece of Warren Buffett's opinion editorial from the New York Times of October 17th that I find important: "Today people who hold cash equivalents feel comfortable; they shouldn't. They have opted for a terrible long-term asset, one that pays virtually nothing and is certain to depreciate in value. Indeed, the policies that the government will follow in its efforts to alleviate the current crisis will probably prove inflationary and therefore accelerate declines in the real value of cash assets. Equities will almost certainly outperform cash over the next decade, probably by a substantial degree. Those investors who cling now to cash are betting that they can efficiently time their move away from it later. In waiting for the comfort of good news, they are ignoring Wayne Gretzky's advice: I skate to where the puck is going to be, not to where it has been." Again, in the annual report that was published in March: "The investment world has gone from underpricing risk to overpricing it. This change has not been minor; the pendulum has covered an extraordinary arc. A few years ago, it would have seemed unthinkable that yields like today's could have been obtained on good-grade municipal or corporate bonds even while risk-free governments offered near-zero returns on short-term bonds and no better than a pittance on long-terms. When the financial history of this decade is written, it will surely speak of the Internet bubble of the late 1990s and the housing bubble of the early 2000s. But the U.S. Treasury bond bubble of late 2008 may be regarded as almost equally extraordinary. Clinging to cash equivalents or long-term government bonds at present yields is almost certainly a terrible policy if continued for long. Holders of these instruments, of course, have felt increasingly comfortable – in fact, almost smug – in following this policy as financial turmoil has mounted. They regard their judgment confirmed when they hear commentators proclaim "cash is king," even though that wonderful cash is earning close to nothing and will surely find its purchasing power eroded over time. Approval, though, is not the goal of investing. In fact, approval is often counter-productive because it sedates the brain and makes it less receptive to new facts or a re-examination of conclusions formed earlier. Beware the investment activity that produces applause; the great moves are usually greeted by yawns." And I will add to that…or usually worse. Let's go to the Treasury bill rate slide (Slide 15). This is where it went negative. I can guarantee you that there was a bottom in interest rates right there because it literally could not go any lower.

> **Audience Question: To what extent has Front Street Capital Management stayed ahead of this mess?**
> Answer: I tried to stay ahead of the mess when I bought some dividend paying stocks rather than bonds ten or eleven months ago, which was ten or eleven months too early. We did cease to buy bonds completely and we will only re-enter that market when the rates return to more palatable levels. Beyond that, our equity portfolios are not based on my predictions of where the market is going but we try to find either the best or the cheapest stocks that we can find.

> **Audience Question: Theoretically, this should be a really good time to invest in stocks right?**
> Answer: I do not know if we will actually pull it off, but we would like to open a mutual fund in here as a business to try to get ahead of this curve.

Now comes the tough part (Slide 17). There is the performance, or the lack thereof. As you can see, the S&P was down a full 37% in 2008, it was down 11.1% in the first quarter of 2009, and from the end of the first quarter to last Friday, the S&P was up 12.7%. After this week, that is about break even from the first of January, we are down a bit this week. (audience comment: so the market as a hole, spelled h.o.l.e. ? Laughter). The Front Street accounts were down 38% last year. As you remember, all of these accounts were managed individually. Depending on when accounts got started, there might be a slightly different mix percentage-wise of companies. So, it is plus or minus 2% on these numbers that your actual account would be. We send out quarterly performance reports, as you all know, and if you ever have any questions on how to read those please give us a call or bring them in. In the first quarter, we were down plus or minus 7% and then quarter-to date we were up 18%.

I think the fund that I have gotten the most questions on is the Aegis Value Fund. It was disastrous in 2008 and somewhat disastrous in the first quarter and a monstrous recovery, so far anyways, since the end of the quarter because of the nature of the companies that they own. They are a pure Ben Graham manager that buys companies that are selling at very depressed valuations. There was a run on those stocks during the last part of the decline in 2008. The thought was that any company that was not Exxon was going bankrupt. So, the further down the food chain you were, the more people thought that you were just going to go completely out of business. So, that sector of the market basically had a meltdown. But the valuations were cheap to get started. I saw companies that were selling at one third of their cash with no debt. You could literally buy dollar bills for 30 cents on the stock market during March 2009. Unbelievable. I question those folks that say they saw cheaper valuations in 1973 and 1974 because how can you get cheaper than that? I think it is a nostalgic memory possibly but I don't think that you could get cheaper than what we saw in February and March of this year. Audience question: What was the value of that in 2007 going into 2008? In 2007 going into 2008, the value was down slightly. The interesting thing about Aegis was in 2008, they were even in June or July for the year. It was the only one of the funds of all of our accounts that was even. It was in this panic that Aegis really came unglued. Obviously, this whole thing has been very devastating and disappointing. However, Aegis was the only fund we own that I actually questioned or was disappointed with anything they had done. The other funds had acted in a way that I would expect them to act, and for the most part so did Aegis but with one exception. We have a very high bar. We talked last year about the bubble that I thought was developing in the commodity and energy field.

END OF TAPE 1

So what we were talking about prior to this was the Aegis Value Fund. We also talked about that the commodities and the energy were getting a bubble environment and we wanted to avoid them at all costs. There was a point in the year unbeknownst to me where I found out that Aegis had taken about a 9% position in some energy and commodity type companies which I believed was somewhat straying from his deep value approach. Everything else that all of our managers did, in spite of the numbers that you are going to see that might not be so pretty, followed their game plan and what their book called for them to do. There is one piece of Aegis of about 9% of his portfolio where he strayed. I think the reason he did it was to try to manage the short-term performance a little bit. As we said before, it kind of worked. Throughout most of 2008, I think it probably helped his performance because in June and July I think he was actually even for the year. So we really cranked up the research effort on Aegis. I just want to talk a little about Aegis and Scott Barbee here for a minute. One thing about Scott Barbee is he is a young man in his early 40s. We think that this whole experience is going to tighten up his work dramatically. One of the things that we have talked about before is one of the criteria that we use for selecting a mutual fund. In case something did go wrong, we would hope that nothing would go wrong, but we would want it so that the entire company was one pool of money. All of the money invested in Aegis is in that one pool. If that pool does not do well, the whole company knows it. It is not like having one of fifty funds in some fund family and the one fund does not do well that you happen to be in and it gets discarded or folded into another fund. It does not get the attention that is meaningful as if your whole livelihood and career depends on the performance of that one pool of money. Believe me, and we will go through this, that that pool of money and the performance that we see up here on the Aegis Fund has caught Scott's attention in a massive way. I will explain that in a second.

In the case of the Aegis Fund, if you remember, we seeked out the Aegis Fund as a pure Ben Graham manager buying reasonable companies at unreasonably low prices. We had always used Bill Dunn for a long time as a compliment to the Phil Fisher style of investing by trying to buy great companies at reasonable prices. Aegis, Bill Dunn, and Ben Graham try to buy reasonable companies at very low valuations. We felt that the two styles complimented each other. When we seeked out Aegis in 2005 is when Bill Dunn had abruptly retired. One thing about that style of investing is, we have talked about this many times, the larger the pool of money in that style of investing, the more difficult it is to buy a lot of cheap stocks from time to time. This is because the larger the pool from time to time there are not that many cheap stocks and you have too much money chasing too few ideas and you have to over-concentrate in particular ideas. We started with Aegis in 2005. It was a fairly unknown fund and was fairly small. By 2007, their performance had started to attract attention (Slide 18). In 2007, Barron's (a high profile weekly investment magazine) came out and actually reviewed all mutual funds and picked the top one hundred funds of all the funds in the United States. There are twenty or thirty thousand funds and out of those funds, they try to select one hundred. With those one hundred funds, they rank them from one to a hundred. In 2007, Aegis was ranked number one. That was the worst day of Scott Barbee's career right there. The problem was that it attracted a fair amount of money with a short-term horizon. They got other kinds of publicity because obviously these things have a tendency to snowball on each other. At one point in time, sometime after this was published, the fund was $800 million in assets. At the end of March 2009, it was $65 million. Most of these investors fled. This is a young man that has been seared through this experience and I am trying to be very careful here not to overreact to one mistake because as a young man, he may be the best manager for another twenty or thirty years that we could find. We talked before about the larger the size of the fund, the more difficult it is to run this style. It is very small again, which is very advantageous to us. I have had almost weekly conversations with Scott and his mind is clear and his disciplines are tight. We have five funds that we use. Just generally, we are going to try to be a little more proactive on making sure the accounts are a little more balanced with all five funds. By the way, that was not an option prior to 2008 because two of our funds had only opened up to new investors in 2008. These mentioned funds were Longleaf and Sequoia.

Another criteria that we have is, and all of the funds do this in spades, that the majority of the manager's personal net worth is in the fund. I can tell you this is also true of the Front Street fund in spades. It is also true with Aegis; every nickel that Scott Barbee has is invested in the Aegis Value Fund. (Slide 19) That was the title of the Barron's article in 2007 and that is our guy. He is kind of frumpy, not a high-powered, slick, just an intellectual fellow. I actually think he is a high-quality individual. (comment: does he lean to the left? Laughter because his picture shows him leaning left)

The next fund will be Fairholme fund which was down 30% in 2008, down 12% in the first quarter of 2009, and up 23% just from the end of the quarter. (Slide 17)

> **Audience Question: When you say the Aegis Fund is up 50%, is that is on some sort of basis?** Answer: The basis would be the end of the first quarter, which is March 31st.
> **Further Question: So it is half the size it was?** Answer: It is not up 100%, it is up 40%.
> **Further Question: It went from say $100 to $51 and then it lost another $7 so now it goes up 49% and it is only going up 49% in an absolute sense on half of the funds.** Answer: Yes, exactly. But it has only been a month and a half or something. The math is exactly correct; it takes twice to get back what you lost.

The next fund is Longleaf (Slide 17). It had a terrible year in 2008, pretty impressive first quarter, and a dynamite recovery. Pinnacle was our star. It was only down 17%. I think of all mutual funds, Pinnacle was number five in performance last year of all thirty thousand funds. It was only down 3% in the first quarter and up 10% in 2009. John Deysher fishes in the same pond that Aegis does. The two managers have very similar style characteristics. We were actually looking very specifically for managers with that style. John is very smart and did a great job. The more risk was evolving in 2007 and he raised a fair amount of cash and then the markets began to collapse. By the way, Scott Barbee did the same thing; he held a lot of cash but he got fully invested by the end of 2007. The difference with John was that every time he bought something, it just melted down in front of his eyes. It immediately disintegrated. So he just quit buying. He would buy a little bit and then it would just melt. It just got sort of burned into him and he went through the whole decline with a fair amount of cash. He still has, which we see his recovery is less, a fair amount of cash and I think it could be overtime that he will always run his fund now with more cash than other funds. We will see.

Audience Question: What is the size of the fund at this point? He was at about $25 million when you started putting money in wasn't he?

Answer: It is about the same size as Aegis actually. Yes, I think he has attracted some good long-term investors that understand what he is doing.

Audience Question: What is his percent in cash now?

Answer: I do not know; I get a report every month. As of the end of last month, I think it was 30% but it does move around a bit. He was at 70% for a while I think.

(Back to Slide 17)Sequoia owns some very lovely companies. We own several companies that Sequoia owns: Expeditors, Fastenal (which is a new one for us this year), Costco, and about 15% of the fund is Berkshire Hathaway. This is really a high-quality fund. They were closed to new investors for a fair amount of time until they opened in 2008 which gave us access to it. They were actually closed to new investors for over twenty years. They are about $3 billion so they are a good-sized fund. The difference with Sequoia, Longleaf, and Fairholme is that their style is somewhere between Graham and Fisher. They look for higher quality companies, they are still pretty tight on price, but they are not like Aegis, Pinnacle, or Tweedy Browne that is a pure Ben Graham investor that have a difficult time with too much cash. So Sequoia, Longleaf, and Fairholme are funds that I am not as worried about that we believe can handle more capital than Aegis, Pinnacle, or Tweedy Browne. With that said, it does not really matter in here. One of the problems with having too many assets on the fund is that you might have a hard time finding something to buy. So you could be running $300 billion and find plenty to buy in this market. That is not an issue now; it may be in a few years again. We were concerned about Tweedy Browne before and I am not concerned about those of us that own Tweedy Browne now because they have plenty of opportunity to allocate capital in this market. The only concern with Tweedy Browne was size. They are astute, they are a Ben Graham, they have a great history, they were students of Ben Graham, they were partners with Ben Graham originally, and it is a better managed fund than 98% of all the funds out there. They just got too big and I am not worried about that now. You can have as much money as you want and you can apply that to any style you want as we speak. A couple years from now, that could be different. The first quarter Sequoia was down 8% and then were up 15% since then.

(Slide 20) The Tweedy American Fund was down 24% last year; we did not update this one to year to date. Tweedy Global was down 38%. It is better to compare it to a global index rather than an S & P.

(Equity Holdings Slide 22) Any questions?

Audience Question: You made a statement earlier about Nucor and how it was your favorite stock but that you weren't going to buy it again. What was your reason?
Answer: It was because it was a commodity business. I actually agree with Ed; there was that period where people were looking for places to put money and all this money flowed into everything that was hard including steel. That stock was a non-performer for thirteen years or more. I mean, I got a new account and I put it in Nucor and it did nothing. It is a very difficult business. They are a great company in a very difficult business. Not only were all of the commodities going up, but the profit margins that they were able to have during that period will never be seen again. It will be twenty-five years before all of the moons line up again for the steel industry. I may miss it and I would like to re-own it. We actually debated keeping it on the list because we still think that it is part of what we do but we do not own it and I am not rushing back into it. There are several companies that we have had on deck for a long time that we have been buying way before Nucor and I am assuming that there will be a day where I get to buy it after an extended period of this industry really consolidating itself out. In all of those years where the commodities were so high, there was a lot of capacity built for all kinds of things that were hard. As the economy starts to come back, it is not going to come back overnight. It is going to be awhile before they fill up that capacity that was built over that period of time would be my assumption. Again, if I am wrong I am not betting against it, I am just not betting on it.

Audience Question: How is Costco doing?
Answer: I think Costco is doing great. Their same store sales have been generally flat through this whole debacle which I think is a minor miracle. They do not look good; the stock goes down every time their same store sales come out because the gasoline prices go down and that affects their same store sales. This is because they run a lot of gas through those places which skews the numbers. Also, foreign currency translations make the numbers less than they would be otherwise. But if you pull those numbers out, the same store sales would be a bit flat or up during this whole period. The cool thing about Costco, I think, is that they can scale down and they can scale up. When things get tough, you go to Costco because you are going to get bargains. When times get better, you will go in and buy something expensive at Costco and not think twice about it because you got a good deal. I think they can scale up better than any other retailer up and down. There are always little things that occur, Thank God, that reinforce why we own something. It was small but, to me, it was huge. In the middle of this, as prices of Costco's merchandise was dropping fairly dramatically. The company lowered their prices in advance of what they were going to buy the merchandise for in the near future, which hurt their earnings by a couple of three cents for one of the quarters. The stock just got creamed when they missed their earnings. They just cannot afford for Walmart to have something cheaper than them. I mean, there is a trust level when you go into Costco that they did the shopping for you. They sacrificed the stock for a quarter and they sacrificed Wall Street for a quarter to guarantee that when a customer walks in the store, they are going to get a price that is as low or lower than anything they are going to find elsewhere. That, more than anything, reinforced that they were willing to do that in the middle of this brutal environment and they knew that the stock was going to get crucified the day they came out with those numbers. (audience comment: I think Costco is a very well managed company) Hurray, if I could own twenty-five Costcos, we would be done and this would be a lot less work. (Laughter)

Audience Question: What is happening with Bookham?

We will just go through the same story that we have gone through God only knows how many years. So we have ADC, Bookham/Oclaro, Level 3, and sort of an ancillary holding that is not up here, some accounts have JDS Uniphase. We own them as a package. They are a package that is involved with the telecommunications industry and we have been adding to those holdings the last couple of years. Let me just reiterate. The story revolves around Level 3. We talk about peeling the onion back; we peel the onion back to Level 3. What was the promise of the Internet bubble? They promised all of the things that we were going to be able to do over the Internet. Literally, all of them have come true. The amount of traffic that goes over these fiber optic networks has grown exponentially. Sixty, seventy, eighty, one hundred percent growth a year since this thing was built in 2000. Those are massive growth rates. When you compound anything at 80% a year, it is a massive number. One of the figures I saw was that an average household with a couple of kids, a couple of televisions, a couple computers, and cell phones; eleven normal households today create as much traffic as the entire Internet had in 1995. It continues to grow exponentially. So, what happened was, companies like Level 3; Level 3 owns a fiber network end to end with complete fiber. It was built with a clean sheet of paper from scratch in early 2000. The power of fiber optic technology is that it can transmit unbelievable amounts of information. It is very efficient. So what happened was when all of the streets were dug up and they laid all of this fiber, the capacity was far greater than where the usage was at the time. With pure supply and demand, there was more capacity than there was traffic going over the network because the technology was so efficient and the prices just plummeted. That is what has fueled all of this; that is why the promise came true because of cheap capacity. The cheaper it got, the more the volumes exploded. For a company like Level 3 that owned the network, their problem was their volumes were exploding but the prices were going down faster than the volumes, even the 100% that was growing as far as the amount of traffic that was going over the web. If you compound anything at 100% for long enough, it is going to fill up no matter what the capacity was. That started to occur the end of 2006 and 2007. Suddenly there started to become bottlenecks where they needed to go into pieces of the network and open it up. Suddenly the unthinkable happened where prices started to go down less than volume was increasing. That has actually increased all through the recession. All through this debacle, there was only one industry that was crystal clear to me that was growing at an unbelievable rate no matter what happened to the economy or things in general. That was the amount of information that was flowing over the network. A landmark event happened this last quarter where Verizon actually raised prices on a piece of their network. As traffic continues to grow and prices stabilize, somebody who owns a network; it is a fixed cost network, and once you get above the fixed cost it turns into a money machine. Level 3 owns the network and ADC, Bookham, and JDS Uniphase supply equipment to build out or to service the network. All of that went to zero during that period where we had this over-capacity so the industry got devastated. We paid a lot of money for Bookham; we bought it at two to three dollars per share and stock got down to some ridiculously low level below a dollar. It looks like we overpaid for it; that stock came down from $850 a share at the peak. With Level 3, it looks like we overpaid for it at two or three dollars. It got down to less than a dollar also in this mess. I think Level 3 was up to $1000 a share during the peak. (actually got to $130)

Audience Question: How does Level 3's financial strength look? Revenues are down and they have this debt load, do you think they are going to have any problems?

Answer: Awful, abysmal. Actually there is a reason why we own four of them and the reason is that each one has their own warts. I was unable to pick the Nucor of the telecommunications industry. If it was there, we could have just piled into it and been done with it. If somebody knows of that Holy Grail, please let me know because we are fighting with some warts here to get this exposure. Bookham and JDS Uniphase supply equipment at the very heart of the network and these are mission critical fiber optic products. In fact, Bookham has this product called the tunable laser which back in the early part of this was something that if anybody could ever perfect, it would be Nirvana. Well they dominate that space and that product had been growing dramatically all the way until the eleventh hour of the recession when finally everybody stopped buying anything no matter what. Network providers like Verizon, Level 3, and AT&T just kept running their network hotter and hotter not to spend a nickel because nobody was spending a nickel, so why should they. There was a pause in these companies' earnings and revenues but it cannot last for long because you can only run those networks so hot. So Level 3, in my opinion, has the most valuable asset right now on the planet. Buffett talks about the power of owning a toll bridge; the only toll bridge in the city to get across the river is a monopoly. Well these networks are becoming toll bridges, but not only toll bridges; toll bridges with volumes that are growing 80% and 90% a year. The thought of owning this network almost sends a chill down my spine. The problem is that they had to spend all of this money to build it and they are weighted with all of this debt. If they had half of the debt that they have, we could just sell all of this stuff and stick it in Level 3. This is a superbly managed company. It is the only company that started with a clean sheet of paper and did not go bankrupt. They are the grittiest bunch that I have ever seen. They have the management and the technology and they are not going to re-dig up the streets. There is a huge barrier-to-entry but they have a lot of debt so we own four of them.

Audience Question: Are they going to be able to raise their prices?
Answer: Yes, they should be able to raise their prices. When that day happens, I will send an email out. (Laughter) There are a lot of smaller companies that own pieces of end to end fiber networks like Global Crossing and some of these guys that came out of bankruptcy. The problem is that most of them have just a little piece. So what they have to do to actually have a business is to buy capacity from somebody else. Level 3 does not need to do that. I do not know how they did it, but when everything was wiped out they had no money and a ton of debt, and they actually consolidated the industry by buying other companies in the industry for nothing and they had nothing. They own an end to end massive network and they do not need to buy capacity from anybody. The guys that need to buy capacity, when prices start to rise, are going to get squeezed out of the business.

Audience Comment: Some of us have been riding this horse for quite a while. (laughter) It finally looks like it is coming along. I will be very happy when it happens; it has been a long time coming.
It has and I apologize. As long as the traffic continues to grow and these stocks do not reflect the economics, then we will continue to own them. Again, the dynamics of this industry have been outperforming the prices of these stocks for a number of years now; the same issue that we talked about before.

Audience Question: Is Level 3 eliminating some of its debt or is it just paying its interest? With shares they will buy more companies or with debt?

Answer: They are just paying their interest. In fact, they want to buy more companies. There is an asset coming up for sale right now. They have two primary competitors which are AT&T and Verizon and then there is Level 3. The problem with AT&T and Verizon is, I think we have talked about this every year that their networks are a hodgepodge of all kinds of technologies that have evolved over the last hundred years. Level 3, by definition, is a lower cost producer because it is fiber end to end.   There is nothing else in there; there is not a piece of copper anywhere in that network. The next largest network that is equivalent to theirs is owned by Qwest. If you remember, Qwest did a similar thing as Level 3 where they took their high-price stock where everything was over-inflated and bought a local telephone company which was US West, or I do not know what they called it when they bought it. Now US West is looking to get rid of that fiber optic system. They are working 24/7 trying to figure out a way, with virtually no money and not wanting to dilute the stock, on how to buy that network. By the way, Level 3 was started by Peter Kiewit Construction which is Walter Scott, one of the Board members on Berkshire Hathaway. Buffett's office is famously in Kiewit Plaza. Walter Scott had a company called Mid-America which is a utility company. He was a large percentage owner and Berkshire bought them. I could see a joint venture between Mid-America and Level 3 to buy the Qwest assets but we will see.

Audience Question: When you say end-to-end, do you mean world-wide?
Answer: Well certainly in this country, they do have a large presence in Europe and a smaller presence in Asia and we would certainly like to see that expand overtime.

Audience Question: What is the status of YRC?
Answer: We had three companies that were basically at the bottom of our food chain: YRC, Symmx and Valassis. Symmx and Valassis are gone and I contemplated cleaning out YRC Worldwide, which is a trucking company. We bought it not because they had some dynamic reason, why they had a barrier-to-entry or a moat or something around their business, but because the stock was very cheap when we bought it, $30 a share or something ridiculous like that. They have $170 a share in sales; that is a really dramatic relationship. What they are is a less-than-truckload carrier. This means that people pick up stuff, they bring it to a terminal, repackage it up, put it together with other people's stuff, and ship it off. There is value added, it is not like you are competing with a guy that can buy a truck and drive across the country. You have to develop a network and there is some barrier to entry. Two of the largest less-than-truckload companies were Yellow and Roadway which combined to create Yellow Roadway Company (YRC). After they did that, the economy was fairly good, they were running things somewhat in capacity, and they were making a lot of money. When we bought it, the PE ratio was ridiculously cheap because the earnings were quite high based on the stock price and certainly a massive amount of earning power based upon their revenues. They put these two companies together and a huge lever they could pull was to eliminate almost half of the terminals and put them together because all of these terminals were in the same cities. The problem is that when you are running at almost capacity, you would cause all of this disruption and you would disrupt your customers for a period of time. They were making good money and it would be very difficult to convince the unions to make the adjustments when the business was good. However when the business fell off the proverbial cliff, their numbers just turned into a nightmare. So the stock really reacted to these plummeting numbers and a bit of debt. It gave them the opportunity to pull this lever in a big way. In three months, they went from 700 terminals down to 480 terminals

or so. Unbelievable; I cannot believe that they could do that in a three month time period. The unions signed on happily, even with all of the layoffs going on. The unions came right up to the table and they got an equity stake in the company. The unions agreed to pay decreases and the savings that came out of all of these actions were $650 million. They have sixty million shares outstanding. You can do the math. That is $10 a share with bottom line earnings. Most companies sell for a minimum of ten times earnings. Ten dollars a share times ten would put the stock at a hundred. That is $10 a share irrespective of the fact that I think they made $6.50 before the cost savings when they were running near capacity. So their normal earnings power was about $6.50 a share and they add to that another $10 a share potentially. If they could take $2 a share to the bottom line the stock goes to $20. We still own it. This could be, certainly not the best company in our portfolio but it may turn out to be the one with the most leverage on the recovery. There is risk that the debt may be problematic going forward but the reward dramatically outweighs the risk. So we are hunkering down with it.

Audience Question: What is the status of Toyota?
Answer: That is a simple one. It is a one-liner. It is the greatest manufacturing company the world has ever known. Not everybody owns it because of the leverage on the upside. It is a very large company. Normally, you have to sell something to buy something else. The leverage on the upside of Toyota is never all that great but I would not be true to our criteria if I could not at least show it on this list every year because they are the model for the management style that we believe is critical to success.

Audience Question: Do you see the current upset in the automobile industry in the U.S. as being to their advantage?
Answer: Absolutely. They have a little problem; they started to build some trucks and they had to rescale that and then they came out with the Prius and now nobody wants a Prius. But there is nobody that can re-tool like Toyota can. Of all of the companies, Toyota can make some of these errors and this awesome manufacturing base can adjust to it much more effectively than any other company on the planet by a factor of several.

Audience Question: Can you share your spin on Terex?
Answer: As you all know, we owned JLG for a long time. It turned out to be quite a successful endeavor for us. Believe me, not without its pain. Terex was a very cyclical business. Over the years, when that industry started to get fairly competitive, JLG went on a Toyota TQM-type manufacturing culture. That is when we really started to get very engaged with JLG. A couple years after that their competitor, Genie (the blue guys with the aerial work platforms) started on their own TQM program. Together, year after year, they were able to become more efficient and lower their costs to manufacture these things. Overtime, they literally drove everybody else out of business to where there were only two players left: JLG and Genie. All through this time, I was aware of Terex. They were basically a joke. Ron DeFeo started the business with nothing. He actually came from Proctor and Gamble originally. They had no resources and so every time a recession would hit, he would go buy a couple of lousy equipment companies for nothing and borrow the money to do it so they were very leveraged. He created this model to where he had junky products that he would sell and he created a business out of it. It is the most awful business I could imagine. During the last recession for the aerial work platform, which was absolutely brutal, Genie was a private company and they decided to continuously offer their own financing in house to be able to continue to generate sales.

They did this more and more until they finally levered themselves right to the edge of bankruptcy and the banks were ready to close in on them. My understanding was that Genie was actually further ahead than JLG. They had actually taken this manufacturing culture to another level than what JLG had, which was unbelievable to me. I heard about these stories but almost did not believe it. So Genie goes to the brink of bankruptcy and in the eleventh hour, before the banks close in on them, guess who shows up at their door? Terex shows up and buys them for literally nothing. They just hand over the keys to him. (laughter) Literally the next day, the recovery in that industry was massive and these two companies were just gushing money. JLG's recovery was enormous. I watched Terex and Ron DeFeo and he is a smart enough guy that he understood there was something to this, this is actually a great company, and this culture is awesome. He started to take that culture and bring it to his other divisions that were terrible. In my mind, it is a company that is going to improve for the next fifteen years little by little. He had the wherewithal to pay down the majority of his debt when Genie was gushing all of this money. JLG gets bought out by Oshkosh Truck and I have no desire to own Oshkosh Truck. I know this is a cyclical industry so I started working really hard on Genie and the culture. I went to a meeting at Terex and at the meeting, the stock hit $110 a share. The game plan was to get to know the company and then when the next cycle turned down, we could take advantage of it and take a position in Terex with this idea that they were a company that was going to continuously get better and better over time. The culture fit our criteria. I think the lowest stock we paid recently was $8.50 from $110.

Audience Question: There have been a lot of companies that are leveraged that have had a major problem re-structuring their debt. Is that a problem?
Answer: We only have a couple of companies that are leveraged like Level 3 and Terex. Terex got levered up because they bought a lot of stock back at $40 on the way down. Other than that, they would have been super clean through here but they will be alright. Ron DeFeo is such a survivor I did not really think too much about him not getting through this decline with the balance sheet that he had. Obviously YRC and Whole Foods had a little bit of leverage and Whole Foods then raised some equity capital. Literally I think everyone else has more cash than they do debt and some by a massive amount. Berkshire Hathaway came into this with $48 billion cash. Cerner has more cash than debt. Cognex has $6 a share in cash and no debt with the stock at about $13. Expeditors has $900 million in cash, two hundred million shares outstanding, and no debt. Fastenal has no debt and a sizable amount of cash. We talked about the discipline of Financial Federal. Gentex has almost $5 a share in cash, no debt, at the low I think stock got to $6.50. Herman Miller has more cash than they have debt. National Instruments has, I think, about $3 a share in cash and no debt. Rogers has $7.50 a share in cash and no debt. SEI had no debt going into this and about $2-3 a share in cash; SEI had to lever up a little bit because they had to bail out one of their mutual funds. St. Joe is totally debt-free and owns 800,000 acres of property, 3% of the land mass in Florida at a cost basis of zero. It was bought in the 1920s. Eleven miles of it is on white sand beach. Starbucks has more cash than debt. Timberland has about $3-4 in cash and no debt. Toyota has a massive cash hoard. Valspar is in great shape. Again, Whole Foods had to raise a little bit of capital in here and is now recovering from that. So that is kind of the balance sheet.

Audience Question: Have there been any trends in your overall portfolio in terms of ratios of large companies to smaller companies in the last ten years?

Answer: All else being equal, a smaller company can grow faster than a larger company. The problem is all else is never equal; larger companies have advantages that smaller companies do not. If everything was the same, I would select a smaller company over a larger company but nothing is ever the same. We are, I guess, agnostic about cap. In fact, we talked about this, if we were going to open a mutual fund, the name would be the "Front Street All Cap Qualitative Value Fund". (Laughter)

Audience Question: How is Rogers doing?
Answer: Rogers is funny in the fact that their numbers held up all through the recession. They have products that go into other people's products. They make materials which are the raw materials of somebody else. Their fortunes are always tied to other people's activities; they never have control of their own fortunes, it is always how good their customer's product does. Remarkably, their numbers held up all through the recession. This never happens because they always get whacked and always at the eleventh hour. And I thought this time was going to be different; there is probably something about their mix this time that was different. We went through almost the whole recession, and their numbers held up remarkably well and then the cliff came in the first quarter of 2009, which also indicates to me that this should be the end because it literally comes right at the end. It is always based upon a dramatic inventory reduction on their customer's part. But they have all of this cash and no debt. They recently bought a company that makes the same products that their PORON business does. They make foams for hoses and the cushions for cell phones and PDAs; it is the cushiony stuff. It has a lot of technology actually involved with value added that is brought to the table. One of their competitors was about to get closed in by the banks and they were negotiating buying their businesses. The banks kept getting closer and closer to the edge on these guys and Rogers called them up and said they were going to take these five businesses and that is it. This company said you guys can't do that; you can't just cherry-pick our best businesses. The next day the bank was going to close in on them and so they called them back and said it was a deal. They literally went into this business and cherry-picked only the five businesses that they wanted. They can make this stuff in their own lines so it is all just additive on their own manufacturing facility so it should be tremendously profitable for them. Their overhead is going to be zero on these products. With the deal, they get a plant and equipment worth about $3.5 million and they paid $7 so they are only out about $4 million. They have $55 million in cash so it does not even make a dent in their balance sheet. They buy $21 million in sales for basically $4 million; it's not a huge piece of their business but it is the kind of thing that we are quite proud that they were able to accomplish through here. They also make a product that goes into a wireless base station, which are the boxes that you use. As everyone knows, wireless communications is exploding. It is really exploding in China. China has all of this stimulus money going to build out their wireless infrastructure and they are not allowing any US companies in there to make the equipment. However, they do not have a choice because Rogers has a material that helps to make the printed circuit boards that go into the electronic boxes and nobody else makes them. They are the only US company that is benefitting from the build out of the Chinese wireless infrastructure.

Audience Question: What is happening with Starbucks?
Answer: We have sold a bunch of it several years ago. People were not very happy with me when we did it but the prices of the stock had gotten a little too rich given the size. You get to a certain size and you just cannot grow at the same pace that you had

previously but the stock was priced as if they could. It was almost a 15% position and it was a huge winner for us over a long period of time. We cut it down to a 3% position which is about as dramatic as I have ever gotten. In this environment, we have actually used it again for currency to buy Terex at eight and some Fastenal. It ranges between a 1-3% position. Howard is still there. You will never see a company this large that has a CEO that has this kind of skin in the game and passion for the business. It is the complete opposite of what was asked about earlier regarding corporate management. This guy lives, breathes, and eats this stuff. He started this company, he is only in his 50s, he is going to do everything he can, and his brand is dominant. They will come back but we are not going to dive into it here.

Audience Comment: Some people call Starbucks "Four Bucks".
Yes, and they call Whole Foods "Whole Paycheck" too. When people are willing to pay more money for something, they can readjust. Whole Foods has done a marvelous job of recreating themselves from being "Whole Paycheck" to providing more products that are not specialty products that carry a higher price tag. We think they have done a marvelous job of re-engineering themselves through this, partially because they are so empowered, which is part of our criteria.

Audience Comment: It just would appear to me that McDonald's is in a better position to beat up Starbucks than Starbucks is to beat up McDonald's.
I think it is apples and oranges. It is a different image. One thing that I have learned about through Starbucks that has lead us to make a strong commitment to Timberland and Coca-Cola is that there is a huge value in strong brand franchises that make connections to people that you cannot put a price tag on. Starbucks has a completely different connection to people than does McDonald's. They are losing some business to them but they are not losing their core customers that are connected to this brand to any competitor, I do not think. They are just spending less in their stores. That is just my opinion. Again, I am not going in and loading up on it either. This has been a great company for us and their culture has been terrific. For the first twenty-five years of their existence, they did it with no advertising; that is the power of a brand. When people make a comparison between Starbucks and McDonald's, given my history with Starbucks, I do not like it. It is probably a bias more than anything.

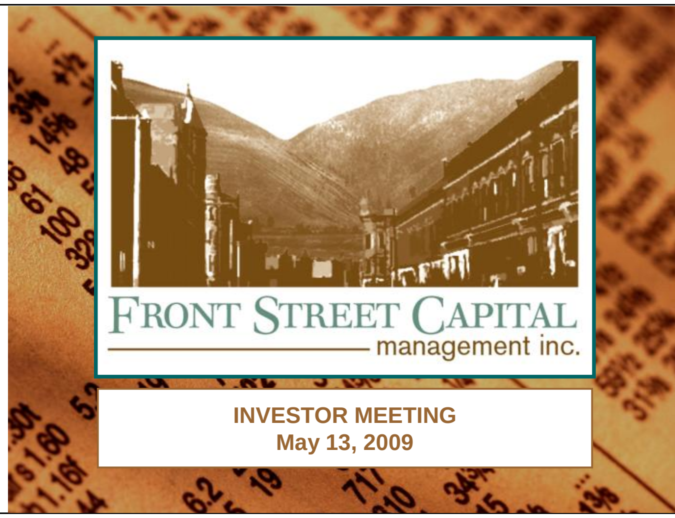
Audience Question: Can you tell us more about what you were thinking of Fastenal?
Answer: It is a remarkable story. It is a very simple business concept. They have these little stores with two people in each store. They sell nuts and bolts and junk to industrial companies and also to some restaurants and hospitals. I think it is a classic example of a silly, stupid business that empowers employees and it has turned into one of the greatest growth stories that this country has ever known over the last twenty years. It is purely about empowering employees. They have two people in each store; one person goes out and sells and the other one fills the orders. Their livelihood is connected to the profitability of the store. They build these stores in all small towns and there is a long ways for them to go; there are many areas where they have not built stores yet. I have wanted to own this stock for fifteen years almost and had not found an entry point that provided a valuation that made sense to me until the debacle of 2008 finally.

Further Question: How did they weather through 2008? Strong?
Answer: Yes, they actually wound up adding a third person to sell out of the stores instead of adding more stores which held their numbers up quite well.

Audience Question: Do you still follow AES?
Answer: No. Peripherally, they changed their culture and there was no reason for us to own it anymore.

Further Question: How did they change their culture?
Answer: Dennis Bakke had this fervor religion about empowering his people. It was very exciting for me. He took on a fair amount of leverage and during the last debacle in 2000, it kind of came home to roost. His partner was very disciplined with how they allocated capital. He retired and left Dennis there with all of his passion and the check book basically. The more Dennis grew the company through debt and empowered all of these people, the more it worked and the more excited I got unfortunately. But when the downturn hit, they got into some trouble with their debt. The disciplined former partner came back in and fired Dennis. He brought discipline back into the company but when Dennis left, so did the passion for the culture. When it recovered, we left it and that was the end of that.

Thank you so much. I appreciate it.

Slide 1	
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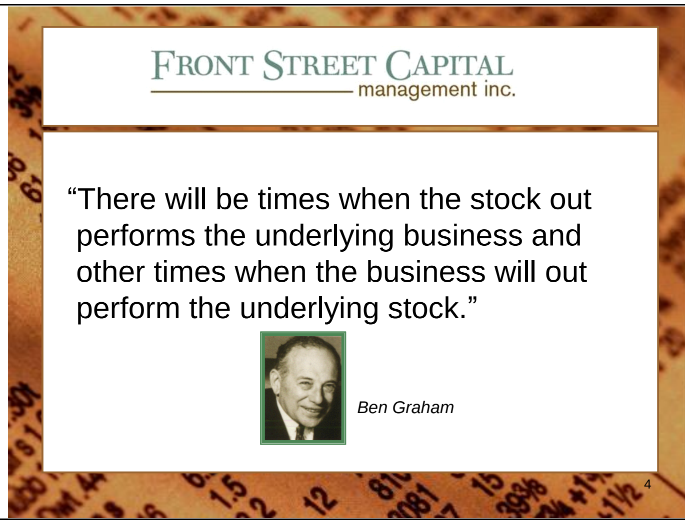

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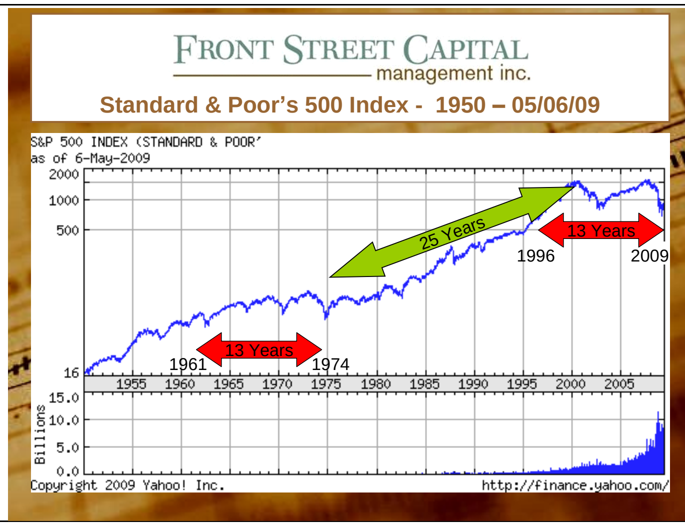

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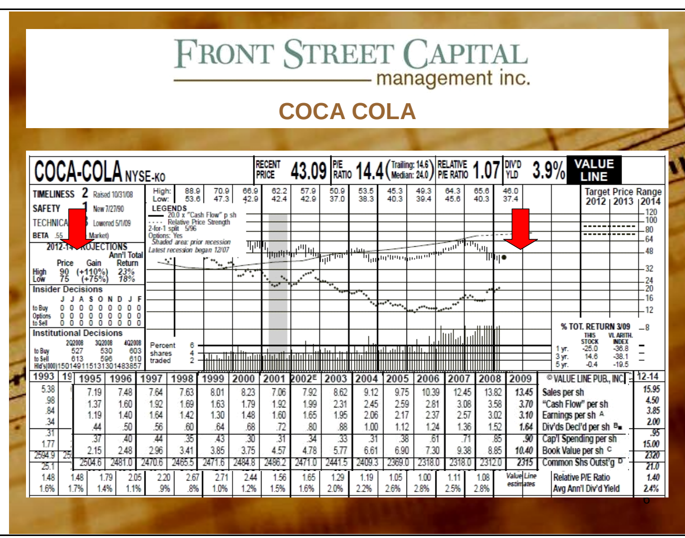

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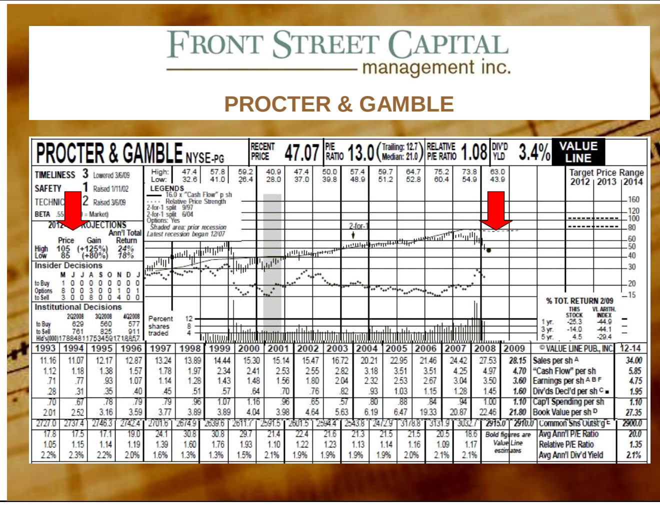

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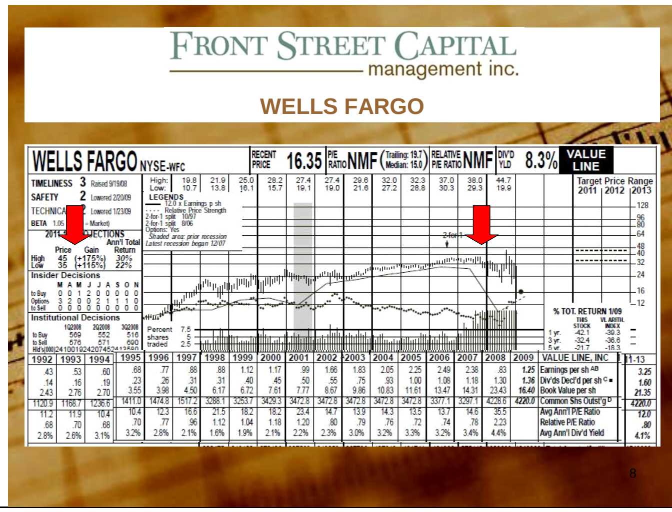

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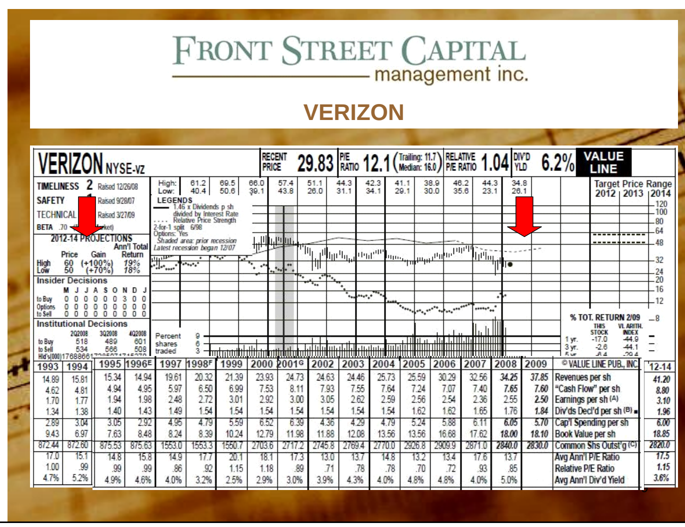

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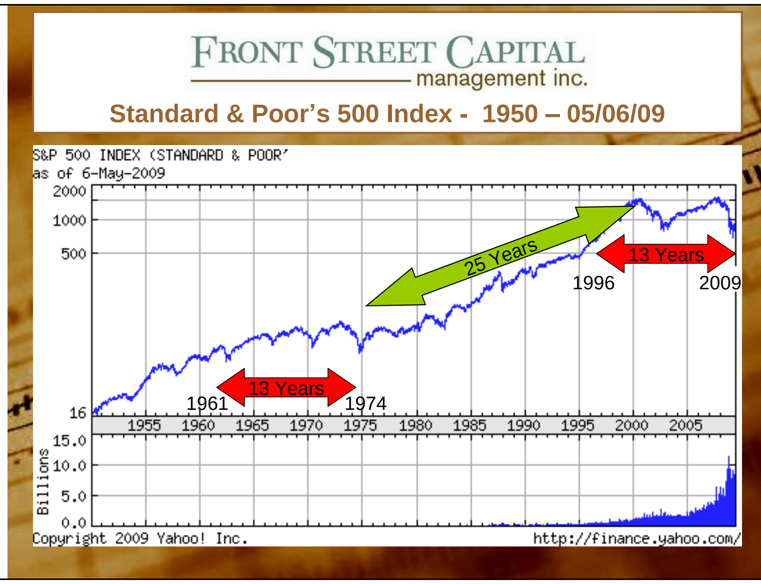

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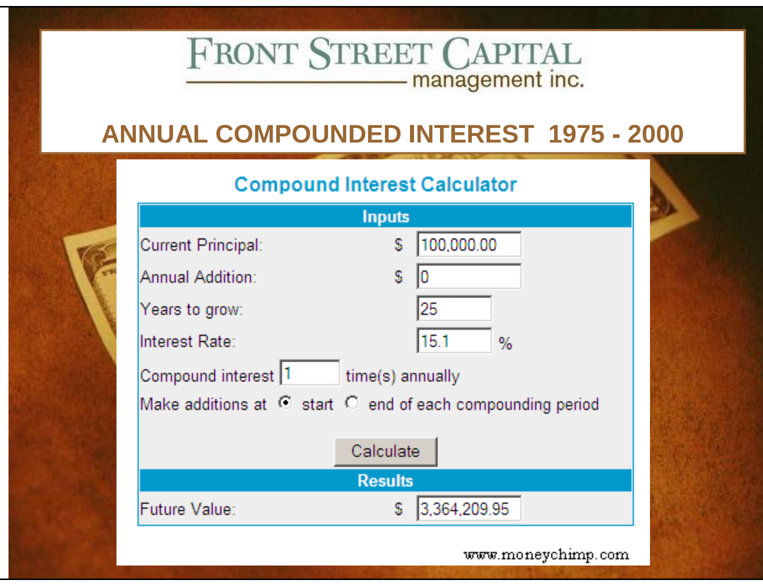

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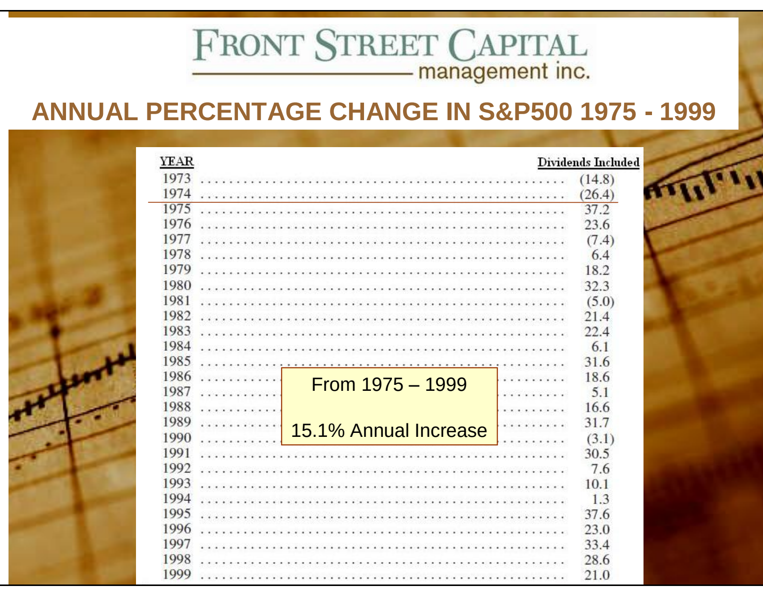

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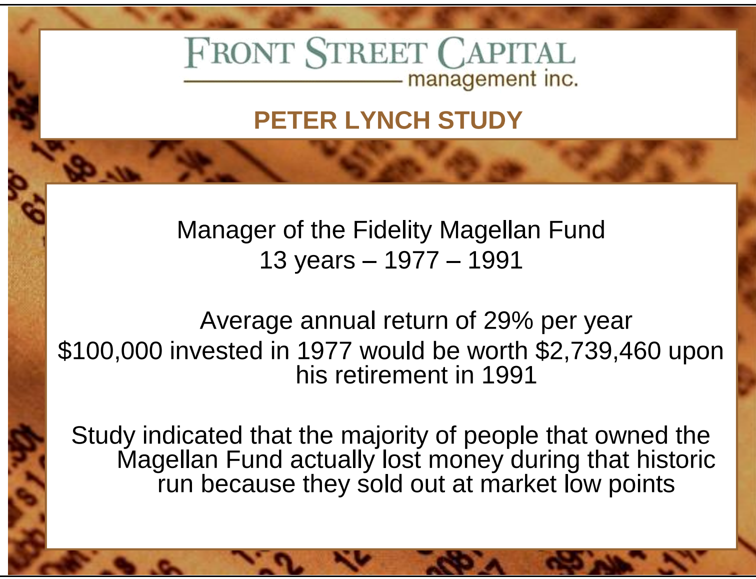

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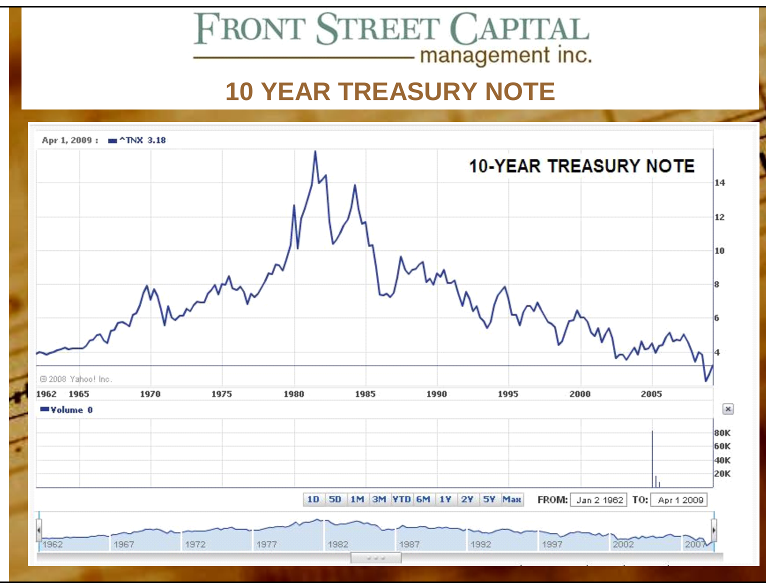

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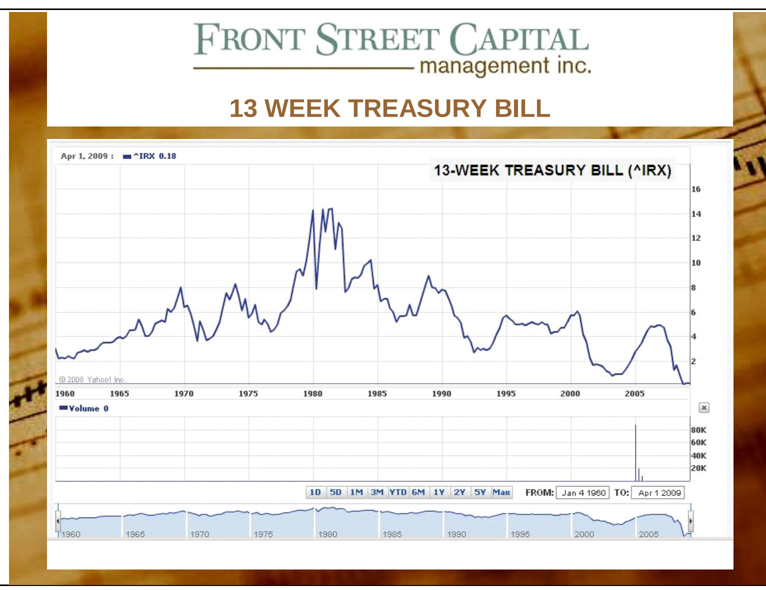

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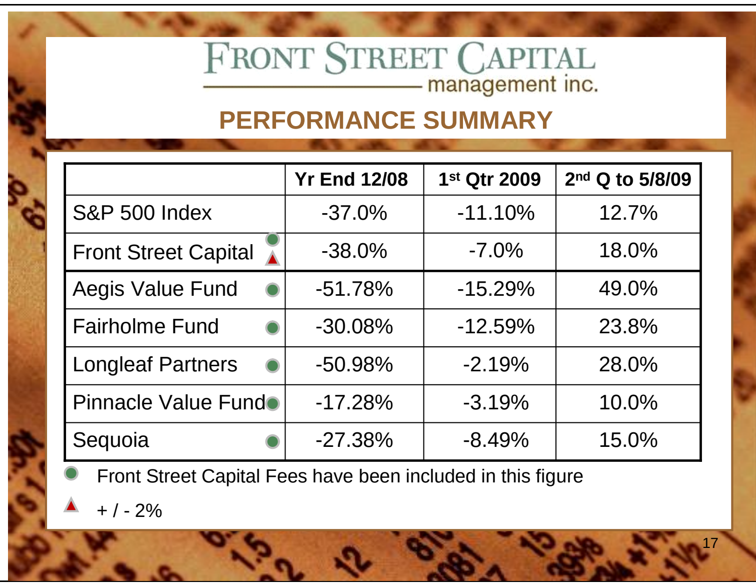

	Yr End 12/08	1st Qtr 2009	2nd Q to 5/8/09
S&P 500 Index	-37.0%	-11.10%	12.7%
Front Street Capital	-38.0%	-7.0%	18.0%
Aegis Value Fund	-51.78%	-15.29%	49.0%
Fairholme Fund	-30.08%	-12.59%	23.8%
Longleaf Partners	-50.98%	-2.19%	28.0%
Pinnacle Value Fund	-17.28%	-3.19%	10.0%
Sequoia	-27.38%	-8.49%	15.0%

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August 13, 2007 BARRON'S

The Top 100

Small- and mid-cap growth funds feature prominently in the 2007 *Barron's/Value Line* survey of mutual-fund managers, a reflection in part of the strength of smaller stocks in recent years. All managers were [illegible] according to how well they performed on a risk-adjusted basis, relative to others with the same investment objectives. Several managers are honored twice, for their stewardship of different funds.

Rank	Fund/Ticker	Objective	Inception Date	Manager	Manager Start Date	Manager Rating	YTD	1-Year	3-Year	5-Year
1.	Aegis Value/AVALX	Growth	5/15/98	Scott L. Barbee	5/15/98	13.60	12.80%	23.90%	13.89%	15.32%
2.	BlackRock Intl Opp Inv A/BREAX	Foreign Equity	9/26/97	Thomas P. Callan	4/1/99	13.30	15.40	37.60	34.35	25.73
3.	CGM Focus Fund/CGMFX	Growth	9/3/97	Kenneth Heebner	9/3/97	13.08	23.30	22.80	25.76	20.10
4.	The Boston Co Intl Small Cap Fd/SDISX	Foreign Equity	1/31/00	Daniel B. LeVan	1/31/00	12.80	10.00	27.30	30.12	27.50
5.	Perritt Micro Cap Opportunities/PRCGX	Small Company	4/11/88	Michael Corbett	11/1/99	10.90	13.80	21.00	17.82	20.76
6.	Fidelity Leveraged Company Stock/FLVCX	Growth	12/19/00	Thomas Soviero	7/15/03	10.80	20.20	29.30	24.10	37.90
7.	Legg Mason Opport Tr Prim/LMNOX	Growth	12/30/99	William H. Miller III	12/30/99	10.40	14.10	28.30	13.55	20.73
8.	Excelsior Instl Mid Cap Val & Restr/UMVEX	Growth	6/1/96	John McDermott	8/1/00	10.40	10.00	24.80	15.33	14.83
9.	Quaker Strategic Growth A/QUAGX	Aggressive Growth	11/25/96	Manu Daftary	11/25/96	9.58	15.67	18.69	15.20	14.59
10.	Winslow Green Growth Fund/WGGFX	Aggressive Growth	5/3/94	Jackson W. Robinson	5/3/94	9.50	17.00	21.50	18.48	20.32
11.	Excelsior Emerging Markets/UMEMX	Foreign Equity	1/2/98	Donald Elefson	8/1/99	8.58	13.00	40.50	35.39	30.14
12.	DFA International Small Cap Value/DISVX	Foreign Equity	12/30/94	Karen Umland	12/31/98	8.30	14.00	33.50	28.78	29.62
13.	Laudus Rosenberg Intl SmCap Inst/ICSIX	Foreign Equity	9/23/96	[illegible]	7/30/99	8.30	13.50	31.00	28.37	27.71
14.	TIAA-CREF Inst Mid-Cap Val Retail/TCMVX	Growth	10/1/02	Richard Cutler	10/1/02	8.18	11.00	25.10	20.26	
15.	Allegiant Mid Cap Value I/ARVIX	Small Company	7/1/02	Michael E. Santelli	6/16/03	8.08	12.50	26.30	20.91	
16.	Royce Value Fd/RYVFX	Small Company	6/14/01	Jay Kaplan	6/14/01	8.00	13.50	24.73	21.48	23.62
17.	Hartford Capital Apprec A/ITHAX	Aggressive Growth	7/22/96	Saul J. Pannell	7/22/96	7.90	9.65	22.56	17.01	17.59
18.	Columbia Acorn Select Fund Z/ACTWX	Growth	11/23/98	Ben Andrews	3/11/04	7.90	16.80	32.60	19.68	18.47
19.	Wells Fargo Adv Discovery Fund Inv/STDIX	Aggressive Growth	12/31/87	Thomas J. Pence	7/1/01	7.70	15.60	23.80	15.42	15.64
20.	Jennison Equity Opp A/PJIAX	Growth/Income	11/7/96	Mark DeFranco	5/1/00	7.70	12.30	23.20	14.00	12.22
21.	Regions Morg Keeg Sel Mid Cap Gr A/RSEAX	Growth	7/10/00	Charles A. Murray	3/12/99	7.70	10.80	10.30	16.30	15.50
22.	Oppenheimer Intl Small Company A/OSMAX	Foreign Equity	11/17/97	Rohit Sah	12/1/00	7.58	24.10	52.50	38.85	34.63

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BARRON'S

The *Barron's*/Value Line Survey

Our Top 100 fund managers consistently outrun their peers. How they're applying their skills in today's rocky market.

The New Masters

by Christopher C. Williams The 12th annual *Barron's*/Value Line ranking of the top 100 U.S. mutual-fund managers comes as growing investor fears about credit quality have sent the Standard & Poor's 500 stock index down almost 7% in the past month—its worst one-month showing in three years. Money managers across the board are feeling the heat, including many who earned a place in our latest survey. ● That said, most of this year's top 100 managers were beating the market and their peers by a comfortable margin at the end of June, and continue to outperform for the year. The top 20 returned an average of 9% for the year through Aug. 7, easily outpacing the broad market's 5% gain. No. 3-ranked **CGM Focus** Fund, in

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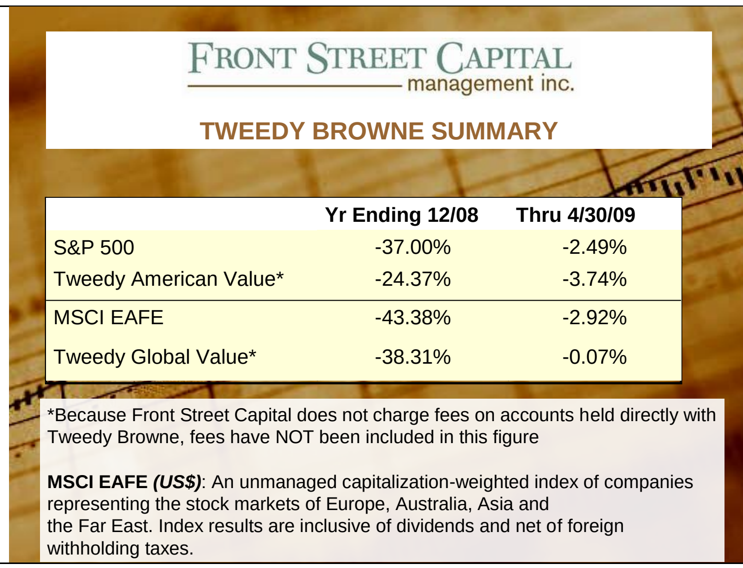

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