Transcript from Front Street Capital Management

Annual Investor Meeting – May 11, 2011

Investor Meeting 2011

Thanks a lot for coming on such a nice evening; I am surprised that anyone actually came tonight. I guess we can start if that is alright. To get started, our team as you know is Michele Blood, Ginger Belker, and our new associate is David Wild (Slide 2). David, as you know, is new this year and his primary responsibility is researching companies. We are all responsible for customer service. The big project that David has been working on for the last six months or so is that we are attempting to get our own no-load mutual fund started which will be called the Tarkio Fund. You can ask questions about that during the Q&A period or anytime you like actually. I do not have a formal presentation on the fund, though.

Since we started the firm, we have had a steady stream of people coming in with resumes looking for jobs and each time somebody came in, I would always sit down with them and explain to them our business model and what our investment philosophy was and as you all know, nobody leaves the office without one of these (Roger Lowenstein's book *Buffett The Making of an American Capitalist*). David was no exception. When he came in, I explained to him the business philosophy and the investment strategies and gave him the book but the difference with David was in two days, he came back and the book was all dog-eared and highlighted with post-its hanging off the edge. I gave him another book, the Phil Fisher book, and it came back in a couple of days in the same way; completely read and dog-eared. I actually gave him the Deming book next and he actually read the Deming book. Nobody I have ever known has actually read Deming's book. Then he read Peter Lynch. He blew through our library like they were potato chips. We kept a dialogue going for about a year and then finally last May, I believe, Michele, Ginger, and I decided that financially we could actually afford to hire David and so he has been here a little over a year. My opinion is that his presence has already added to your performance. I strongly believe that his work will continue to be a positive catalyst for your net worth over time. His resume is he graduated from Elon University with a history and philosophy major. He started his career in this business at the fixed-income desk of Bear Stearns (we won't hold that against him). He then went on to a registered rep at B.C. Ziegler and then went on to a registered investment advisor called the Appleton Group in Appleton, WI. While he was there, he was instrumental in that firm launching their own no-load mutual fund. David is married to Angie, who is here. She is a counselor at the University of Montana.

We are going to change the format a little bit. Over the past few years, we have spent over half of the meeting with me giving a formal presentation. We are going try to shorten that up by request this year. A lot of the time was spent talking about last years' performance and the first quarter performance. We will leave that to whatever you want to talk about in Q&A. However, with that said, the performance in 2010 and the first quarter of 2011 was good.

In March of this year, you might have seen it in the newspaper, there were 20 or so students that went from the University to go visit Omaha for a Q&A session with Warren

Buffett. David and I had the privilege of being invited to speak to the class before they went to kind of prep them for their Q&A session. So before we actually go on to the formal Q&A session, I thought it would be kind of fun to review a little bit of the material that we covered in that session. The material was obviously geared towards MBA students, people just starting their business careers. I thought about it and actually rewrote this but then went back and decided to keep it in that format. There they are (Slide 3). These are the students and they were kind enough to send us a picture of their visit. I decided to keep it in the format of talking to a group of MBA students so do not be offended that it is geared towards a younger audience. I think the great part of the Warren Buffett story is viewed from a younger person getting started in a business and so I decided to keep it in that format. David and I can tell you that the discussion with this group was unbelievable. It was very lively and interactive. I do not know if we will get to that tonight but I encourage you to interject something or ask questions to get this into a dialogue. Anything close to what we had with this group, it will actually be a bit of fun.

We called this Introduction to Buffett or Value Investing 101. In my opinion, most students leave college pretty much full of idealism. Over the years, in my opinion, that idealism consistently or systematically declines, the real world tries to "beat it out of you." I have always felt that the most successful career is the person who keeps their ideals throughout their career as long as they possibly can. To me, that is the Buffett story. Actually in the end here, now that he is reaching the twilight of his career, I think he actually is more idealistic even than when he got started. I think a large part of being able to do this is he has worked really hard to create an environment for himself to be able to isolate himself from the pressures and misguided incentives that encourage people to take shortcuts or to make compromises. I think the key to accomplishing this is he did not let other people define what success was for him. He defined it.

So whenever Buffett meets with students, his introduction is always the same. He starts off and tells them; at some point what you need to do is sit down and write down all of the admirable qualities that you know in people. Whatever that may be: they are honest, they have a positive outlook, they give others credit where it is due, they under-promise and over-perform. On the other side of the ledger, he tells them to write down all of the things that are offensive to you. Things like people that take shortcuts, they take credit for other people's work, they are disingenuous, they are arrogant, they over-promise, and under-deliver. Then he tells the students that all the things on the admirable side of the equation are within your reach. All you have to do is be that person and it is a matter of habit. It is not beyond anybody's reach to be what they think in their own image is an admirable person. Over time, his theory is that you will become that person. That is one of the key reasons why Buffett likes to meet with young people. As people get older, it gets harder and harder to break the chains of habit. He thinks he can have the greatest impact on people when he gets them before they start their careers, which is why he always invites these students to Omaha every year.

Buffett talks about the hiring process and three qualities that people would generally want in hiring an individual and they are integrity, intelligence, and energy. His theory is that without the first, the other two will kill you. A major theme of all of Buffett's communication is the concept of the circle of competence. This is kind of the oval of competence (referring to Slide 4 where the circle appears to be oblong). The idea is that you draw a circle around yourself and that is your circle of competence. Knowing where the perimeters are is essential, however; the size of the circle is not. The idea is that it is as important to know what you do not know as it is to know what you do know. So it is basically a discipline to be able to focus on the variables that you have control over. Again, the idea is the size of the circle is not important but knowing where its perimeters are is absolutely essential. The theory is that your odds of success go up exponentially as you make decisions closer to the center of the circle. To say it another way, Buffett likes to talk about low hurdles (Slide 5). What happens is that most people, when they become proficient at something, have the tendency to want to raise the bar all the time. And they keep raising the bar until eventually, inevitably, they fail. Buffett's idea is that you keep doing more of what you know. You stay within your circle of competence and your success rate goes up dramatically. Some people think that maybe it is more fun to keep raising the bar or having a higher challenge, but particularly in this business, it is way more fun to stay within your circle of competence, know what you are doing, and have a good success rate. This business is no fun when you are not successful. The funny thing that happens is that if you just say and do what you know and consistently do what you know, over time people start to think that maybe you are smart but in reality, all you are is smart enough to be disciplined to stick to your circle of competence. Buffett's example is that if he was to select a basketball team without any obvious expertise in basketball, it would be very difficult for him to look through a group of people and say "this guy is 6'1" but he can dribble well and has great passing skills." That is nowhere near his circle of competence. Buffett says that if he were to pick a basketball team with his area of expertise, he would pick the obvious: all seven footers. That is what you want to do; you want to keep your decisions in an area that you know so well that when you see it, it is pretty obvious. In investing, you want to make sure you select consistently all seven footers. When you see it you know it, it is obvious, and it is within your circle. We can have any interaction you want (here), guys.

Buffett points to three chapters in Ben Graham's book, *The Intelligent Investor*, that are the foundation for what he thinks and we think lead to investment success (Slide 6). The three concepts are: 1) you are buying a piece of business, you are not just buying a stock, you are buying an ownership stake in a business, 2) Mr. Market, and 3) the margin of safety. So the concept of buying a piece of a business is again, that you are buying an ownership stake in a business. These are not just little numbers that move up and down. Basically, they are tangible entities that have qualitative and quantitative aspects of them that can be analyzed and measured. So, we think that in order to be successful in this business, you have to be a business analyst and not a stock market analyst. We think that you need to be an expert in microeconomics and not macroeconomics. Now, macroeconomics is a fine field of study and has added a tremendous amount of value to society. But I can tell you it is only a distraction from being a successful business analyst and value investor.

A lot of times you will hear stock market analysts and pundits and they are always talking about complex matters and items that have many variables and as you listen to them you think 'wow, that guy must really know what he is talking about because I did not understand a word he said.' Buffett calls this approach basically the 'high priests' of investing. I actually just learned this the other day, that the actual high priests were priests in somewhat medieval times. They gave all of their sermons in Latin and at the time in Europe, nobody understood Latin. So people had a greater sense that what they were saying sounded smarter or more mystical because they did not understand what they were saying. This is how Buffett equates and a lot of what is promoted in the stock market these days or most days. So we think that really smart people can take something complex and break them down into very understandable terms. If you break it down into understandable and simpler terms, suddenly you start to get clarity. Again, it is the concept of the seven footer. When you see it, you know it. One of Buffett's great geniuses is taking very complex matters and being able to break them down into very understandable terms. If you have not read his annual reports, I strongly advise that you do so because they are just marvelous in the process of doing that.

So, we will move down to Mr. Market. Most of you have been here almost every year; I usually read Ben Graham's allegory of Mr. Market (Appendix 1). I am going to spare you that this year. We have copies here if you like. The idea of Mr. Market is that you have to accept market volatility as a reality and use it to your advantage. It is not a negative thing; it is a very positive thing. Market volatility is there to serve you, not to guide you. If you know the quality of the merchandise and you know generally what a fair value is, then the more wildly the price goes up and down, the better it is for you. It is not a negative, it is a positive. The more manic Mr. Market is, the better it is for those who know the quality and the value of something. Ben Graham says that in the short-term the stock market is a voting machine, but in the long-run it is a weighing machine. Along these lines, Buffett describes the investment process as akin to baseball, but you never get called out on strikes. So, you could stand there all day with a bat on your shoulder, but the pitches keep coming. To swing is your choice. There is nobody forcing you to swing. You do not get called out on strikes. That is the beauty of investing that most people do not take advantage of. You have the bat on your shoulder and the pitches keep coming by. And you get Google that comes by at $600 and you let it go, you get GE maybe at $20 and you let it go, and you get Cognex maybe at $36 and you let it go by. I came to work last week, and all of a sudden, there is Timberland at $29. This big fat pitch was coming right down the middle of the pike. It was as big as a basketball. You just lay into it with everything you have. If you know the value of things and the prices keep coming, it is to your advantage the more manic or volatile Mr. Market's behavior. The hardest part for most people is to be patient, particularly, as Buffett describes, as the crowd chants, "Swing, you bum!" What is really important is creating a proper environment to be able to work in that somewhat insolates you from all of these outside influences and noise. Another part of Buffett's genius is that he understood this very early in his career, where most of us have had to learn it through trial and error. Buffett's great line is that, "it is really good to learn from your mistakes, but it is infinitely easier to learn from the mistakes of others."

The concept of the margin of safety is that in everything you do, you need to make sure you build a cushion in case you are wrong. As we talked about before, we are trying to launch this Tarkio fund which will be a no-load equity fund. One of the funds that we have used, many of you probably own, is the Fairholme Fund. They have a tag line that goes with the fund that says, "Ignore the crowd." I was talking to David one day and I said, "We should have a tag line." Along the lines of the margins of safety, it should probably be 'We do not know anything.' You have to accept the fact that you do not know anything for sure. Once you accept that fact, you start to view the world differently; you start to make decisions differently, your behavior changes, and you are also always looking at the upside as well as the downside. Charlie Munger consistently says, "Invert. Always invert." It is one of those great lines that you can use in many contexts. Initially, it would be that you look at the downside. Like on a P/E ratio, if you inverted it, it would give you the earnings yield of the stock. It is much clearer than what would be a P/E ratio. So at 20 times earnings, the company is making 5% earnings yield, which is much more understandable than 20 times earnings. So sometimes if you look at things from a different angle or invert it, suddenly clarity comes very quickly.

I recently heard somebody quote that Warren Buffett said that investing was easy. I have heard him talk about this in forums before. I do not think they heard him say investing was easy, I think they meant to hear him say that it was not complex. The right foundation and mental framework are far more important than having a high IQ in this business. We think that the right framework is understanding that you are buying a piece of a business, understanding that Mr. Market is there to serve you and not guide you, and understanding the concept that is embedded in the margin of safety. We think that if these principles become part of who you are, over time you start to see the world with clarity. If Buffett said that it was easy, that is what he meant. With the right foundation you start to see things with clarity. Once you have the right foundation, on top of that, it is just a hell of a lot of hard work. Although it is not complex, it is not easy in the fact that it does not take any work. It takes a massive amount of work that David can attest to. Actually, we think that if you do not have the right framework, the more effort you put into it, your results are not necessarily going to get a whole lot better. In fact, we think that with the proper framework, knowledge becomes cumulative. It stacks on top of each other over time. Today, I think that I could make a quicker decision than David can because I have all of this information built up on a nice base. Buffett talks about that he can look at a company and, in a matter of maybe a half hour, make a pretty clear decision whether it would be something that Berkshire would be interested in or not. We think that with the proper framework, knowledge and information becomes cumulative. Without the proper framework, we think knowledge just becomes almost more noise and it becomes scattered. With more knowledge, you are just spinning your wheels faster but you are not actually going anywhere. Buffett talks about the fact that the 4-cylinder engine running on all four cylinders will outperform the 6-cylinder engine running on 5-cylinders every time. It is the framework that gives the investor the advantage. So, in conclusion for this part of the presentation, we think there is no formula, algebraic equation, or pie chart to ensure investment success. We think it is just these basic principles that create a mental model so that you can efficiently process information. On top of that it is just processing a lot of information and that is a lot of hard work. Actually, and I think David can attest to this too, that is the fun part. The fun part is going through all of this information daily because it changes and it is exciting.

I guess we will just go through the list of companies and now we will open it up to questions.

<u>Q&A</u>

Q: When you go through this process, what are the top three items that you focus on to get started and interested in a company?

A: It depends on what your circle of competence is. Our circle of competence is management, culture, and companies that are driven by a purpose. So, that is our circle and that is what we are looking for every day. You read everything and then all of a sudden, maybe once or twice a year, an article will come up about a company that is obsessed about teamwork or empowers their employees. They are very rare but when I see it, it is very obvious that that is a starting place. Buffett's starting point is going to be something else. Different investors are going to have different circles of competencies that would be the starting point. For us, it is these bullet points (Slide 7): companies that have integrity, long-term focus, passion, employee empowerment, teamwork, and discipline with how they allocate capital.

Q: What tells you that a company has integrity?

A: More than anything, it is living with them for a period of time. The more time that you live with them, the more you are going to understand the types of people you are dealing with. Most of these other things, you can do research up front and you can get a feel for the idea of the quality of the people involved. On top of that, it is just literally time. As time goes on, you either realize these are not the type of people that we thought they were or over time we are more impressed as time goes on. That is the big advantage for us of being a very long-term investor because we actually get to know things. By owning something for 10, 15, 25 years we actually get to know things.

Q: One lad said, "Never ride the same horse twice," referring to stocks. I notice that Corning is on the list again. Comment?

A: We had three companies that caused us problems during the 2001 and 2002 time frame. Corning was one of them. It was obvious that our last bullet point was disciplined capital allocation. All three of those companies had a little problem with disciplined capital allocation. As you know, we added that bullet point after the 2002 debacle. At the time, Corning had made somewhat of a rebound. There were other stocks that we were interested in putting the money in. I was very disenchanted with how they allocated their capital. We made the decision to move on. Part of it was I think I was looking for a scapegoat for some of the problems. We actually sold Corning, but kept the ADC and the AES. We wound up selling AES later and then later on we sold the ADC. Now, all of the sudden, as time has gone on, the culture of Corning was always pretty fabulous. We think that they learned well during the 2002 debacle. It was a young fellow by the name of Wendell Weeks that got them into the problems. He was actually quite a brilliant fellow. They had high aspirations for him. It was pretty incredible that they did not can him after they had made these acquisitions at very high prices that really put the company in danger of going insolvent at one point in time. Instead of firing Wendell Weeks, they kept him. He is still a young man, maybe 50 years old. I can assure you that this guy is going to be very disciplined with how he allocates the capital in the future. The stock has gotten very cheap in here. Their primary business that revitalized the company has been the glass that you use for flat-screen televisions. It is a very capital intensive business. People have gotten nervous because of the last time they were in a capital intensive business, which was making the fiber optic cables. When the business turned down, it started to really bleed a lot of red ink because they had all of this equipment that was not being utilized effectively. People were very scared that people would not buy flat-screen televisions due to everyone being scared of a nightmarish scenario reoccurring. Now the product is going into notebooks or iPads. The stock got to about 7 or 8 times earnings which we think was really a joke for a company of that quality. We thought that the future for that piece of the business would, at best, be pretty good. They have a lot of new products coming to market as they always do. It is really a research and development machine and their culture in that regard, we think, is terrific. With that said, for most accounts unless there was new money that came in, we have not gone out and switched a lot of things to buy Corning. We have only done it when there has been an opportunity with either new cash or something that we were looking to lighten up on for some reason or another. Everyone might not own Corning at this point in time. We just had some new money come in this week, and the first thing we did was plug it into Corning.

Q: Where you have gone most recently in the last year? What company site visits have you done and tell us about those trips.

A: I do not travel as much as I probably should. The last trip I went on was probably ICU Medical, which you might recognize in your portfolios. ICU Medical was a situation where a few years ago there was a Wall Street Journal article that just went on about how this company is obsessed with teamwork and it is all about self-empowered teams. Literally, the article was moving. However, I read the article and I did some research, but nothing verified it. So I just shelved it and did not think too much about it but followed the company peripherally. Then, when David came onboard, he has been taking every one of our companies and re-researching them, which has really been phenomenal. He has been uncovering things. As you get older, because of the idea that knowledge is cumulative, you get the impression that you do not have to do as much work as you used to do. In some degree that is true, except for the fact that David is coming up with stuff that I used to do but am just not willing to do anymore basically. He came up with another article that really verified this teamwork and empowered team concept at ICU. From a business model standpoint, it is really a very nice business. They make connectors for IV systems and they are a low-cost producer. We think that if you empower people, you will become a low-cost producer because you need less people and you need less middle management. So the idea was that they were able to be a low-cost producer in this business because of this teamwork concept that they had. I am interested in the medical business but I am always a little fearful of the liability involved. With very low-cost products, these things sell for a few bucks anyways. It is high volume and low price products, which makes it a very low risk business. The stock was selling in the $30's with 7 or 9 times earnings, which is ridiculously cheap for a business of that quality. The idea was that we will take a position because the price is right and then I will get down there when I can to verify what we thought was true. That was the last trip we took. I went to Salt Lake City to visit their manufacturing plant. I went down to the manufacturing guy with the article and I put it in front of him and said, "This is what I want to talk about and learn about today." He looked at it and he said, "I do not know what this is talking about. This is not our company. This is not what we do." I was pretty stunned actually. They have got some team stuff going but it is not nearly as sophisticated as the few articles stated, which is probably why I never could get it verified easily. It is still a wonderful business. The fellow that runs this plant, which is the biggest plant in the company; he actually gets it and understands self-directed work teams. He has a vision of transforming this company eventually to where this article had described it. It is obvious to me that he is very frustrated that it is not there yet and he is trying to get there. But you cannot tell me that this company already does these things were basically his comments. We like the company and we are going to monitor it so we can see if this guy is able to get traction in creating this culture. But if some of you have noticed, we have had some availability come up to purchase some things at some prices that we thought were very attractive and we have used ICU to do it. We might scale it back over time or we might get more comfortable with it and add to it. We do not know yet. It is a very nice business model. The stock is very reasonably priced. The CEO is very passionate about the business. He is a little quirky. But so far, it has done quite well for us, actually.

Q: I want to take just a moment to build this question, so bear with me for a second. One of the most brilliant things I think Munger has to say is to "watch out for authority bias" and he is an authority. I think it is brilliant that he goes out and says to watch out for the advice of an expert per se. He also very carefully says to watch out for inertia that you have in businesses that you have stayed with for a long duration. With that being said, with the companies that you invest in, and I am going to pick on one of them here in just a second, what do you do to make sure you do not become the victim yourself of authority bias or of inertia. The company I would like you to talk about is Whole Foods. I am just kind of curious about their culture.

A: I am not sure if I got your authority bias question dead on. We do not take anybody's advice. David and I talk about that. When reports come through, we just cross out all of the opinions. We do not want anybody's opinions; all we want are the facts. If we cannot make a decision based upon the facts, then we are not qualified to do this. We do not want somebody else's opinion. We do not really like analyst reports and if we do get them, we literally go through and cross out all of the opinions. They have done some groundwork and so there might be some facts in there that we do not know but we do not want anything to do with the opinions, period. I do not know if that addresses that. As far as Whole Foods is concerned, if there is a model for a company that we would like to duplicate, it is the Whole Foods model. It has evolved. This guy was kind of crude the way he thought about these things originally. Over time, you can see that his thinking has evolved right smack dab in the middle of our circle of competency. It starts with a company that has purpose, which we think is a powerful tool. The company is not simply about making money but they have a purpose in mind and it drives the passion throughout the entire organization. He understands the empowerment aspect of a business to a large degree which, by the way, really saved them during the downturn. The rap on Whole Foods was that their prices were too high and that nobody is going to pay that kind of money to go to a grocery store. There were some communities, like Greenwich, CT, that were still willing to pay the high prices. There were other communities that they had to modify what they do and bring in products that were at a lower price point. Because their store managers and their employees were empowered, each store had the ability to alter their product mix to bring down the cost structure or not depending on the area that the store was located in. It has fired out of the decline bigger and stronger than any company that I am actually aware of. The recovery has been dramatic, massive, and exciting. Our only concern is that the price has gotten a little high. Again, as you may have noticed, we have shaved little bits off just because the price might have gotten a little ahead of itself. If we had not have done anything, it would have been 7 to 9% of the portfolio and we are trying to keep it between 5 and 6%.

Q: Can you talk a little bit about Oclaro? Because for a while you were a buyer for several years, and then, at least in my portfolio, a seller, and I am just wondering where you feel they are now.

A: Yes, we are a buyer. We have gone through this almost every year so we have some area of expertise, I guess, in the fiber optic network. Oclaro makes the boxes that enable the network by transmitting the information. The story is that in the Internet bubble era, the fiber optic network got overbuilt and was ahead of itself. There was too much capital available and more capacity than what was needed at the time. What happened was when they had more capacity; the prices for being able to deliver things over the network plummeted. Very few network operators had any money to put money into equipment even if they wanted to and they did not want to anyway. So that sector got completely decimated. Our entrance into Oclaro was after this decimation. They had reverse splits and all kinds of things happening. The original Bookam stock was probably $800 per share and I think our original entry point was $2-3 per share at the time and we just kept averaging all the way down. Because the prices that one could charge to deliver this information over the network was plummeting so rapidly, it enabled all of the things that we love and enjoy today that is attached to the internet including all things that are wireless. The traffic all through the last 12-14 years has been growing at almost 100% a year compounded. If you grow anything at 100% per year compounded, it is a staggering number. The theory was that at some point in time, the capacity of these pipes would get filled. And that is exactly what has happened and is happening as we speak. Prices are firming. Even though prices are firming due to video, which takes up an enormous amount of bandwidth, the amount of traffic going over the web is not only continuing at the same pace but is actually reaccelerating now. The need for these products has been in great demand. The industry shrunk so much that there was not enough product available. The Oclaros of the world could not create enough product to service their customers. When that happens, there is a tendency for customers to purchase excess inventory just to make sure that they have something on hand. Since we have owned Oclaro, there have been two major inventory corrections in and of the fact that the customers bought more than they needed just so they made sure they had product on the shelves. When they get caught up, the revenues slack off for a period of time and the stocks have had some pretty major swings. For some accounts, yours included, the last time we got this big swing up we shaved a little bit off. Now we are getting another big swing down. We are very aggressively adding to the Oclaro position as we speak. The real story for us is the one that everyone has the most skepticism about, and that is Level 3, which is the actual owner of the network. There are some accounts, depending on timing and when we had money available, you might see names like JDS Uniphase, Oclaro, Finisar, OpLink, OpNext, and Ciena, which are all companies that are involved with these optical boxes. There will be a time when we do not own any optical boxes, but we will probably always own the owner of the network, which is Level 3.

Q: Who are Level 3’s main competitors?

A: AT&T and Verizon obviously but the problem with them is that, as you can imagine, this is a network that has been amalgamated over 75-80 years or more. It has copper and fiber in it and all kinds of different technologies that are kind of cobbled together over long periods of time. There are a lot of companies that had access to capital in the bubble era of the internet that were able to build a fiber optic network end to end all fiber. By definition, those networks are more efficient at a lower cost than the networks of AT&T and Verizon. So in a lot of ways, they are really not competitors in the back haul network because AT&T's network is not nearly as efficient. All of the other companies that competed with Level 3 with a clean sheet of paper have gone bankrupt. Level 3 is the only one that utilized that funding from that period of time that did not go bankrupt. One of their main competitors that did go bankrupt, they just acquired them here last week is Global Crossing. There are a lot of little players that have little pieces of the network here and there that are all fiber end to end. They are not nearly as extensive as Level 3's. The only ones that are really that extensive are the big players: AT&T and Verizon. The problem with being a small player is that if you charge your customer to send information, then you have to lease a line from somebody else to connect all the way to the other end. If you have to lease too much capacity from somebody else, as prices start to go up, eventually they get squeezed. There were actually two small fiber companies that were basically put up for sale and the assumption would be that they own some piece that they are not able to raise their prices and they are getting squeezed out. You could sort of make the case that they (Level 3) might not have a lot of competition for exactly what they do.

We could wrap this up and everyone could go and enjoy the wonderful weather if you like.

Q: Could you talk about your mutual fund?

A: Yes. As I indicated before, we got a few new accounts this week. It is very challenging to start a new account. You cannot just go in and buy a little bit of everything. What you try to do is buy what is available at a good price. You leave the ones alone that are not at an attractive price. If you wait, eventually those stocks will come down to the price you think is reasonable, and so you add piece meal as you go. It is a challenge. The customer on the other end, who brings money, expects that when the market goes up their account will also go up. You have to get engaged, but be careful that you do not over pay. It is not an easy process. For an existing account, if someone added new money it is easy because I always have two or three new things which I am salivating over due to the price. So when new money comes in, it is just easy to plug in to those three or four ideas. Then the account goes on and everything is just hunky dory. The idea of a mutual fund is that you have one account, that over time, once the infrastructure gets built, as new money comes in it is easy to just add on to what you have originally. We have sent this chart (Slide 8) out a whole bunch and we actually think that this bottom here in 2009 was somewhat equivalent to the bottom that occurred in 1974. If that is the case, actually from here to here (1974-1999) the market grew 14 and a half percent a year for twenty five years. After a thirteen year drop, the point of maximum pessimism spawned a tremendously long terrific run for common stocks. We think the reason is that during these periods you get these long bear markets where people become very disenchanted with stocks. The ownership of common stocks has a smaller and smaller percentage of the population. Then we think that people come as the market gets turned around, which we see here and here, which is very similar the logarithmic thing does not show it. People are very skeptical. Money certainly is not flowing in even as we speak in spite of the fact that we have had a pretty good run off the bottom here. We think that most people are very skeptical, and as long as people are fearful and skeptical, we are in very safe condition. In fact, it doesn't get really risky until here (1998-2000). We have gone through these periods and we have a fair amount of confidence that we can duplicate some of the performance and actually I think we are way better off today than we were in this period where numbers were pretty terrific (1981-1996). With David on board, I have more knowledge in the business than I had before, we are more disciplined than we were before, and everything about what we are doing is better. How could we leverage this? I don't think we can manage twice as many relationships as we have today. The mutual fund enables us to leverage our work without really having to manage twice as many relationships. The only thing we will have to manage is the money that comes in and out each day. We won't even know who they are for the most part. Does that make sense?

Q: How is that?

A: We own some mutual funds; I think you might own the Fairholme Fund. You do not talk to Bruce Berkowitz, who manages the fund. We put the money in and take it out. It is just a different model and we think that it will enable us to manage the same style of investing that we do today.

Q: Do you visualize about the same list of equities in the mutual funds as are in our individual accounts now?

A: That is the dream! I will be a lot more comfortable when that fund looks exactly like your account. Getting there makes me nervous. If the market just takes off, we might not get the full range of companies that we want. It will happen, I know it will happen. It is the same anxiety that I get when I get a new account. The only difference is that this account, for all intents and purposes, will be one of the last accounts we will have to put together, and that part is comforting.

Q: Is there a time frame for when that will happen?

A: Yes, right now we have been spending the past nine months getting things up and running. The fund is registered with the SEC, so they pretty much govern the operations there. We are at a point in time where we have replied two times to them so the ball is in their court. It could be as early as one or two months or it could be pushed out further than that. We are waiting for them to give us the green light right now. David is working really diligently at it. I do not even think about it. My theory is that I want to run everything as if we are never going to have a fund because we may not with the SEC, who knows. I do not want to restructure and just think about managing the business in relationship with the fact that it is all going to be about the fund. I am pretending like we are never going to have the fund. It is a nice business as it is, it really is. If we never had the fund, it is a terrific business. We get to work with terrific people. We own terrific companies. We love what we are doing as it is. When the fund is available, we will start to make plans then. Until then, I am going to pretend like it will never happen. David has been fighting that every day.

Q: Are you going to phase out your clients on the individual stocks? Who is going to own the fund?

A: I would say, to some degree, when a new customer comes in and they want to buy our Front Street equity portfolio, they will probably go into the Tarkio Fund unless, for some reason or another, they really insist that they would rather have their own account. The Fund will be more efficient. Over time, the cost structure will be the same. Actually, it will be a little lower because the cost of transactions will be a little lower. We would not be averse to opening an individual portfolio, but I cannot really envision why one would want that rather than putting money in the fund.

Q: Individual balance I guess?

A: It is going be identical as to what I would put together personally.

Q: If the fund is up and going, are you going to work any less or more diligently on the equity piece if this thing is supposedly off taken?

A: The SEC rules are that we have to treat the individual portfolio identically to the fund. We cannot front run one verses the other. So as a group they have to be managed the same way. So the fund is just going to be one more equity account that I manage is the way it is going to be. We cannot really treat the equity fund differently than the rest of the accounts. With that said, on the flipside of what you said, there is no advantage to taking money out of the equity account and putting it into the fund. In fact, it would be a disadvantage for several reasons.

Q: Would you recommend in the future, say the fund was up and running, that we transfer our equity account into the fund?

A: No, absolutely not.

Q: As you know, I recently brought in some money after sale of real estate and you parked it temporarily in several mutual funds. My impression was that you were doing that because you did not have a place to split it all up. When you have the mutual fund, you will have a place to split it all up, right?

A: As you know, we have two account structures. We have the mutual fund account and we have the equity account. With managing an individual relationship, it is nice to have both to provide some balance for the client. I really cannot manage everybody's entire assets in 25 different stocks. The idea of being able to offer four other funds that compliment what we do is a better way to manage an individual's personal net worth. But in the future, with the fund, we are not going to get all of anybody's net worth that comes into the fund. Like we are going to put a piece of your net worth in say, Aegis, somebody is hopefully going to put a piece of their net worth in the Tarkio Fund. They will have a whole bunch of other stuff out there that balances out their personal needs. If somebody comes in and I am managing an individual relationship, then I am going to put some money in the fund, and some money in Sequoia, and some money in our four other funds. Tarkio will only be a piece of it, just like the equity program for most people is only a piece of what they have. I can tell you, if we can do anything close to the superb job that Sequoia and Aegis have done, we are going to have a very successful no-load mutual fund. I am not, in any way, discounting the funds that we already own. We are still daily researching and looking for new funds as well, that part of the business is not going away.

Q: Can you talk a little bit about the Pinnacle fund. Are you still encouraging people to put money into that or not?

A: No, we are not adding any new money to the Pinnacle value fund. For a lot of people, each time the market takes a big dip, we move some money out of Pinnacle and spread it out into some of the other funds that we are working with. The situation with Pinnacle is that he is a very excellent stock picker. He is a deep value Ben Graham style investor looking for reasonable companies at ridiculously low prices. The problem with that style of investing is that it does not scale well. The larger the size of the fund, the more difficult it is to manage that amount of money. So it was a startup fund with a very small amount of capital. He has a seasoned track record working with the Royce value funds. We thought it had all of the characteristics of what we are looking for in a deep value fund which are very hard to find. We actually think it is a lost art. Aegis is one of the few funds really left that we believe can execute against this and is still small enough to do it. The problem with Pinnacle was that he had a lot of cash back in 2007. Believe it or not, I was a little nervous in 2007. I liked the idea that he had all of this cash because if the market would take a correction, he would have the resources available to take advantage of it. The slide was far beyond anything I had ever dreamed of. I certainly was not anticipating that. But I was excited about that fund because they had all of this cash. As the market started to go down, sometime in 2008, he started to allocate the cash and that sector of the market turned into a massacre. It really did. Basically any company that was not thought to be a Johnson & Johnson or some kind of a AAA rated thing, the consensus was that company would be priced for bankruptcy. The managers that fished in those ponds found it very painful for a period of time when the panic was all out. So he started to get invested, and then everything disintegrated on him, and then he pulled back, and stopped dead. We will never see values like this again. I knew that. So I started to move money away from him at that point in time because it seemed like he was unable to pull the trigger. Then the places where I put the money disintegrated on me. Suddenly I just stepped back and realized I couldn't find the bottom of this thing. He has had the courage to keep all of this cash all during the downturn so why don't I let him make the decision of when to allocate it; why should I? Let me give him the benefit of the doubt and let him allocate the capital at the right time or when he thinks the right time is. So I kept watching and watching, and the market kept going down lower and lower, and he continued to not invest. Then suddenly, I started to get worried, thinking that maybe he does know where the bottom is. And if he does, that completely blows apart my entire investment philosophy. If somehow or another, he could get fully invested at the bottom, then I do not know what I am doing. My whole premise was based upon the fact that nobody could do that. The pressure that comes on me almost daily to figure out how to get out at the top and in at the bottom and I reject it is something that any human being could do. On the one hand, I am thinking that it is an opportunity of a lifetime for him to have all of this cash where the values are so unbelievable. But on the flipside, if he actually pulls this off, I look like a monkey. I was confused, to say the least. And low and behold, the market bottoms in March of 2009. John Deysher gets 80% invested, which he has been running at 40%. The bottom occurs and it is a dramatic move. On the one hand, I was sort of excited for him and on the other hand, I was a little disenchanted that he could actually do it. Then, three weeks later, after this big move off of the bottom, he is back to 50% invested again. He has not been able to pull the trigger since. So, I know his head is spinning. There will be a day when he gets it together, but until he does every downturn that occurs, we are probably going to pull some money away from him. He was performing quite well only half invested and now that has flat lined. So I have become a little more aggressive. I like him and I know he is capable but I also know that once you get your head kind of messed up, it is not a good thing. We have other alternatives that are brilliant. Aegis does what Pinnacle should be doing. Most of you probably know the story of Sequoia. It is a masterpiece is what it is. Are there any other questions?

Q: Does Front Street Capital have on its horizon anything to do with alternate energy? You say you are always looking for new funds.

A: Our criteria are the management criteria that we laid out for you. It would be accidental. We are always looking for new ideas but we are looking for new ideas with these management principles. In other mutual funds, we look for mutual funds that also are value investors in some form of the scale but not investors that are looking for any particular market segment. With that said, one of our longest term holdings happens to be in a big R&D operation that makes polymer materials for a variety of industries. I am almost pinching myself that this has evolved. They have solar energy, wind energy, electric hybrid automobiles, and high-speed rail electric trains. They are positioned in a way that makes me almost weak in the knees to think as to what may happen to this company. It wasn't the fact that I went looking for a company to solve those problems; it is a company that we have loved for a long time. Their products naturally lent themselves to this area. It is the Rogers Corporation. They have a very small capital base so the upside potential is more than I actually want to think about tonight.

(Audience Comment) I am surprised more isn't being done. We have finite energies out there as the world gets smaller and we use up our resources. I mean we were looking hard at the solar energy 25 years ago here in Missoula. I was building solar panels down at the Courthouse. I am still scratching my head wondering why we are so dependent and remain so dependent? Is it the forces that be or is it just not profitable yet?

That is a macroeconomic problem and I will let others figure out the solution. I feel fortunate that we happen to have a company that is unbelievably well-positioned in this area. It is almost by happenstance because we would not go out looking for a company that is going to solve those problems.

A: David: With that being said, we have two companies that are taking huge leaps in terms of addressing the finite materials that you are talking about. Coca-Cola is committed to being water neutral in their manufacturing process for the soft drinks by 2020; and Herman Miller is committed to achieving zero emissions with zero waste and 100% green energy sustainability by 2020 as well.

The last question was not captured on CD. . .

Mr. Market

Long ago, Ben Graham described the mental attitude toward market fluctuations that are most conducive to investment success. He said that you should imagine market quotations as coming from a remarkably accommodating fellow named Mr. Market who is your partner in a private business. Without fail, Mr. Market appears daily and names a price at which he will either buy your interest or sell you his.

Even though the business that the two of you own may have economic characteristics that are stable, Mr. Market's quotations will be anything but. For, sad to say, the poor fellow has incurable emotional problems. At times he feels euphoric and can see only the favorable factors affecting the business. When in that mood, he names a very high buy-sell price because he fears that you will snap up his interest and rob him of imminent gains. At other times he is depressed and can see nothing but trouble ahead for both the business and the world. On these occasions he will name a very low price, since he is terrified that you will unload your interest on him.

Mr. Market has another endearing characteristic: He doesn't mind being ignored. If his quotation is uninteresting to you today, he will be back with a new one tomorrow. Transactions are strictly at your option. Under these conditions, the more manic depressive his behavior, the better for you.

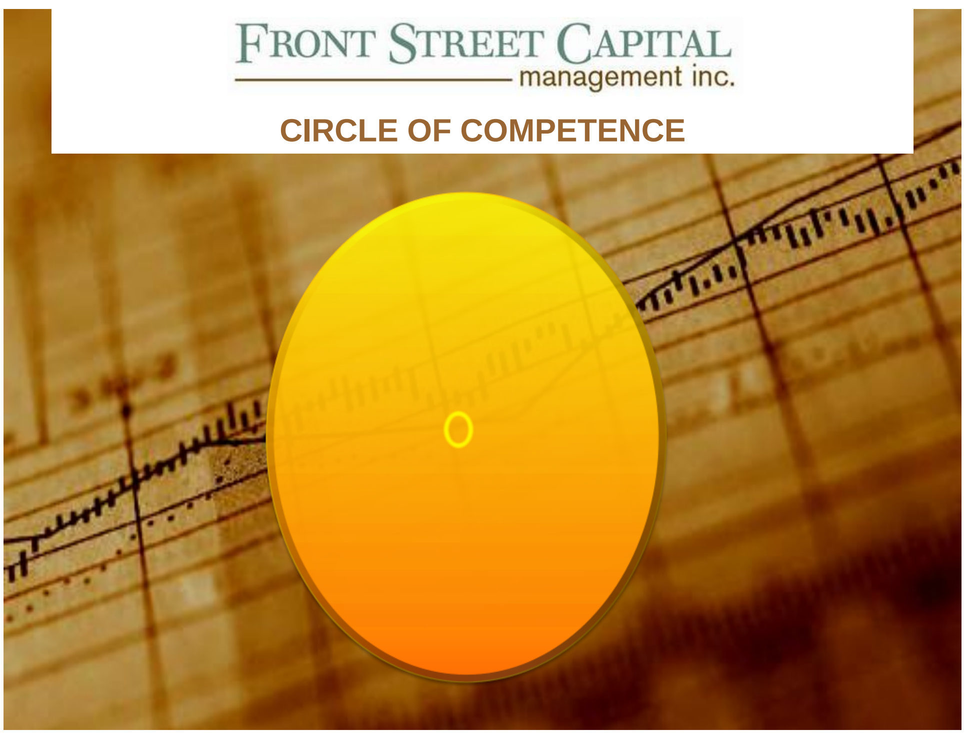
But, like Cinderella at the ball, you must heed one warning or everything will turn into pumpkins and mice: Mr. Market is there to serve you, not to guide you. It is his pocketbook, not his wisdom that you will find useful. If he shows up some day in a particularly foolish mood, you are free to either ignore him or to take advantage of him, but it will be disastrous if you fall under his influence.

Excerpts from the 1987 Berkshire Hathaway Inc. Annual Report

Slide 1

Slide 2

Slide 3



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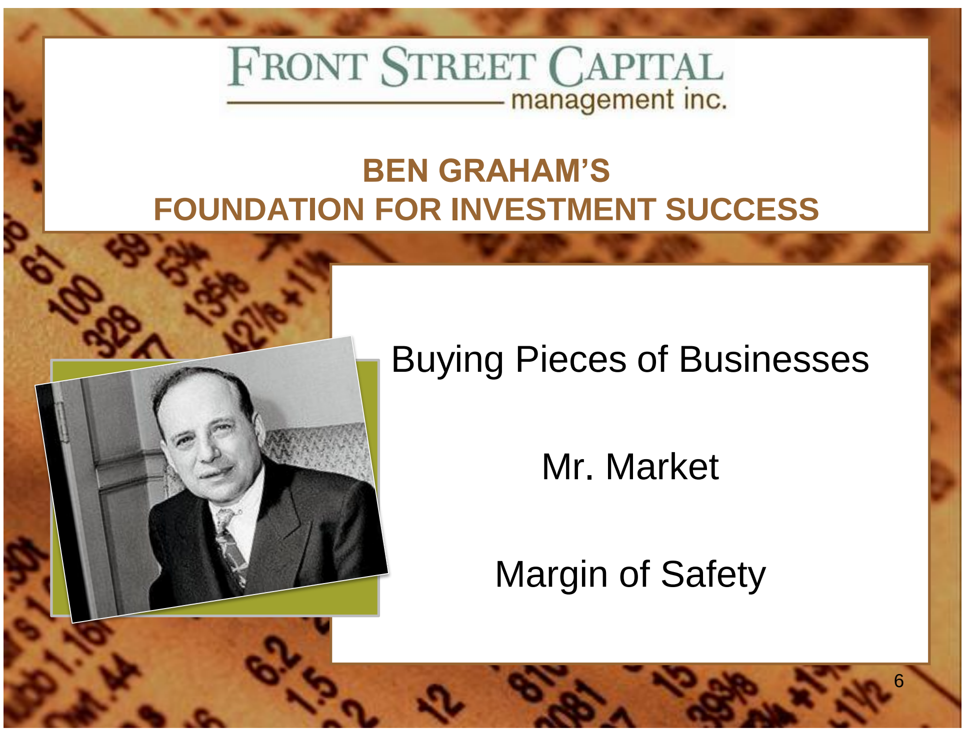

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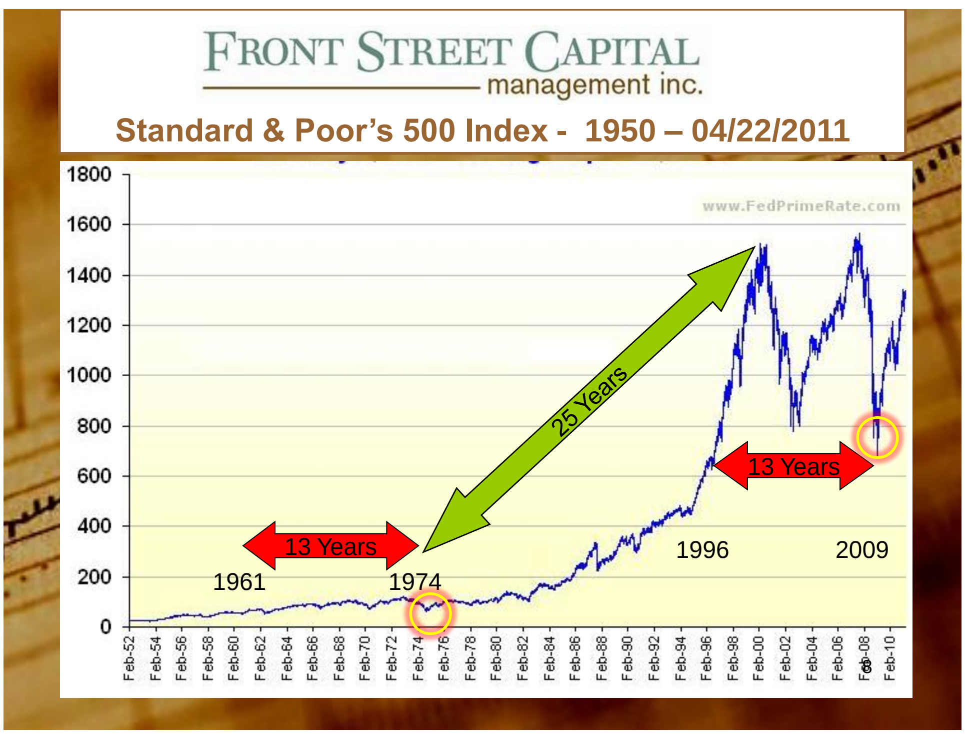

Slide 8