WALTER & EDWIN SCHLOSS ASSOCIATES, LP'S
WALTER & EDWIN SCHLOSS - PART I

from the *Outstanding Investor Digest* March 6, 1989 edition

Walter Schloss attended Ben Graham's finance course before World War II and went to work for Graham-Newman in 1946. Leaving to establish Walter J. Schloss Associates in 1955, he was joined by son, Edwin, in 1973.

As one of Warren Buffett's "Super-Investors of Graham and Doddsville" in his *Hermes* article of the same name, the Schlosses have run circles around the indexes. For the 33 years ended 12/31/88, Walter J. Schloss Associates earned a compound annual return of 21.6% per year on equity capital vs. 9.8% per year for the S&P 500 during the same period.

Here are Walter & Edwin Schloss Associates' annual return figures along with those of the S&P 500 for each of the 33 years ended 12/31/88. All performance figures were provided by Walter & Edwin Schloss Associates, LP.

Year	Gross Annual Return	Net Annual Return	S&P 500
	+6.8%	+5.1%	Total Return
1956	-4.7%	-4.7%	+6.6%
1957	+54.6%	+42.1%	-10.8%
1958	+23.3%	+17.5%	+43.4%
1959	+9.3%	+7.0%	+12.0%
1960	+28.8%	+21.6%	+0.5%
1961	+11.1%	+8.3%	+26.9%
1962	+20.1%	+15.1%	-8.7%
1963	+22.8%	+17.1%	+22.8%
1964	+35.7%	26.8%	+16.5%
1965	+0.7%	+0.5%	+12.5%
1966	+34.4%	+25.8%	-10.1%
1967	+35.5%	+26.6%	+24.0%
1968	-9.0%	-9.0%	+11.1%
1969	-8.2%	-8.2%	-8.5%
1970	+28.3%	+25.5%	+4.0%
1971	+15.5%	+11.6%	+14.3%
1972	-8.0%	-8.0%	+19.0%
1973	-6.2%	-6.2%	-14.7%
1974	+52.2%	+42.7%	-26.5%
1975	+39.2%	+29.4%	+37.2%
1976			+23.8%

1977	+34.4%	+25.8%	-7.2%
1978	+48.8%	+36.6%	+6.6%
1979	+39.7%	+29.8%	+18.4%
1980	+31.1%	+23.3%	+32.4%
1981	+24.5%	+18.35%	-4.9%
1982	+32.1%	+24.1%	+21.4%
1983	+51.2%	+38.4%	+22.5%
1984	+8.4%	+6.3%	+6.3%
1985	+25.0%	+19.5%	+32.2%
1986	+15.9%	+11.9%	+18.5%
1987	+26.9%	+20.2%	+5.2%
1988	+39.2%*	+29.4%*	+16.8%
1956-88	+21.6%	+16.4%	+9.8%

* -Figures for 1988 represent estimates.

A two-man firm with no employees whatsoever, the Schlosses occupy a small room within Tweedy, Browne's offices. Alongside other memorabilia is a letter from Buffett to members of the "Buffett Group" before its Hilton Head conference in 1976.

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(continued from preceding page)

Warren E. Buffett
1440 Kiewit Plaza
Omaha, Nebraska 68131

February 3rd, 1976

To the Hilton Head Group

Dear Gang,

Normally, when you get a letter from the wife, partner or secretary of Joe Glutz saying, "Of course, Joe is too modest to tell you about this

himself, but I know you want to hear that...", it means that Joe is standing over the writer with a gun at his head, telling him not to look up from the xerox machine until the mailing has been completed.

This one is for real.

Today I received the 1975 annual letter of Walter J. Schloss Associates, which included a 20-year compilation of Walter's record since he left Graham-Newman. You may remember I went to work for Graham-Newman in 1954.

Walter left in 1955. And ... Graham-Newman closed up in 1956. I would prefer not to dwell on the implications of this sequence.

In any event, armed only with a monthly stock guide, a sophisticated style acquired largely from association with me, a sub-lease on a portion of a closet at Tweedy, Browne and a group of partners whose names were straight from a roll call at Ellis Island, Walter strode forth to do battle with the S&P.

On the following page is a re-cap of his yearly performance and calculations I have made regarding compounded results. The difference between the gross results and the limited partners' results is accounted for by the fact that, as General Partner, he takes 25% of the profits - a quaint, easy-to-calculate method of tribute not entirely foreign to many of you.

Walter has had five down years compared to seven for the S&P. His superiority in such down years would indicate that not only is he a man for all seasons, but that he has special strength when facing a head wind. Maybe all of you had better watch Ben Graham on Wall Street Week this Friday.

As for me, I'm going right out and buy some Hudson Pulp & Paper.

Best,

/s/ Warren

With a long waiting list of individuals wishing to become limited partners, the Schlosses have the luxury of picking and choosing among them. Highly unusual within business generally and the investment field in particular, the Schlosses give preference to clients with a demonstrable need for their services.

Somewhat publicity-shy, the Schlosses consented to an OID interview in an uncharacteristic lapse of judgement following prolonged begging by an unidentified ~~editor~~ party.

The following excerpts were selected from a series of highly enjoyable conversations with the Schlosses at their office in Manhattan. The first part of a two-part interview, we hope you enjoy it as much as we did.

OID: Thanks for agreeing to an OID interview. Where should we begin?

Walter Schloss: In The Merchant Bankers, there's a chapter I find particularly interesting. Mr. Warburg, who just recently passed away, lived in pre-Hitler Germany with his family. The Oppenheimers, the Mendelsohns and the Warburgs had been living there for many years.

When Hitler came to power, Warburg became very concerned. He arranged to meet with one of the top people in Hitler's government. Afterwards, he told his wife, "We've got to get out."

And they did. In 1934, they took their two children and they went to London giving up most of their wealth in the process. They were criticized by all of their friends. "Why are you leaving Germany?"

He gave up a lot to get out. But he saw what was coming. Most of the other people who were wealthy and had been living there for years just ignored it.

But Warburg was a non-conformist.

Edwin Schloss: Thankfully for him and his family, he was a contrarian.

Walter Schloss: Starting nearly from scratch, he didn't do very well at first. But then, after the war, he backed Reynolds in an aluminum deal that worked out very well and put him on the map. Anyway, he became very successful.

He made the point that it was good for families to lose their money every third generation. Otherwise they got too soft.

OID: Good thing for you, Edwin, that you're generation number two. Anyway, it sounds like a page straight out of Warren Buffett's book.

We understand that Peter Kiewit, whom Buffett often speaks of admiringly, had a father who felt the same way as Buffett does about the evils of inherited wealth.

As we recall, much to Kiewit's surprise some years after his father's death he received a delayed out-of-the-blue inheritance of a few million dollars. While it was peanuts compared to the estate his father had built and relative to the success he himself achieved, he said it made him feel like his father was extending ***his approval from the grave.***

Walter Schloss: I've noticed that children of very successful fathers quite often don't get along with their fathers and leave. But in many cases where the sons and the fathers do get along, the sons do much better than the fathers.

Apparently, they use the springboard of the first generation. The father has a little store on the Lower East Side and through the son's efforts, it becomes Macy's.

Some of it has to do with the power of compound interest. If you start with a dollar and you double it every so many years, it builds up. In the first twenty years it doesn't look like much but eventually it does.

OID: Compound interest - the eighth wonder of the world.

Walter Schloss: Government Employees' Insurance was a case in point. It started in 1936. Graham-Newman bought its interest in 1948 as I recall. But it took a long time to build up.

When Graham-Newman bought it, GEICO was ready to take off but they didn't know it. Nobody recognized that their gradual growth was about to accelerate. It was viewed as just a nice little company making money.

After they bought it, of course, it suddenly took off and their timing turned out to be brilliant.

OID: Better rich than right, I believe the saying goes.

As I mentioned to you in a prior conversation, Templeton's worst ten years investment-wise were his first ten years. And you told me that the same was true for you.

Walter Schloss: Yes, that's right. I think the first ten years you get kind of acquainted with what you're doing.

OID: So we shouldn't feel too bad about not knowing what we're doing in our fourth year at OID?

Walter Schloss: Hope springs eternal....

But I honestly don't see how you're going to be able to use this material - unless it's possibly to keep it in the file to blackmail me.

OID: As logical a business extension as any we've considered.

Walter Schloss: I especially liked your interview with Templeton. I think I made a xerox of it.

OID: We'll send you a bill.

Walter Schloss: It was excellent. At some point, you should put his and others into a book.

OID: At 32 pages an issue, some would say we already have.

Walter Schloss: But people have to be very humble about money if they want to keep it. They have to work at it. It doesn't just happen.

And different children have to be treated differently. Some people are even afraid of money. My mother, for example, would have been one of the worst investors and my father was a terrible investor.

And it's because they lived through fear - through the Depression. As a result, they allowed fear to make their judgments

OID: We didn't realize your parents were both pension fund administrators.

Walter Schloss: Don't laugh. We had a client who used to be the perfect contrary indicator. Everything was fine so long as the market was doing well.

But when the market went down, he'd get very panicky. Finally, he'd call me and say, "Walter, I can't stand it. We've got to sell."

And it would invariably occur at market bottoms. I actually missed it the first time. But he did it several more times and I always knew it was the bottom of the market.

This man was very logical in his own business. But in declining markets, he would get very scared.

OID: What is he saying today?

Walter Schloss: Now he's made a lot of money so that he's no longer panicky. But I wish we had more like him.

OID: If you'll lower your minimums and accept IOU's, we'll volunteer to replace him. But you say he's not panicky today? Isn't that a bad sign?

Walter Schloss: Not really. He's got so much money now that if he called panicky today, I'd really be worried about him.

Edwin Schloss: If we get the call, we'll be sure to tell you.

OID: Please. We'll report it.
By the way, we mentioned you in a recent issue. I hope you won't find it in the least disparaging.

Walter Schloss: "Making Money Out of Junk, Part 2"?

OID: No, we just mentioned that you're up there in years, but still love what you do.

Walter Schloss: That's very nice, but I'm not that old. I'm only 72.

OID: If you'd invited us to your 70th birthday party, we wouldn't have made the mistake. Anyway, age isn't that important.

Walter Schloss: At my age, most people want to retire to Florida and play tennis and relax. But I get a great deal of pleasure from what I do.

OID: That's apparent.

Walter Schloss: First of all, I like working with Edwin. Second, it's intellectually stimulating.

Finally, I'm helping my partners. Many of them don't have that much money. So I'm making life easier for 50 or 60 people and I get pleasure from that. And I make money out of it, too.

It's fun - so long as it doesn't get too difficult. If it ever gets too difficult, we'll quit. Phil Carret is 90 years old and he still enjoys what he's doing.

Actually, for 105, I think I'm doing remarkably well.

OID: No question about it. We stand corrected. And we'll point out that you're an extremely young 72 in our next issue.

But changing subjects as quickly as possible, you worked with Ben Graham and Warren Buffett. A key principle of investing for each of them was the importance of not losing money.

Conversely, in a recent issue, hedge fund manager Randy Updyke spoke of a little known investor by the name of Lou Thomas who quietly built up an incredible 30-year record in quite a different way.

His philosophy was that you can't eliminate risk - that it's always going to be there. Therefore, what you try to do is be compensated for it by looking for maximum reward relative to risk and maintaining lots of diversification.

Walter Schloss: Beta on the upside but not on the downside.

OID: Exactly.

Walter Schloss: Albert Hettinger, ex-Lazard partner, did that. Bill Ruane talks about Hettinger being such a successful investor.

But Graham was concerned with limiting his risk and he didn't want to lose money. People don't remember what happened before and how things were. And that's one of the mistakes people make in investing as well.

In the last 15 years, it's been a remarkable stock market. But people forget what things were like during the 1930s. I think Graham - because he lived through that period - remembered it, was scared it would happen again and did everything he could to avoid it.

But in the process of avoiding it, he missed a lot of opportunities. That's one of the problems you always have - you don't really lose, but you don't really make, either. I believe you should remember what took place - even if you weren't around at the time. One of the problems of a lot of the people who went through the Depression - Ben Graham, Jerry Newman and others - is that they keep on thinking that things will always be like that.

Even Graham used to say - and quite correctly - that you can't run your investments as if a repeat of 1932 is around the corner. We can have a recession and things can get bad. But you can't plan on that happening. People who did missed this tremendous market.

Some people can do it. Most people can't and I don't think they should try.

OID: Many would say the same of the 1973-74 period.

Walter Schloss: I agree. It was much like 1929. The only difference was that in 1929, the companies went bankrupt. In 1973-74, the stocks went from $70 to $3. They didn't go bankrupt. They just went way down.

And they went down very quickly - not as quickly as October of last year,

but very quickly and then up again.

I remember Londontown - which manufactured London Fog coats. The darned stock was selling at maybe $12 and went down to $5. It had working capital of $10 so we bought it.

And then it went back up - we sold it between $10 and $15. And then Interco took it over at $20.

Edwin Schloss: More than $20.

Walter Schloss: All in the space of two years. The profit potential in a market like that was really unbelievable.

OID: The good old days.

Edwin Schloss: To a somewhat lesser extent, you had the same thing in the aftermath of the October break two years ago. The deep drop in prices whetted the appetites of the LBO and takeover guys.

Walter Schloss: As aided and abetted by low interest rates. Some of these companies were afraid of being taken over themselves. And one great way of avoiding being taken over is to leverage your own balance sheet by buying another company.

OID: A la Philip Morris.

Walter Schloss: Exactly. When Philip Morris bought General Foods for 4 times its book, it seemed like a high price. But, in retrospect, it seems like a pretty good deal, at least compared to Kraft. Everything's relative.

OID: Of course, compared to Kraft, almost anything would seem like a good deal.

Walter Schloss: I remember we owned stock in Schenley back in 1960 or so when it was selling below working capital.

I went to talk to their treasurer. At that time, their stock was selling at $20 and they had $33 of working capital, including a huge inventory. I was asking how good their inventory was. In the course of our conversation, he said, "We've spent $100 per share on advertising."

That advertising was on the books for nothing. And that's also true for Kraft. You have Philadelphia Cream Cheese and Miracle Whip. You couldn't replace those for almost any price. They've got a niche.

If somebody said, "Gee, I want to be in the businesses that Kraft is in now," it'd be a very difficult thing to do.

So even if book is only $20 and Philip Morris paid $106 a share for it, their book value and assets are only part of it. The rest is in the goodwill, the name - the franchise, if you will, as Warren Buffett would describe it.

OID: Your advertising comment is a very interesting one. Advertising clearly builds long-term value even though it's expensed each year. That may help explain why Buffett reportedly subscribes to Advertising Age and pays attention to advertising expenditures.

Philip Morris may have paid a multiple of book for General Foods but they paid only 50% of sales. They paid over 100% of sales for Kraft.

Edwin Schloss: I know what you're saying. But thanks to General Foods, Philip Morris had just about everything except cheese. In hindsight, Kraft was an obvious fit.

OID: Certainly a great franchise, but at what price?

Edwin Schloss: It's clearly late in the market cycle for food stocks. It's dangerous to play the game at these prices.

Walter Schloss: People just weren't willing to pay those prices for great franchises in the past.

Also, anti-trust was enforced much more severely. If a company wanted to buy another company, anti-trust enforcement forced companies to buy market share the hard way. Most companies realized they couldn't do it.

Many years ago, when I was at Graham-Newman, U.S. Steel agreed to buy Consolidated Steel. Graham-Newman bought a lot of it - at least, it seemed like a lot then. Of course, it seems like a lot less today.

Anyway, the board began to worry about the possibility of enforcement action by the government enforcing anti-trust and canceling the whole deal.

So Graham said, "Well, I think the Supreme Court is going to rule 5-4 in favor of the company." And he named the justices who he believed would vote for it and the justices he believed would vote against it.

The board evidently decided that they needed a lawyer who specialized in anti-trust to come over and tell them what they should do. So they brought in this lawyer who determined that the Supreme Court would vote 5-4 against the merger and that it would therefore be disallowed.

At that point, despite this authority's opinion, Graham still thought he was right. Characteristically, he was very modest. He never pushed his opinion. And, after all, this attorney was an authority and he wasn't. So they compromised and sold half of their stock.

When the decision came down from the Supreme Court, sure enough, Graham was exactly correct and the authority was wrong. The Supreme Court voted 5-4 in favor of the merger and each of the justices voted exactly as Ben Graham thought they would.

OID: Fascinating.

Walter Schloss: Graham would often compromise if there was more than

one opinion.
There's a lesson to be learned. If you truly think you're right and some lawyer tells you otheiwise, stick to your guns - even if the other guy knows more. You've got to make up your own mind.

OID: Randy Updyke told us how he let his broker talk him into reducing his purchases of Chrysler at $3 a share.

Walter Schloss: I've never met Randy Undyke. But Tweedy, Browne had a closed-end mutual fund called Asset Investors. They bought all these undervalued stocks at discounts.

Because Tweedy was managing other money, they had to be very careful that they met all the myriad requirements for a mutual fund. As it turned out, Randy Updyke bought enough stock to make them a personal holding company.

At that point, they had to liquidate since they didn't want to be a personal holding company. So he really forced them into liquidating. And the stock had been selling at a discount to its asset value. Everybody could see the holdings

OID: Very clever.

Walter Schloss: Apropos of that, while I was at Graham-Newman, a man called up and said he'd like to speak to Mr. Graham. Because he was out of town that day, I asked if there was anything I could do in his stead.

He said, "I just wanted to thank him. Every 6 months Graham-Newman publishes their portfolio holdings. And I've made so much money on the stocks that he had in his portfolio, I just wanted to come by and thank him.

That was one of the reasons I decided never to publish our holdings. We work hard to find our stocks. We don't want to just give them away. It's not fair to our partners.

OID: Spoilsport.

Walter Schloss: Also, Graham-Newman bought a lot of Philadelphia-Reading from the Baltimore & Ohio Railroad at $14. And the stock went down to $8. And all these people were buying the stock at $8 and $9 per share when Graham-Newman had paid $14. And Graham-Newman was doing all this work trying to turn it around.

Of course, it worked out very well. It went way, way up and Northwest Industries took it over. It eventually grew to several hundred dollars per share.

But I'll never forget the story of that guy wanting to thank Graham for all the money he made.

OID: One of our subscribers refers to Buffett as "Uncle Warren" for exactly

the same reason.

Walter Schloss: If we like a stock and it goes down, we like to buy more. So if you talk it up and convince everyone that you're right, you can create competition.

One of the problems Warren has is that when he buys a stock and people find out, it automatically goes up 15-25% over what it would otherwise do. So he has to establish his positions quickly. That's why he buys those big blocks.

OID: Our most heartfelt sympathies. I think it was his partner, Charlie Munger, who said he likes having the problem of investing several billion dollars of their own capital. We should all be so lucky.

Edwin Schloss: *Another problem - if we just mentioned one or two securities and someone bought them, we'd feel responsible if they went down. It's not exactly a diversified portfolio.*

OID: If you'd prefer to name 25 or 30 bargains, we'll list all of them.

Edwin Schloss: How generous of you.

OID: Why did you start Walter J. Schloss Associates when you did?

Walter Schloss: The opportunity came along and it just seemed like the time to do it. It was a bit of a contrarian thing to do.

OID: Naturally.

Walter Schloss: My mother is a fairly good judge of things in which she's not emotionally involved. She's only begged me twice not to do things. The first was not to enlist right after Pearl Harbor. But I felt very strongly about doing my part and I signed up anyway.

The second time she begged me not to do something was when she begged me not to go into business for myself.

I didn't have any money but I had an opportunity. Someone said they'd put some money into my partnership.

Mother pointed out that I had two small children and shouldn't take the risk. Well, we are both pleased that she was completely wrong.

OID: And Ben Graham didn't like the idea either?

Walter Schloss: In 1955, Graham testified before the Fulbright Committee. The market had gone up to an all-time high - up to the 400 area vs. 381 in 1929.

And Graham and John Kenneth Galbraith both testified before the Fulbright Committee that the market was too high. Everybody else - about 18 others testified - thought the market was reasonably priced.

Graham was looking at it historically. Galbraith was just against the capitalist system generally, I think. But, anyway, they both testified against it.

And here I was - I admired Graham tremendously, and I was going into the business at just the time when he was saying the market was too high.

It was just one of those things. You do what opportunity allows you to do. It turned out to be a fabulous decision. I didn't know it at the time.

You really have to stick to your guns no matter what other people think.

It's also important to know what you know and what you don't know. Templeton, for example, does something that I think is brilliant that I'm incapable of doing - he buys securities all over the world.

I've found the few times that I've bought outside the United States, I've had my head handed to me - not every time, but most often.

OID: We achieve the same thing domestically.

Walter Schloss: And the rules are different in different countries. I can't help but think about Cuba where Castro suddenly came in and confiscated everything.

While we in America have a little bit of an unstable economic situation, our political system is stable. We don't have to worry about confiscation.

OID: Except on the margin - with rent control, insurance premium rollbacks and the like.

Walter Schloss: Exactly. It's very interesting to watch what's going on in the insurance business in California. You just can't ask companies to take 20% off the top.

OID: If it were put to a vote, what price rollback wouldn't pass? There are more buyers than sellers of almost every product in the world. It smells like confiscation of property to me.

Still, we were hoping the trend would spread into other areas. After all, if there's a 50% rollback in prices for everything, we'd all be twice as rich.

Walter Schloss: Wouldn't it be great if things really worked that way? There's no reason anyone – insurance companies or anyone else - should just be required to lose a lot of money.

Yet, Fireman's Fund was in Massachusetts and wanted to withdraw from writing insurance there. Massachusetts wouldn't let them. Fireman's Fund had to sue to get out of doing business there.

In the end, they had to pay $43 million to withdraw from doing business there. And they were happy to get out at that price.

It was disgraceful. And, then, you hear about what a great manager Dukakis was. From the point of view of getting $43 million, maybe so. But from the

point of view of doing business in the state, it's terrible.

Fireman's Fund isn't in business to lose money. Incidentally, we think it's a good long-term investment.

OID: Of course, the governmental interference will come home to roost when governmental inefficiency leads to higher rates and/or higher taxes.

Walter Schloss: Of course.

OID: The perspective on many issues is so different in New York and Massachusetts.

Walter Schloss: We've got a warped point of view here.

OID: Rent control, for example. To most people, rent control is not silly. We imagine you would agree that rent control is a terrible idea.

Walter Schloss: Except for my mother.

OID: And present company, of course.

Edwin Schloss: Having a sense of humor is terribly important.

Walter Schloss: One of the reasons why Warren is such an attractive personality is that he has such a great sense of humor and all those terrific stories.

But apparently, he was shy when he was young and decided that he wanted to overcome it. So he went to the Dale Carnegie course. One of the first things he did when he graduated was to propose to his wife.

I saw him in Omaha back in 1961 or 1962 when he got up before a Rotary Club and gave a brilliant speech culminating in asking for money. He was the youngest person there and it was very, very funny. I wish I'd had a tape recorder. It was great.

OID: If not for his investment successes, the world would have another Will Rogers. He has an ability to express things so concisely and yet humorously at the same time.

And what can you say about his annual reports?

Walter Schloss: Absolutely brilliant.

Actually, I think Ben Graham wrote better than Warren. He was very succinct in what he said, but he didn't have Warren's humor.

The difference is Graham didn't really like investments. He liked the challenge. He liked the game. He liked to make money. But he didn't really enjoy investments.

As he once told me, it was easier to make more money than to cut down on his expenses.

He was involved in a lot of things. He was involved with charitable organizations. He used to write articles for the Analysts' Journal, including their first issue. He used to write under the name "*Cogitator."*

And he did a lot of other things. He had a great idea about using commodities as a backing for currency. He wrote a book called Storage and Stability on the subject.

OID: What's a guy like you doing in a nice business like this?

Walter Schloss: Wall Street got very busy and I worked there during the summer of 1933. And I loved it.

So, in 1934, I went over to Salomon Brothers looking for a job. I can still remember the guy there telling me, "We're an old bond house. There's no future in here. Business is terrible. We're not hiring anybody."

Of course, that's the great Salomon Brothers of today.

OID: With foresight like that, it was probably their investment banking analyst you spoke with.

Walter Schloss: Probably. Anyway, I got this job as a runner with Loeb Rhoades for about a month. Then they put me in the cage. In those days, we counted the box every day with the partner in charge of the box.

Can you imagine each day counting every security at Carl M. Loeb & Co., later Loeb, Rhoades & Co.? It's hard to imagine today. I worked there for seven years.

During that time, I also went to school at night at what was then called the New York Stock Exchange Institute - now known as the Institute of Finance. The man who ran it was a fellow named Birl Schultz, who was a very lovely guy. His son was pursuing his Ph.D. at the University of Chicago. And Birl admired him tremendously. His name was George Schultz, our Secretary of State in the Reagan administration - only in America.

Ben Graham's brother, Leon, was a sweet guy, but he wasn't too good in his investments. So Ben supported him by giving him business from Graham-Newman. Anyway, Graham lectured at the courses I took at the Institute of Finance. He'd take all these live examples and use them to illustrate his principles. It was fascinating. And I liked what he did.

I went in the army. At the time, I had about $1,000. I gave it to Leon. When I came back, it was worth $2,000.

When I got out of the service, I got a note from Ben telling me that the fellow who was doing security analysis for him was leaving to work with his father and would I be interested in going to work with him. That's how I got the

job with Ben Graham.

OID: Tell us about your duties at Graham-Newman.
Walter Schloss: I joined Graham-Newman on January 2nd, 1946, right after the end of World War II. The first thing I did was to prepare the results of the first ten years of Graham-Newman. Interestingly, Graham-Newman only operated for twenty years.

Graham had partnerships before that where he managed money for individuals. But during the late '20s he managed partnerships where he got 50% of the profits, but he also took 50% of the losses.

What hurt him is that when the market went down in the 1930s, he was responsible for the losses. But what hurt more is that people pulled their money out so that he couldn't make it back.

OID: Ouch.
Walter Schloss: Anyway, I went to work for him for 9-1/2 years.

You know the Government Employees Insurance story, that they never should have bought it at all because it was illegal?

OID: We did a piece on GEICO recently but we're not familiar with that facet of the story.
Walter Schloss: It's still true today - an investment company can't buy more than 10% of an insurance company without the approval of the SEC.

Edwin Schloss: But Graham-Newman didn't know it at the time.

Walter Schloss: They'd paid $750,000 for half of the company. Fred Greenman, who was Graham's attorney and an old friend, had brought the GEICO deal to them.

When Graham bought the stock, the SEC said, "You can't buy more than 10%. You violated the SEC laws, even if it was inadvertent."

Manny Cohen, a tough administrator at the SEC, said, "You've got to get rid of it. Go back to the people who sold it to you and see if they'll take it back."

So they went back to the family from whom they'd purchased the interest and tried to sell it back. But they said, "No. We don't want it. We sold it. Forget it."

OID: Amazing. And this was the best investment Graham ever made in his career by a wide margin.
Walter Schloss: Next, the SEC looked at the profit- sharing arrangement and asked themselves how they could make sure that Graham-Newman wouldn't get any profits out of it.

The answer that they came up with was to require Graham-Newman to distribute the GEICO shares to its shareholders at cost. So that's how Graham-

Newman stockholders got their GEICO stock and became millionaires.

OID: Unbelievable. Graham describes how the deal almost fell apart over some minor provisions in The Intelligent Investor. But, in addition, Graham-Newman was also forced to try and sell its GEICO shares back at cost and they weren't allowed to benefit from the best investment they ever made?

Walter Schloss: Unfortunately, that's correct.

Even more ironic, the 25% of GEICO stock that was not owned by Graham-Newman and other outsiders was retained by the founders' family - when Leo Goodwin died, he left the stock to his son.

His son went into other ventures. But instead of selling his stock to finance them, he borrowed against his GEICO stock. When it collapsed in 1976, he was wiped out. The bank sold him out and he committed suicide.

Warren [Buffett] bought most of that stock when it went way down. And that's how Warren got the GEICO stock that Goodwin had owned.

So that's a short history of GEICO. The whole thing was pathetic in a way - some people became millionaires, some didn't benefit at all and others went broke.

OID: If you made a movie or wrote a book, nobody would believe it.

Walter Schloss: And Dave Dodd, the late co-author of Security Analysis, said to me when the stock was way down, "I've always lectured at my course at Columbia***, 'Don't let paying taxes affect your judgement of when to sell.'*** And I didn't follow my own advice."

He had 125,000 shares of GEICO. And when it went up, he didn't sell it because he didn't want to pay the taxes.

OID: What a package of ironies.

Edwin Schloss: And that's not all of the ironies. My father sold his stock when I was born to pay for my birth.

OID: So you were a very expensive addition to the family.

Edwin Schloss: I know.

Walter Schloss: A great bargain, nonetheless.

When I first went to work for Graham-Newman, they were offering Graham-Newman stock to their stockholders at net asset value or a slight premium. At the time, I took all the money I had, which was about $3,000, and put it into Graham-Newman stock.

When Graham-Newman was forced to distribute it, I received GEICO stock. Subsequently. GEICO spun off Government Employees' Life Insurance.

When Edwin was born, I sold my GEICO stock to pay for his birth. Then,

when my daughter was born, I sold my Government Employees Life Insurance stock to pay for hers.

So while it's true I didn't get Graham-Newman stock, I did get two children. which I thought was a good buy.

Edwin Schloss: And I'm working awfully hard to make that money back.

Walter Schloss: After-tax.

OID: No wonder you and Edwin work so closely together.

Walter Schloss: Not at all. But you never know how things are going to turn out. It could have gone the other way.

It's funny also that I would have been better off to sell my Graham-Newman stock and keep my GEICO stock. But because I was working at Graham-Newman, I didn't want them to think I was being disloyal.

Everybody was buying a share of Graham-Newman at $130 to $140 to learn what stocks they were buying. One firm actually wrote up Graham-Newman, recommending it. I never saw any other firm write them up.

So they had a one for ten reverse split. Following the reverse split, Graham-Newman stock was selling for around $1,000 a share.

So when I left Graham-Newman, I wanted to raise some money to put into my partnership. At the time, the premium was about 35%. So with net asset value between $900 and $1,000, I got about $1,300 apiece for my shares.

About a year later - and I never thought they'd do it - they decided to liquidate. Of course, the damn thing was only worth $900.

They asked me, How'd you know?" Of course, I didn't.

OID: Sometimes it's better to be lucky than smart. Speaking of being lucky, how did you originally meet Buffett?

Walter Schloss: I met Warren in 1951, I believe, at an annual meeting of Marshall Wells in Jersey City. They were a wholesale distributor located in Minneapolis whose stock Graham-Newman owned.

I suppose they had the annual meeting in New Jersey because they wanted to have it where no shareholders were likely to attend.

OID: An all-too-common practice. We'll be interested to see where Philip Morris holds its next annual meeting.

Walter Schloss: So Warren showed up with a friend of his - Fred Stanback. He was going to Columbia Business School at the time. And Warren had an investment in Marshall Wells.

After the annual meeting, we went out to lunch. I liked Warren, he liked me, and we got friendly - all because we met at this Marshall Wells' meeting.

OID: Sounds like quite a coincidence, Graham-Newman and Warren Buffett simultaneously owning shares in an obscure wholesale distributor like Marshall Wells.

Walter Schloss: I think he saw Marshall Wells in Graham-Newman's portfolio - Graham-Newman reported its ownership of Marshall Wells stock in its list of holdings in its annual report. Whether he bought it because he saw it in the portfolio or because he liked it, I don't know. But they all saw the list.

In fact, Warren told me he was very upset at one point. Graham-Newman set up a partnership around 1953, sort of like ours. It was called Newman & Graham instead of Graham-Newman. It did the same thing Graham-Newman did except it was a partnership. Their minimum, as I recall, was $50,000, which was a fairly good sum in those days.

As it turns out, a couple of the limited partners contributed GEICO stock instead of cash and Graham was selling some of it. Meanwhile, out in Nebraska, Warren was buying it at the same time which was before he went to work for Graham. He saw Graham-Newman selling it.

And he said, "Gee whiz. I don't understand it. Graham is selling it and I'm buying it. One of us is wrong."

Of course, it was Graham-Newman who was wrong. But they were doing it because they wanted to get cash in lieu of the stock which they had taken in.

OID: The fact that Buffett once monitored the portfolio activities of Graham-Newman for investment ideas definitely eases my own conscience for monitoring his.

Buffett has been quite vague about his duties at Graham-Newman. What did you guys do there exactly?

Walter Schloss: As I recall, Warren came to work with Graham in 1953. Basically, we were just looking for undervalued stocks. We'd go through Standard and Poors' manuals.

I also had the job of placing orders. But we weren't that active - sort of like we are here.

OID: The fact that you and Edwin share a single phone is a dead giveaway there.

Walter Schloss: We try to keep a low overhead.

Newman & Graham actually wrote a letter to their partners in 1954 because they thought the market was too high -" Take back some of your money. We have too much to work with."

They only had about $12 or $14 million altogether.

OID: Hard to imagine today.

Walter Schloss: Even then, I can recall thinking that it may be time for me to leave. They were buying American Telephone. I thought I could do better than that.

One of the stocks I looked at was Lukens Steel. Lukens Steel was selling at $19 or $20 and it was earning $6 a share. So I ran into Graham's office and showed it to him. He agreed it was a good idea and we started to buy some.

Then, he went out to lunch with a guy who asked him what he liked. And Ben told him that we were buying a little Lukens Steel. So the guy went out and bought a lot of Lukens Steel and pushed the price up. Graham was a little too generous with his ideas.

Another example was in The Intelligent Investor. When it came out, Graham had bought Northern Pacific and was going halves with Baruch. The idea was to buy control of the company because it was so cheap.

But after they bought 50,000 shares and Baruch bought 50,000 shares, Baruch got cold feet. Graham went out there as their largest shareholder and let them know he wanted to be a director. But Northern Pacific made it clear that they didn't want him to be a director, for whatever reason, and Graham didn't push his way on.

The Intelligent Investor came out the next year and said it's a cheap stock at $16.

Norton Simon who ran Ohio Match went out and bought 171,000 shares. The stock went from $21 to $28 or $29 and Graham didn't want to follow it up.

Norton Simon, however, was a pretty aggressive guy. He went on the board of Northern Pacific with 171,000 shares - I believe between 1.7 and 2.2 million shares were outstanding.

Then they struck oil in the Williston Basin and the stock price shot right up. Ben didn't buy it because they were going to find oil in the Williston Basin. He bought it because it was a cheap stock.

But lots of times when you buy a cheap stock for one reason, that reason doesn't pan out but another reason does - because it's cheap.

OID: Simply more potential for good than bad.

Walter Schloss: That's true. As a matter of fact, Graham mentioned the fact that they had recommended it at $16. And by the time his subsequent edition was published, it had gone down to $11-1/2.

He said the fact that it went down to $11-1/2 at one point didn't mean that it was a bad investment at $16.

OID: An awfully important point to remember and an easy one to lose sight of.

Walter Schloss: Of course, it worked out very well.
Edwin Schloss: Maybe you should mention the example that Ben Graham gave about the two companies.
Walter Schloss: In Security Analysis, Graham used a great example of two companies - one popular and one unpopular selling at wildly different valuations.
One was a very popular company with a book value of $10 selling at $45. The second was exactly the reverse - it had a book value of $40 and was selling for $25.
In fact, it was exactly the same company, Boeing, in two very different periods of time. In 1939, Boeing was selling at $45 with a book of $10 and earning very little. But the outlook was great. In 1947, after World War II, investors saw no future for Boeing, thinking no one was going to buy all these airplanes.
If you'd bought Boeing in 1939 at $45, you would have done rather badly. But if you'd bought Boeing in 1945 when the outlook was bad, you would have done very well.

OID: In other words, it wasn't an earnings play but an asset play.
Walter Schloss: Exactly. It was an asset play. In 1945, they had all the assets but the earnings outlook was terrible.
Edwin Schloss: It's a wonderful example.
Walter Schloss: It was a great example.
While at Graham-Newman, I can also remember buying Brewster Aeronautical. Why? Because Brewster Aeronautical could liquidate at something like $5.75 and we could buy it at $5.
Well, we did buy it at $5 or $5.25. And the profit was maybe 50¢ a share over a period of time - it was really a lousy investment. We made 10% over two years or so. It was such a sweat and the margin was so small.
But they were shooting for this kind of guaranteed return. They didn't want to lose money.
There weren't that many liquidations floating around. And because interest rates were so low in those days, 5% per year returns were considered very good.

OID: On a relatively secure basis.
Walter Schloss: That's right. But even then, you weren't always sure because there could have been government claims against them.
Of course, if I had bought the stock, there would have been government claims or they'd have found some other liability.

OID: Your 30+ year record of outperforming the market by a factor of better than two wouldn't seem to support that statement. On the other hand, our purchase of Allied Bancshares...

Walter Schloss: One of the great sayings is that you never really know all about a stock until you own it. And that's very true.

You're looking at the stock originally as an outsider and you don't get emotionally involved. After you get into it, that changes. You see the flaws much more clearly.

Of course, after you've owned something for awhile, you find that there are a lot of opportunities you didn't see at first. We bought Western Pacific when it was coming in by the bucket at $6 to $6-1/2 per share. In retrospect. we didn't buy nearly as much as we should have. I never thought they'd have all these great things happen.

Micky Newman did a great job with that company. At the time, it looked like just another stock without much risk down from $23 with a lousy outlook and so forth.

And then Micky Newman facilitated Western Pacific's purchase of Veeder-Root. They made the counters for gasoline pumps.

When oil prices went up and the gas thing hit, it took off. The counters had never before been over 99¢, so that 2 digits had always been fine. When everyone had to replace their counters, Veeder-Root became a real big winner.

OID: Tell us about Ben Graham.

Walter Schloss: Graham was a sweet fellow. Actually. he was too sweet. People took advantage of him.

I think he was more interested in ideas. And if he could come up with a new way of doing something that interested him, he'd fool around with it - games, lecturing, writing - he was a renaissance man.

Edwin Schloss: He even wrote a play about Wall Street.

Walter Schloss: He had several marriages and several children. But basically, he was a man of ideas.

At the end of his life, he was translating Latin into Greek. He liked intellectual challenges. I think Wall Street was a challenge.

Then, he discovered he could make good money by just buying stocks at 2/3rds of their working capital. My job was really finding those working capital stocks and then recommending which ones we should buy.

After he found out he could make money this way, he kind of lost interest. It seemed like a good game. If he were alive today and couldn't find working capital stocks, he'd very likely be looking around for something else.

I always thought he was much better at picking stocks than fooling around with predictions of the Dow Jones. He always liked to figure out where the

Dow Jones should be selling at. But that's another business.

OID: And many would say an impossible or irrelevant business at that.

Walter Schloss: It probably is.

But he was a nice man to work for - again, probably too nice. I'll give you an example.

There was a company called Associated Telephone and Telegraph that had a preferred stock which was in arrears for something like $80 a share. It was the Theodore Gary Telephone Company which was located in the Midwest.

Leon Levy wrote it up, recommended the stock and sent a copy to Graham-Newman. I looked it over and thought it was good value.

Then I discovered that the Department of Justice had a whole bunch of stock that they had confiscated. So I went into Graham and told him about it. To make a long story short, we bid for it and bought it for around $123 a share.

Six months and a day later, since that was long-term for tax purposes, the stock was selling at $153. And it still had this $80 in arrears.

Graham called the company and asked them if they were planning on retiring the stock. "Oh no," they said. "We have no plans for that."

So we wound up selling our position to them at $153 or $155 which I thought was wrong. There was nothing like it. It was unique. They were paying their $6 or $7 dividend and there was no reason why we should sell it.

But Graham wanted the quick profit. Percentage-wise he was right. But it seemed to me that it was unique and that we shouldn't sell it.

Two months later the company called it. I was sore. And I said to Graham, "I think these guys could be sued because they're calling the stock. I can't believe they didn't know what they were doing. Can I get a lawyer in on it?"

He said, "Sure."

So I reviewed the facts with an attorney and he said, "I think you've got a good case."

I told Graham what the attorney had told me. And he got red in the face. I'd never seen him red in the face. "Walter," he said, "I don't want to get involved with this thing. Forget it."

He just didn't want to get involved in a lawsuit. I felt like we were being taken advantage of - and I still think so. Sometimes you have to sue just to keep your self-respect.

OID: Unfortunate, but probably true.

Walter Schloss: Another time, I recommended we buy a company called Haloid. It had the rights to a promising new process called xerography. It'd been paying a dividend all through the 1930s. I went into Graham and said,

"You know, you're not paying a hell of a lot for a process with this much

potential."
He said, "Walter, I'm not interested. It's not cheap enough at $21."
Of course, that was Xerox. And you know the rest of the story.

OID: One of the most successful companies of all time - at least for a good long while.
Walter Schloss: In the same vein, we had some American Research and Development stock. They were spinning off all of these little companies. And someone came into Graham-Newman and recommended that we should get into these little spinoffs.
One of those companies turned out to be Digital Equipment which, of course, was one of the biggest winners of all-time. Needless to say, the same was true of xerography and Xerox.
The only thing I should add is that if Graham-Newman had bought Xerox at $21, I can almost guarantee that we would have sold it at $50. The fact it went to $2,000 would have been beside the point.

OID: And he's in good company. Didn't Buffett miss out on Control Data despite being related by marriage to its founder back in the early days?
Walter Schloss: Yes, Ed Norris. And Buffett mentioned to me that he once urged one of his relatives not to put money into it.
He also discouraged her from borrowing against it to pay for a vacation to Europe after Norris had persuaded her it was worth borrowing against. Warren was appalled that she was going to borrow money against it.

OID: Of course, it could have turned out like GEICO. A dip could have made her lose everything.
And, as Buffett has frequently observed, there's no penalty for being selective. ***Isn't it OK to pass on Xerox if that's your discipline and you stick to it?***
Walter Schloss: That's true. ***He had a discipline and knew what he wanted.*** They had this formula and it worked. They couldn't lose, really.
When Warren came in, he originally did that as well. But, of course, they ran out. And he said he liked buying good businesses.
Warren came about his approach through experience, seeing what happened the other way and seeing he could do much better his way. Like he's said, he doesn't want to row upstream. Of course, he was right.
Edwin Schloss: On the other hand, we're experts at it.

OID: Thanks for taking the time to speak with us.
Walter Schloss: It's really our pleasure. We get a few other publications.

But I don't think there's anybody around like you - I don't know anyone else who has your niche. What you're doing is very good.
Edwin Schloss: It's excellent.

OlD: Thank you for the compliments. You've now ensured yourself prominent placement and favorable editorial treatment.
Edwin Schloss: And a lifetime subscription.

OID: You drive a tough bargain.
Walter Schloss: I know it's a lot of work. You must enjoy doing it.

OID: We're certainly not in it for the money.
Walter Schloss: ***Of course, that's the key to anything you do - loving what you're doing. If you like something and you're good at it, it's really very nice.***

OlD: Absolutely. Besides, how else would we have the opportunity to sit down with you two?
Walter Schloss: That's right. If you were a broker and you called us on the phone, we'd probably tell you we're too busy. You see how busy our phone is.

[Editor's note: The single phone in their two-man office rang only several times each afternoon I was there. On hearing the phone ring at one point. Walter quipped, "It's the second call of the day. I wonder what's going on."
The call turned out to be from his wife.

As reported last issue, Graham-Newman alumnus Walter Schloss formed Walter J. Schloss Associates in 1955 and was joined by son, Edwin, in 1973. Selected by living legend Warren Buffett to be among his "Super-Investors of Graham and Doddsville," the Schlosses have consistently run circles around the broad indexes.

For the 33 years ended 12/31/88, Walter J. Schloss Associates earned a compound annual return of 21.6% per year on equity capital vs. 9.8% per year for the S&P 500.

Here again are Walter J. Schloss Associates' annual return figures - along with those of the S&P 500 - for each of the 33 years ended 12/31/88. All performance figures are before fees to the general partner and were provided by Walter & Edwin Schloss Associates, LP.

Year	Annual Return	S&P 500 Total Return
1956	+6.8%	+6.6%
1957	-4.7%	-10.8%
1958	+54.6%	+43.4%
1959	+23.3%	+12.0%
1960	+9.3%	+0.5%
1961	+28.8%	+26.9%
1962	+11.1%	-8.7%
1963	+20.1%	+22.8%
1964	+22.8%	+16.5%
1965	+35.7%	+12.5%
1966	+0.7%	-10.1%
1967	+34.4%	+24.0%
1968	+35.5%	+11.1%
1969	-9.0%	-8.5%
1970	-8.2%	+4.0%
1971	+28.3%	+14.3%
1972	+15.5%	+19.0%
1973	-8.0%	-14.7%
1974	-6.2%	-26.5%
1975	+52.2%	+37.2%
1976	+39.2%	+23.8%
1977	+34.4%	-7.2%
1978	+48.8%	+6.6%
1979	+39.7%	+18.4%

1980	+31.1%	+32.4%
1981	+24.5%	-4.9%
1982	+32.1%	+21.4%
1983	+51.2%	+22.5%
1984	+8.4%	+6.3%
1985	+25.0%	+32.2%
1986	+15.9%	+18.5%
1987	+26.9%	+5.2%
1988	+39.4%	+16.8%
1956-88	+21.6%	+9.8%

* -Figures for 1988 represent estimates.

As we reported in Part I of our conversation with the Schlosses, they are generally somewhat publicity shy and consented to an OID interview only following alternate begging and threats by an unidentified party.

The following excerpts were selected from a series of highly enjoyable conversations with the Schlosses at their office in Manhattan. The second part of a two-part interview, we hope you enjoy it as much as we did:

OID: As Buffett has repeatedly observed, the number of Graham alumni who have achieved exceptional success is quite remarkable.

Walter Schloss: It really is. I'll always be grateful to Ben Graham for his giving me a chance to work for and learn from him as a young security analyst. He was always interested in helping young people. There's no question that I, Warren and many others learned a great deal from him.

Ben was a very sweet guy. He graduated number one in his class at Columbia and wanted to go into philosophy. But he couldn't make any money in it.

OID: Sounds like publishing.

Walter Schloss: Jerry Newman's brother, Douglas, went to school with Ben. He was so impressed with Ben that he had his brother Jerry meet him. And that's how they met. At the time, Graham worked for an old brokerage firm - Newberger, Henderson & Loeb.

Ben was fairly rigid in his investment discipline at Graham-Newman. ***When I was working there, we'd buy related hedges.*** We bought Crucible Steel convertible 5% preferred and shorted the common. And in those days. you d get a long-term gain and a short-term loss. Then the Treasury changed the rules.

I always thought it tied up a lot of capital. But when you could borrow money very inexpensively, the preferred paid a dividend of 5% and the common paid nothing.

We shorted them at parity. If they went up. you had a long-term gain and a short-term loss. If they went down, the 5% preferred went down less - maybe it went from $100 to $80, whereas the common might go from $20 to $6. Then, he'd buy back the common and sell off the preferred.

OID: So it was extremely low-risk investing.

Walter Schloss: That's right. They couldn't lose. ***Graham basically didn't want to lose so he did that.***

He also did liquidations - some of which took a long time. They were profitable in the '30s. Today, you hardly see any liquidations at all. Generally, companies can sell their assets for more than they would receive from liquidating them.

There were also unrelated hedges, which turned out not to be so good - we did a study of a number of them and it turned out they were not particularly profitable.

OID: Unrelated hedges?

Walter Schloss: For example, Graham decided that Illinois Central was a cheaper railroad at the price then than Missouri Kansas Texas. So he bought Illinois Central and sold Missouri Kansas Texas short.

While it may have been true statistically, it worked out very badly. It's very difficult to short one railroad and buy another over a short period of time. Maybe over a longer period of time, it would work***. Anyway. we stopped doing it.***

And then we bought common stocks. ***The idea was to buy common stocks selling at two-thirds or less of working capital. If working capital was $100 a share, they paid $67 or less for the stock. And that was a great idea.***

Of course, in those cases, there usually wasn't too much debt. But they were often tertiary or secondary companies - like Gilchrist, which we bought. It was cheap. It was a secondary department store in Massachusetts. They had rents to pay which were a heavy expense.

Today, if a company has very good space in a shopping center, it's often viewed as an asset. In those days, it was viewed as being onerous.

OID: Because there is so much more inflation today?

Walter Schloss: That's right.

I think the big change was the huge debt of these companies which 20 years ago didn't really exist. The large amount of debt against the assets of these companies makes them very vulnerable.

In those days, a lot of the railroads were in bankruptcy. Graham would buy the bonds - usually the first mortgage bonds - of these bankrupt companies.

Today, they're forming big funds to buy bankrupt companies and make their profits on the reorganization. That wasn't so popular in the '30s and '40s. I'm not so sure that because of the current competition to get into this field, that they may not be overpaying today.

In the case of bankrupt securities, the company would work out a reorganization plan. But before the plan would be put into effect, when-issued securities would start trading.

Graham would buy the first mortgage bonds and sell off the when-issued securities. They would sell off everything - $500 worth of first-mortgage bonds, $300 worth of second-mortgage bonds, $100 of preferred and $100 of common - they'd sell it all off and they'd walk away with 15% profit.

Henry Crown did the same thing. The difference is that he'd keep the new common stock - which might represent only 5% of the proceeds - and wind up controlling the company.

I thought Graham hadn't thought it through. His argument was, "Look, we made 15%. Why tie up our money in the common?"

But the common enjoyed tremendous leverage. Graham missed an opportunity. Of course, that's with the benefit of hindsight.

OID: As we mentioned, we had the great pleasure of speaking with Mutual Series' Max Heine a few weeks before his death. He told us that over his entire career the best performers in his portfolio had been his bankrupt bonds.

We asked him why he invested in anything else. He said he couldn't get enough of them to fill his portfolio. Randy Updyke said the same thing.

Walter Schloss: That's the problem. You can't get enough of them - and everybody wants to do it. It's sometimes not worth the trouble - particularly when there are all kinds of lawyers and so forth.

OID: Updyke agreed that where you are in the economic cycle is important, as well. This late into an expansion, they may be less of a bargain.

Edwin Schloss: That's a good point.

Walter Schloss: One of the great investment successes we had was with the Penn Central bankruptcy.

The only mistake we made was in buying the first mortgage bonds. They worked out well but the junior bonds worked out even better. New York

Central bonds, which were selling for $50 on a $1,000 bond, worked out at par whereas the senior bonds, which we bought at $150, worked out at par.

But I was trying to be conservative. Anyway, we did very well with the Penn Central bankruptcy.

OID: Not bad.

Walter Schloss: It was a fabulous success. And in retrospect, you wonder why it worked so well. I guess it was in the '70s and people were scared.

The problem in investing, I think, is timing. You may be right. But in the long run, we're all dead. Even if you're right, if it takes 20 years to work out, it can be a disaster.

Things usually take longer to work out but they work out better than you expect.

In the meantime, the economic cycle can change. Somehow, I don't think we've really been too happy with those reorganizations.

Edwin Schloss: No. And there are too many people now who are focused on doing the same kind of thing.

You can tell by the behavior of bankrupt securities. When a company went into Chapter 11 ten years ago, we usually had a period of 3 months to accumulate a position if we were interested.

OID: Where the stock was inefficiently priced?

Edwin Schloss: Exactly.

Walter Schloss: Now you have one day.

Edwin Schloss: Or less. Sometimes, it's the same day that the stock moves down sharply and then recovers. It's discounted that fast.

Walter Schloss: Too many people chasing too few goods.

OID: That too will change, right?

Edwin Schloss: I guess the new trick will be reorganizations of leveraged buy-outs - like Revco.

OID: That's what Michael Price, Peter Cundill and Charles Brandes all say.

Walter Schloss: You really have to know your stuff on those things.

Edwin Schloss: That's right. It's more complicated - like a pyramid - with debt upon debt upon debt.

Walter Schloss: You have to know the laws of the states in which they're incorporated, their judges, how they've ruled in the past, and which properties are valuable. I don't think we're really set up to do that.

Edwin Schloss: We're not.

OID: How would you summarize your approach?

Edwin Schloss: ***We try to buy stocks cheap.***

OID: Might you be just a tad more descriptive?

Walter Schloss: Each one is different. I don't think you can generalize.

In the old days, Graham had a very good theory - you just buy below working capital and you don't worry too much about the business they're in - don't worry about management, earnings or anything else.

I think it worked until about 1960 and again in the 1973-74 break.

But I think you just have to look at each situation on its own merits and decide whether it's worth more than its asking price.

OID: But everybody's got his/her own bias. For example, Graham would be called a value investor and so would Buffett. But their approaches are very different.

Walter Schloss: ***Warren wants franchises and good businesses. We do too, but we're not willing to pay for them so we don't buy them. I guess we buy difficult businesses.***

As Warren would say, he likes to row downstream and we like to row upstream.

OID: Could you give us an example?

Walter Schloss: The Timken Company. Edwin discovered it for us. We believe it's a good company in a tough business - highly competitive, heavy industry. We own stock in it at a lower price. Timken spent some $450 million on a new steel mill a few years ago and recently announced that they intend to spend up to a billion dollars over the years on additional modernization and development of new techniques in their field.

There are about 30 million shares fully diluted. Roughly 20% of Timken stock is controlled by family members. The stock sells around $35 with a reported book of that amount but they have a big inventory reserve and are the low-cost producer in their field.

The FTC has fined foreign competitors for dumping tapered roller bearings in the United States. Competition is tough and there is no franchise but we think they make an excellent product. As a survivor, they run a tight ship. We think they have a good chance at some point to earn a decent amount on their blood, sweat and tears. You couldn't duplicate their plants for what they carry them for on their books. But there are no guarantees.

OID: In terms of the way you look at a stock, relative to the way Graham looked at a stock or Buffett looks at a stock, how do you look at it differently?

Walter Schloss: Basically, we like to buy assets.

OID: Why assets? Why not earnings?

Walter Schloss: ***Assets seem to change less than earnings. You could argue that assets are not always worth what they're carried for.***

Graham made an argument at one point that inventory was a plus, not a minus. In an inflationary period, having a big inventory might be very helpful. While in a deflationary period, a big inventory would not necessarily be good.

But if you are going to have to liquidate inventory in the next week, that would not be good for you. If you have a nice inventory and business is alright, you benefit from having that inventory. So I don't know. It may be a wash depending on other factors.

How do people value inventory? Fifty percent of what it's carried at? It may be worth more than that. Generally, it's not as good as cash or receivables - we know that. But it may not be as bad as some people say.

If you have two companies - one with a plant that's 40 years old, another with a new plant - both are shown on the books but the new plant may be much more profitable than the old one. But the company with the old one doesn't have to depreciate it. So he may be overstating his earnings a little bit by having low depreciation.

OID: Lies, damn lies and financial statements?

Walter Schloss: That's often the case. ***Ben made the point in one of his articles that if U.S. Steel wrote down their plants to a dollar, they would show very large earnings because they would not have to depreciate them anymore.***

Would that be proper? Of course, he didn't think it would be. But that means a company could really increase its reported earnings.

And that's only one of the reasons why Edwin and I aren't wild about earnings. They can be manipulated - legally. If people are just looking at earnings, they may get a distorted view.

Edwin Schloss: I think a lot of people have been hurt by buying something solely on the basis of a low P/E. We could go for a low P/E or for a high P/E. Basically, earnings are hard to predict.

Walter Schloss: If a guy estimates earnings of $2.25 and it turns out to be $2.50 - that shouldn't really change the value of the stock that much. But the stock price often changes radically when that happens.

On the other hand, with book value at $25 a share you'd be rather surprised if the next year it fell to $15.

OID: So earnings are much more volatile than book value?

Walter Schloss: That's right.

Edwin Schloss: Also, we like to see if we can buy something with earning power behind it. With some of these growth companies, you're happy if they earn 50¢.

Walter Schloss: That's true. With these growth stocks, if the growth doesn't continue, you can get stuck.

If observers are expecting the earnings to grow from $1.00 to $1.50 to $2.00 and then $2.50, an earnings disappointment can knock a $40 stock down to $20. You can lose half your money just because the earnings fell out of bed.

If you buy a debt-free stock with a $15 book selling at $10, it can go down to $8. It's not great, but it's not terrible either. On the other hand, if things turn around, that stock can sell at $25 if it develops its earnings.

Basically, we like protection on the downside. A $10 stock with a $15 book can offer pretty good protection. ***By using book value as a parameter, we can protect ourselves on the downside and not get hurt too badly.***

Also, I think the person who buys earnings has got to follow it all the darn time. They're constantly driven by earnings, they're driven by timing. I'm amazed.

I look in that little stock guide book and I see some stocks trade 20% of their market in one month. ***We'd prefer to avoid the volatile issues with huge trading volume.***

Edwin Schloss: I think there's going to be a shakeout in the OTC Market. There are too many little companies in there that I don't think are all that wonderful - many of them are penny stocks and dead wood.

OID: You don't sound like fans of penny stocks.

Walter Schloss: One of the things people are most foolish about is that they think the market price of a stock on a per share basis reflects the total price of the company.

They forget that if a company has 100 million shares outstanding and it sells at 10¢ per share, that it's selling for $10 million - even though it's selling at 10¢.

Whereas, if another company has only 100,000 shares outstanding and sells at $20, it's selling for only $2 million. Many people think the first company is cheaper than the second based on the per share price.

OID: Like the guy who orders a medium-sized pizza when asked if he'd like it cut into 4 slices or 8. His reply: "Only 4 please, I could never eat 8."

Walter Schloss: Exactly. Back in the 1930s, there were a lot of these companies with a very small number of shares outstanding selling at $20. People didn't want to pay $20.

Now you're getting this crazy thing where people are buying options which is another gimmick similar to buying penny stocks. They're in somewhat the same kind of category - they're both junk.

OID: Like being scared away from Berkshire Hathaway when it was selling for $150 per share.

Walter Schloss: Because it's selling for $150 per share instead of looking at the implied value of the company - at that time, $150 million.

People do not take into consideration the market value of the company they're buying. They just look at the price per share rather than the value of the company.

Warren has been very good at valuing companies.

OID: In treating shares as fractional interests in business?

Walter Schloss: That's right. I don't think we're as good at valuing businesses as Warren. We just figure it's worth more than we're paying when we buy it.

They're bigger companies than we have in most cases. But it's very difficult for us to buy a lot of small companies.

We've learned not to have too much in unmarketable securities because you can find that you're stuck with them. In a bad market, you just can't get out.

Edwin Schloss: But if you do buy an inactive security and you really think it's undervalued, stay with it even if you grow impatient. Once you sell it, you can't always buy it back.

Walter Schloss: That's true. If somebody's got 1% or 2% of their money in an inactive security, that's fine. But if they have 20% or 25% and they want to sell it because they're nervous about it, they're stuck. Then they have to sell it to some fellow who specializes in taking advantage of those guys.

OID: On the other hand, Buffett recommends buying your stocks as though you're not going to be able to sell them for ten years.

Walter Schloss: Warren came to me in 1962, as I recall and he said, "Walter, I'm too big to hold these small holdings. But you're small and you can take them."

This package of securities was worth about $65,000 at the time. So I said, "Warren, how are you valuing them?"

So he said, "I'll sell them to you at the price I carry them at."

I said OK.

OID: Cost or market?

Walter Schloss: Their market price at the time.

So we bought Genessee and Wyoming Railroad, Vermont Marble, Jeddo Highland Coal and Merchant's National Property - we just bought them as a group.

And they all worked out beautifully except for one which I still have. And that one's gone up to ten times what we paid for it. But they all worked out.

They were small and you really couldn't sell them. I mean you could sell them to an over-the-counter broker who'd take advantage of you if you don't know your prices.

But I remember those because they were so inactive and yet they were good values. I doubt if you could get something like that now.

OID: How has your approach evolved?

Walter Schloss: We just try to buy cheap stocks. That's really all. We try to buy things that are out of favor - stocks that others don't want.

OID: Being as specific or unspecific as you wish, what's out of favor today?

Walter Schloss: I don't want to talk about stocks particularly, because you have an influence on it.

OID: I hate to beg in public, but could you give us an example or two to help us understand your thinking process?

Walter Schloss: Cleveland Cliffs may give you a good example of our thinking process. Their primary business was selling iron ore to steel mills. We bought their stock not because we were looking for a cheap investment in the steel industry. We looked at the stock because we thought it was a good value.

Cleveland Cliffs was the best company in its field. As I recall, Warren bought a lot of it at around $18 a share and later sold it around his cost. But

then, when the steel industry was in decline and so many of these companies defaulted on their debt, and the biggest shareholder sold his share because he no longer liked the industry, the stock went down to $6 a share. We bought a lot of it.

OID: Going where others feared to tread.

Walter Schloss: That's right. We bought it although there was talk of bankruptcy. If we'd lived in Cleveland, we probably wouldn't have bought it because we would have been too close to all the bad things.

Anyway, after we bought it, the company started to do better. They've sold off some assets and bought back some stock.

We didn't buy it knowing what would happen. But we did like the idea that it was the low-cost iron ore producer and they have 50% of the reserves in America.

OID: Is that low-cost within America?

Walter Schloss: With the low dollar, it makes it tough for foreign competitors. They're even exporting a little.

Edwin Schloss: A weak dollar helps.

Walter Schloss: So it came together. But the point is that we felt it was cheap. The people in Cleveland were scared to death. There was a proxy fight among other things.

Edwin Schloss: When we were buying it, nobody wanted it. Now, it's being written up by investment houses.

Walter Schloss: Sometimes an industry can appall you so much that you don't buy cheap stocks.

OID: Did you look at Mesabi Trust?

Walter Schloss: The Mesabi Field is a high-cost field. But it's a good example. Mesabi had an agreement where they would get a royalty on all the

ore that was mined from the Mesabi field. But once the price of iron ore went to the point where it didn't pay for them to mine that ore, it was all over.

There's a case of a stock that fell from $10 to $3.

OID: Below $2, I believe.

Walter Schloss: Maybe Mesabi will work out. But I'd much rather be in a low-cost producer.

You can argue that a high-cost producer is a more speculative mine and the place to be at the right price. Of course, the low-cost mine is safer - I'd be more comfortable with a lower cost mine.

But you can often have more upside with a high-cost producer. If the cost of iron ore went way up, Mesabi stock could go back to $10 again. But we're not smart enough to know which industries will do well. That may help us in the long run. ***We look at companies rather than industries.***

OID: Speaking of cheap stocks, what's cheap today?

Walter Schloss: We don't see much that's cheap now. It's much more difficult to find bargains today than it was 10 years ago.

OID: Yet you're fully invested.

Walter Schloss: We have to invest. But it's more difficult to find things today than it used to be. It's very hard.

I wouldn't want to change our standards and buy earnings instead of assets. ***I like the idea of buying assets.*** I think Edwin likes better quality companies. I don't dislike them but you pay more for them. The question is how good a quality do you want to get?

We could be wrong. One of the things you learn in this business is humility because you see your mistakes the next day. Many people make a mistake but they don't see it in the paper the next day.

OID: Doctors bury their mistakes. Newsletter editors publish theirs.

Walter Schloss: And you don't always know it's a mistake right away.

Edwin Schloss: ***It's also easier to know when something's cheap than when it's overvalued.***

Walter Schloss: That's true. I had a guy come to me as a client many years ago and he said, "Walter, you're good at picking undervalued stocks. I think you ought to be able to pick overvalued stocks so I can short them."

I said, "it's a different ballgame. You can't put them in the same category."

A stock can be overvalued and then double in price as it becomes more overvalued. The same bunch of investors are not involved. In fact, it's not even an investor that's in an overpriced stock.

Concentrate on what you know and forget about everything else.

OID: Over the past 30 years, you've outperformed the S&P 500 by a factor of better than 2 times. Earning 2.2 times the S&P 500 is pretty remarkable.

Walter Schloss: Was it really 2.2 times? I'm really surprised it's 2.2 times the S&P 500. I knew we were better, but I didn't know it was that much better.

I'm very impressed by that.

OID: As are we. Anyway, that explains your humility.

How'd you manage to do so well in 1987? You outperformed the S&P 500 by almost 3 times.

Edwin Schloss: The rust belt turned around. That helped.

Walter Schloss: We did very well for the first nine months of 1987. We were up 53%. Meanwhile, the market went up 41.5% for the first 9 months,

but gave back all but 9% by the fiscal year-end. We came down from up 53% to up 26%. So we lost half of our overall profits.

We did well for the first nine months but we gave a lot of it back in that last quarter.

OID: Give me a break. You outperformed the market as it went up and as it went down.

Walter Schloss: In the past, it seemed that two good years in the market were invariably followed by a third year that was not so good - at least up until 1974.

Since 1974, we've had 14 fabulous years without any down years. That's never happened before and it'll never happen again - every single year since 1974.

That's unbelievable. If you look back, you see the Dow Jones hasn't gone down in 6 years and that's never happened before.

I don't think you'll find any 6-year period - except maybe in the '20s - where you've had 6 up years in the market.

OID: Probably not a very good omen for the future.

Walter Schloss: Terrible! And that's what I thought two years ago.

OID: Yet you remained 90% or more invested.

Walter Schloss: We're willing to buy bad businesses - and we find some.

Edwin Schloss: I don't think our companies are bad.

Walter Schloss: Cleveland Cliffs and Timken are not great businesses.

Edwin Schloss: Timken in its field is considered to be a fine company.

OID: Hardly the most glowing praise ever paid a company.

Walter Schloss: It's a good company in a tough industry.

Is it true that even your clients don't know what you're buying for them?

Walter Schloss: That's correct. And a little story might help explain why we don't tell them what we own.

One of our partners said, "Walter, I have a lot of money with you. I'm very nervous about what you own."

So I made an exception and said, "I'll tell you a few things that we own." I mentioned the bankrupt rail bonds and a couple of other things we owned.

He said, "I can't stand knowing that you own those kinds of stocks. I have to withdraw from the partnership."

He died about a year later. That's one of the reasons we don't like to give people specifics.

OID: You shouldn't blame yourself. He might have died anyway.

So you don't ever tell clients what you own?

Edwin Schloss: No, we don't. ***At the end of the year, we list a few of our holdings with the largest gain. But usually that's after we've sold most of our position.***

OID: It's interesting to me that two of the vehicles with the best long-term records around don't report their holdings to clients.

Walter Schloss: Who's the other?

OID: Buffett Partnership. That's got to be a tremendous advantage - not reporting.

Walter Schloss: I think so.

OID: Shareholders can hardly be a positive influence - unless they're very unusual shareholders.

Edwin Schloss: So why did we agree to this interview?

OID: We all make mistakes.

Walter Schloss: The problem, of course, is that you can't do that as an investment company. You have to disclose your holdings and you can scare your clients.

OID: I believe Buffett was once quoted as saying something to the effect that behavior is irrational in direct proportion to the size of the projected payoff, irrespective of risk.

Edwin Schloss: Just like the golf story.

Walter Schloss: That's right. It's a perfect example of what he's saying.

Warren was playing golf at Pebble Beach with Charlie Munger, (Berkshire Hathaway vice-chairman), Jack Byrne (Fireman's Fund chairman) and another person.

One of them proposed, "Warren, if you shoot a hole-in- one on this 18-hole course, we'll give you $10,000 bucks. If you don't shoot a hole-in-one, you owe us $10."

Warren thought about it and said, "I'm not taking the bet."

The others said, "Why don't you? The most you can lose is $10. You can make $10,000."

Warren replied, "If you're not disciplined in the little things, you won't be disciplined in the big things."

I spoke with Warren and it's a true story.

Graham-Newman invited Warren to be a partner. But at that point, he wanted to go back to Omaha. A year after I left Graham-Newman, they went out of business. By that time, Tom Knapp [Tweedy-Browne] had taken my place.

OID: Why was Graham-Newman liquidated?

Walter Schloss: I really don't know all the reasons that went into it. But before they went out of business, they offered Abraham & Co., who they liked, the opportunity to take over the firm. But they didn't want to be involved in it.

I think it was Jack Bleibtreu, the senior partner. who didn't want to be involved because if they took over Graham-Newman, they'd have to disclose their holdings - so they turned it down. And Graham and Newman wouldn't allow anyone else to buy their firm.

OID: Why not?

Walter Schloss: By that time, they had enough money of their own. Abraham & Company said that they'd run it so long as Graham and Newman could be consulted. But Graham and Newman said, "We don't want to be consulted. We want out."

And they were not willing to lend their name to have someone else run it. I can understand it. They built it up and didn't want anyone to come in and hurt it. So they closed it down.

Many people said, "Oh, Graham and Newman are such a wonderful combination because they're so different and they don't agree about things. So if they ever agree about them, it's good."

I don't agree with that argument. It may have been good for Graham. But ***I like people who are simpatico, who don't disagree. Partners, it seems to me, should have somewhat the same point of view.***

OID: You've actually done much better absolutely and relatively since Edwin joined you in 1973.

Walter Schloss: Well, I like working with Edwin. He has made it possible to continue running the partnership. I couldn't do it without him. Edwin has been invaluable in choosing stocks for us.

It is very difficult to run a one-man firm without anybody to talk to about things. Lots of times, your ideas may make sense to you but they

really need somebody else to talk them out. I don't know who else I'd talk to about them.

OID: We volunteer.

Walter Schloss: Also, as regards working with Edwin, I've seen things happen in life that are unpleasant. It's trust. And I do think blood is thicker than water - or money.

If I had somebody there who wasn't in the family, in the back of my mind, I'd always be afraid of going away and God knows what.

When I go away, I'm not worried. Whatever Edwin does is fine. Peace of mind is very important to me. It's something you can't measure in dollars.

OID: Amen. I understand you guys don't even like to talk with managements of the companies you own. Is that true?

Edwin Schloss: ***You can waste a whole lot of energy running all over the country checking on managements of the companies you own. We only go to annual meetings if they're within a 20-block radius of the office.***

Walter Schloss: ***I think I agree with Ben Graham. He didn't like to speak with management because he thought he would be influenced by what they said.***

On the other hand, if you're smart enough.... ***Warren could go to an annual meeting and because he's very analytical and not emotional about it,*** he could analyze what goes on without being swayed by the fact that the guy talks well, acts well or whatever. He could probably do it. He's very good at it. I don't think I would be.

Besides, while it's nice to go to meetings, they're time consuming. I agree with the expression, "You never know all about a stock, until you own it."

OID: Quite often an extremely tragic expression.

Walter Schloss: Like the old story about the guy being pestered by a broker to buy something for $10 a share. The broker keeps pushing him and it gets to $8 a share. The broker keeps pushing him and it gets to $6 a share.

Finally, the guy says, "OK. Buy me a thousand shares. And when it gets back to the price I paid, sell it."

OID: The best humor in the investment business - at least outside this room - has got to be Buffett. Has he always been so witty?

Walter Schloss: He's always had a great sense of humor.

One of my favorites is the letter he wrote to his partners about compound interest. He pointed out that the Indians actually got the better of the bargain when they sold Manhattan to Peter Minuet for trinkets worth $24. It's just that they didn't invest it well.

In another letter, he pointed out how the guy who commissioned Leonardo Da Vinci to paint the Mona Lisa made a bum investment for the same reason - that he'd have had some monstrous sum of money if he'd invested only moderately well.

And he made a similar comparison with the voyage of Christopher Columbus in which he discovered America.

OID: Compound interest truly is a wondrous thing, isn't it?

Walter Schloss: It really is.

OID: Would you compare today's market to any historical period?

Walter Schloss: The 1987 break was much more like 1962 than it was like 1929. The market was far too high. And it revalued itself - much of it in one day.

But we never know where the market is going. In October of 1987 before the market broke, we were both saying that the market was too high.

OID: And we quoted Edwin on that point shortly before the crash.

You mentioned earlier that you prefer to be - and generally remain - nearly 100% invested. As I recall, before the Crash, you were 90% invested.

Walter Schloss: That's correct. Over any extended period of time, stocks generally outperform bonds. Most people who have been really successful in the securities markets say the same thing - ***that they're not smart enough to get into the market and out of it.*** So they tend to remain more or less in the market at all times. I don't know anyone who got rich owning high-grade bonds.

OID: What percent invested have you been over the years on average?

Walter Schloss: Very close to 100%.

OID: What's the most out of the market that you've ever been?

Walter Schloss: 10%. And again that was before the Crash.

We try to buy good values and not worry too much about what the market is going to do. You could say, "How come you had 90% of your money in stocks if you thought the market was too high?"

Our answer was that what we owned didn't seem that overpriced. But when the market went down, our stocks went down too.

OID: But you were up more than the market before the crash and down less during it.

Walter Schloss: That's correct. And if we'd sold out, we might have missed being up 26% for the year. We did better by being in the market and not trying to figure it out.

It's the same thing today. I think the market may be vulnerable. I don't know what's going to happen. But I think I sleep better owning stocks than owning cash.

But everybody's different. You should own what you're comfortable with.

OID: Actually, that's debatable. Most people would probably do well to own what makes them uncomfortable - if only they wouldn't then sell at the worst possible moment. But it's fortunate for you and your partners that you're most comfortable in stocks. Has your investment philosophy changed over time?

Walter Schloss: Yes. I think it has - largely because of the situation in the market. Graham-Newman used to buy working capital stocks - which I thought was a great idea. But by 1960, there were practically no working capital stocks. With the exception of 1974, at the very bottom of that market, there have been practically no working capital stocks.

A good way of seeing it is to look at Value Line's list of working capital stocks. If you go back 15 years, you'll see they have some on the list. Today, there are very few. And the ones that are on the list are really pretty bad - often with a lot of debt - especially in relationship to the equity.

With working capital stocks gone, we look next at book value.

Edwin Schloss: We used to look for companies selling at half of book. And if they weren't available, we looked for companies selling at two thirds of book. Now we're looking at companies selling at book value. But we hardly ever pay over asset value unless it's a special situation or franchise.

Many so-called fundamentalists don't even pay attention to book value anymore. They will after they lose half of their money. It's getting very tricky.

Walter Schloss: It seems now that everybody else is doing what we're doing - or at least a lot of people are. And many people have huge amounts of money to invest. So we try to get in between the rain drops.

OID: What has been your most common mistake?

Edwin Schloss: Being too aggressive initially - buying so much of a stock initially that when the price moved lower, it took too much capital to average down. We've occasionally bought so much that we couldn't buy as

much as we'd like when it went down further without becoming overly concentrated.

OID: We can certainly relate to that. How much concentration do you utilize?

Edwin Schloss: It varies considerably. We'll own as little as 2,000 shares of a $5 stock. But if we really like something, we'll put as much as 10%-15% of the portfolio into it.

Of course, it depends on the situation.

OID: How do you add security in today's market?

Edwin Schloss: Recently, it's gotten to the point that a lot of the loaded laggards have been picked over to the extent that the things that are left selling at discounts from book value are not nearly as attractive as they used to be. Therefore, we're upgrading our portfolio so that many of our holdings might look more like Pioneer Fund than Graham- Newman's.

OID: Out of the garbage heap -for now.

Edwin Schloss: You have such a way with words but that's exactly right.

OID: Barry Ziskin recently told us that asset-based investing has been more successful than earnings- based investing in recent years. And that's the biggest reason why earnings-based stocks currently offer better value.

Edwin Schloss: I agree with him. That's why we're shifting into higher quality companies as long as they're selling at reasonable prices.

The trouble with many growth investors is that they're overly concerned with quarterly comparisons. They have to depend on earnings to support the stock's multiple. Besides, their criteria are much too rigid. I know people who are looking for the perfect company that sells at 8 times earnings growing at 25%. You just don't find those companies around today. And they could be making a big mistake - either by buying things that are too pricey or sitting on the sidelines.

Conversely, buying something at book value doesn't necessarily make it cheap. So many of these companies have been picked over.

In my judgement, the opportunity in today's market lies in the middle ground between the two. These companies aren't quite up there with the ones Buffett buys, but they're not bad.

The fact is that medium-sized growth companies have been overlooked - they fall between the cracks. They're too high quality for the asset investors and aren't growing rapidly enough for the growth buyers.

OID: Being neither fish nor fowl, they're neglected.

Edwin Schloss: Exactly - by both camps. So it's important to be flexible.

And we're in a different kind of market today than we were in the '70s, during which you could buy almost any kind of asset situation and make money.

OID: Have you observed any differences between what you and your father wind up favoring?

Edwin Schloss: When you've gone through the Depression - as, of course, my father did - book value has been a tremendous benchmark to his approach. Buying companies which are selling at book value or at a slight discount from book is something that he wouldn't have considered ten years ago.

However, I do think he's become somewhat more flexible.

OID: Being willing to pay up a little?

Edwin Schloss: That's right - although I always get a little bit worried about shifting or changing criteria. It's too easy to destroy something that has worked so well for so many years.

OID: I suppose you could call beating the market by a factor of 2.2 times over 30+ years working well.

We understand that Buffett respects your dad tremendously.

Edwin Schloss: He admires his integrity and, as he describes it, his special strength when facing a headwind. He also says...

Walter Schloss: Let it go at that.

OID: Even though Buffett's approach and that of you and your dad is almost like night and day.

Edwin Schloss: That's right. Warren thinks that we operate a little like Noah's Ark.

OID: Two of every animal - dogs included?

Edwin Schloss: That's right. We tend to be generalists.

We prefer to invest in asset-rich situations but it's important to be flexible when so many are focusing on those situations.

OID: We agree with you and Barry Ziskin on that one. It's a novel thought, though - that for your dad and you to buy stocks at book value is a reach.

Edwin Schloss: It certainly is.

OID: Most managers consider themselves to be virtuous if they buy something not too much over book. Most people don't think twice about paying two times book.

Edwin Schloss: Well, we do. We will not buy anything at twice book. We just have a rule about that. We simply will not do it.

But there are a lot of other factors we consider. For example, it's really important to concentrate on areas of the market that other people are neglecting.

OID: What else can you tell us about you and your dad?

Edwin Schloss: We often come into the office kind of late and we sometimes leave a little earlier than scheduled - sort of like the LIFO method of accounting - last in and first out.

OID: We'll keep that our little secret.

Edwin Schloss: On the other hand, we sometimes call each other at 11:00 o'clock at night. We frequently talk on the phone quite late. We have a tendency to get our best ideas at that time.

OID: Because of having fewer distractions and interruptions then?

Edwin Schloss: Exactly.

And speaking of interruptions, what amazes me about Wall Street is that there are so few registered reps who have any background in security analysis. It's surprising to me that we get calls from all these different brokerage houses - people who want to bring something to us. And yet, they don't know anything about what they're touting. They're just reading a racing sheet.

When a broker called me recently, I asked him what the book value was. He told me 25%.

OID: It was higher than 25%?

Edwin Schloss: Exactly.

They waste our time. We'd bring business to people if they'd come up with a good idea. But why should I give somebody business because they decided that they just uncovered IBM.

Their favorite line is, "It's moving! It's moving!"

That's what they usually do. They call up, "It's $21." Then they call up about 2 hours later, "It's $24." Then they'll say, "You missed 3 points but it's not too late to climb aboard." You know, "Hurry, hurry, hurry."

Meanwhile, all day over the loudspeaker at the firm, they've been touting it, so the stock usually plummets within a week or two.

Or if it doesn't plummet, they call you up after it goes up 50% or so and say, "You missed it, you missed it."

And after they tell you that you missed it, they think they've hooked you - that you'll be conditioned to buy the next hot one.

OID: Pretty sophisticated.

Edwin Schloss: Brokers will tell you crazy things. Whenever they say they have a hot one for you, right away I get nervous. But they usually say something like, "You better buy it. It's selling at its all-time high."

I'll say, "What's it selling for?"

And they'll say, "Five and three-eighths."

OID: Pre-split, of course.

Edwin Schloss: Naturally.

OID: Anyway, the broker stories we hear never cease to amaze us. But that's not the way you find most of your ideas?

Edwin Schloss: No, generally not.

Over the 15 years I've been here and the many years my father has been in the business, we're aware of an enormous number of companies. And I have a fair idea of where something becomes reasonably priced. So I will quite often focus on industries that are out of favor.

For example, right now it would not be food stocks.

OID: Hallelujah on that one.

Edwin Schloss: Maybe there'll be another Kraft. But I'm not used to buying food stocks at these prices.

I remember the days when you could actually buy Campbell's Soup and Kraft and all those things at a 10% premium over book. Now they're going out at six times book. It's just another world.

OID: And you could buy General Foods at 25% of sales.

Edwin Schloss: Exactly. It's unbelievable. I don't find the food group at all timely. We tend to be overweighted in the capital goods sector.

For the last two years, we've been pretty strong believers in the Rust Belt stocks.

OID: You're not making a prediction? It's just because they're cheap?

Edwin Schloss: That's right. In the numbers, they're not as cheap as they were but I think they've been through their recession already. Many of the companies in heavy industry are somewhat attractive.

OID: What about the S&L's?

Edwin Schloss: I'm not crazy about banks or S&L's. Some of the S&L's look cheap based on the numbers. But I feel more comfortable with a company that actually manufactures something.

OID: Why?

Edwin Schloss: I'm worried enough about the financial consequences of the deficit that I just can't get worked up about anything to do with the banking system.

There's either too much regulation or not enough.

OID: No OID interview is complete without a little bank-bashing. Don't banks take most of the risks without very much of the rewards?

Edwin Schloss: I feel that way. But some of the S&L's still look attractive on a fundamental basis.

OID: No question about it. What else is cheap?

Edwin Schloss: Defense stocks.

OID: Are they cheap enough to buy?

Edwin Schloss: I think so. But I'm not interested in the obvious ones. I'm interested in some of the secondary defense companies in electronics like Watkins-Johnson and Whitehall Corp.

I know there's going to be major cutbacks in defense and I've read over the last 6 months about the fraud and so forth. But I think there's good value there.

Sometimes, Dad and I can sit at the desk for the entire day discussing the theatre, current events and social trends.

OID: Don't let your limited partners see this.

Edwin Schloss: If you're not in touch with what's going on or you don't see what's going on around you, you can miss out on a lot of investment opportunities. So we try to be aware of everything around us - like John Templeton says in his book about being open to new ideas and new experiences.

OID: What has your average turnover been?

Edwin Schloss: About 25% per year.

Walter Schloss: That's about right. But it depends on the market. If you have a very good market, then your turnover will be higher because we're selling stocks after they've gone up. Conversely, in a very poor environment, our turnover would be much lower.

OID: Do you have any preference for small, medium or large companies?

Walter Schloss: No, we don't have any preference. If it's cheap, we like to buy it.

Edwin Schloss: Today, we prefer medium-sized companies by and large.

OID: Is that in today's market or generically?

Walter Schloss: It depends on the market.

OID: Are there any areas or industries or companies you avoid?

Walter Schloss: Tobacco. We will not buy tobacco.

OID: For ethical reasons?

Walter Schloss: That's right.

OID: Anything else?

Walter Schloss: We try to avoid foreign companies. They have different standards and different problems. And the SEC is definitely a plus.

The information standards in the U.S. are quite good relative to the rest of the world. In many of these countries people do things which are illegal here.

OID: Are there any areas you tend to have a preference for other than whatever's cheap and out of favor at the time?

Walter Schloss: Cheap is good enough. I don't want to tell people what kind of companies we own. Why should we tell them that? We like cheap stocks.

Edwin Schloss: Loaded laggards.

Walter Schloss: That go up.

OID: Beating a hasty retreat, how diversified are you?

Walter Schloss: We own roughly a hundred companies.

OID: In terms of the market right now, basically you've said it's kind of difficult to find things. Is that because asset stocks have been bid up?

Walter Schloss: We're not ready to play the takeover game. Therefore, we tend to be out of the big companies, which is where the takeovers generally are.

OID: How tough do you find this market relative to other markets you've seen?

Walter Schloss: I think it's a tougher market than other markets because of the efficiency factor.

OID: But you find it tougher than 1969, for example?

Walter Schloss: It's not as tough as September '87 - which was a tougher market. There really wasn't so much around. In fact, we even had some cash.

OID: What about relative to 1972-73?

Walter Schloss: You have to understand that each market has a dynamic of its own. In 1972 and 1973, you had the so-called Nifty Fifty - and they were going wild.

On the other hand, many stocks were doing very little. We didn't do very well in that period because we weren't in the Nifty Fifty. And the other stocks were lagging.

OID: As we noted in our initial back-of-the-envelope study, some of the best managers underperformed during that period. I guess if you didn't buy tulip bulbs during tulipmania, you'd have looked bad, too - at least for a while.

Walter Schloss: That's exactly right. When the market collapsed, we were barely hit - because we weren't in the Nifty Fifty. This is not that kind of a market exactly.

Edwin Schloss: The secondaries were massacred in 1973.

Walter Schloss: But not <u>our</u> secondaries.

Edwin Schloss: We did better than the averages, but it was still pretty rough. We just had one or two situations that held up very well. But basically, most people were creamed in the secondaries.

Walter Schloss: That's right. Morse Shoe went from $40 to $2 or something.

OID: The 1974 equivalent of Service Merchandise. I can only imagine what we would have owned during that period.

Edwin Schloss: We look back at those prices. And there just aren't the bargains today that there were then. It's clearly not a period of bargains today.

Walter Schloss: If the market's going wild and you want to be in it, you either have to lower your standards to stay in the game or you buy stuff which may not participate because it's not part of the game at that time. In that case, you can miss the market because you don't get in on the way up - because you were buying stocks which weren't popular.

When the market goes down, these things maybe don't go down as much. Again, that's what happened to us in 1973 and 1974.

OID: You've consistently excelled in down markets. Yet it sounds like you will adjust your standards to find the best available bargains if there aren't bargains meeting your normal standards.

Walter Schloss: That's about it. We lower our standards to fit the situation - so-called relative value.

OID: Would you pay full value for something or would you hold cash first?

Walter Schloss: Just because we think a stock is undervalued doesn't mean we're right. We may be wrong in our judgment.

But if we had to pay full value for a stock because it was the only thing we could find, we wouldn't be in it.

OID: So even you guys have certain standards?

Walter Schloss: Believe it or not.

OID: How do you decide when to sell? Do you tend to sell when you find a better bargain?

Walter Schloss: I don't think we switch. Theoretically, that would be the smartest thing to do - when you find something cheaper, sell A to buy B. Logically, we should - we should say if this company is cheaper than the other, just switch.

But it's very difficult to judge the relative values of companies in different fields. It's difficult to come up with a figure. ***Also, many stocks we buy take years to work out.*** They don't go up right away after you buy them.

A stock gradually works itself into a good position and you become familiar with it. If you sell it because its relative value isn't there, you have to sweat out the new one for three more years. There's a life cycle to these things.

So we don't like to switch out of A into B. If we want to sell A, we'll sell A. If we want to buy B, we'll buy B. But we won t sell A to buy B.

OID: If that's the case, what is the most common reason for selling something?

Walter Schloss: I guess because it's selling at a price we think is reasonable.

OID: At fair value?

Walter Schloss: That's right. And we're probably selling it too soon - because lots of fair value stocks go up a lot more.

OID: Soros' reflexivity theory - where they may sell for more than they're worth.

Walter Schloss: Usually what happens is that when a company's earnings are getting better, its value goes higher; and it's somewhat difficult for us to adjust to the new facts. If we buy a stock at $30 and believe it's worth $50, once it gets up to $50, we may believe it's really worth $60. But it's hard to adjust to the new circumstances. So there's a tendency to sell too soon.

It's very difficult in today's markets to know what fair value is.

OID: Besides balance sheets, what else do you look at?

Walter Schloss: You've got to get a feel of a company - their history, background, ownership, what it's done, the business they're in, dividend payments, where earnings are headed. You've just got to get a general feel of a company.

But as I've said, you never know all about a stock until you own it.

OID: Do you ever get involved in risk arbitrage?

Walter Schloss: No.

OID: Have you ever sold short?

Walter Schloss: Yes, we did, but it was an unpleasant experience. We made money in it, but it was unpleasant. So we just made a rule of not doing it.

OID: Buffett says the mathematics are very unattractive. Another of our subscribers puts it another way. He says he hates to play any games in which he can lose an infinite amount of money.

Walter Schloss: The problem we have with it is the emotional reaction. There are people who short the market who do very well, but they're a different type of people. We're just not that kind of people.

OID: What have been some of the mistakes you've made?

Walter Schloss: The mistakes we've made are in a couple of areas. One mistake we've made is believing what somebody says they're going to do. The arbitrageurs now, as a matter of policy, will not buy a takeover stock until it's actually announced a takeover.

There's one I recall in which we did very badly. It was announced that Chicago Northwestern was going to buy Chicago Milwaukee - I've forgotten the terms. But it was a good deal higher than the market price. So we bought it.

The stock market fell down and the deal fell through. If you own a stock which is a takeover attempt, do you sell it once you've gotten a big profit or is it better to stay with it until the deal goes through?

It's a tough one. We've made mistakes. It's very difficult to know which way to go.

OID: It's clearly a percentage thing; you're going to be right some of the time and wrong some of the time no matter what you do.

Walter Schloss: That's right. And it all depends on the people who are in it. I suppose another mistake we've made - I don't think we've done it so much - is to be involved with a company where the guys who are in it didn't have very good reputations, but the stock was really cheap.

We've found that people with a poor reputation, on the whole are out to take care of themselves, not stockholders. I think we would just as well stay away from companies where the management is not too reputable.

OID: Looking for shareholder-oriented managements.

Walter Schloss: That's right. Obviously, you can't protect yourselves from mistakes. But we try to get in with people we feel are honest. That doesn't mean they're necessarily smart - they may be dumb.

But in a choice between a smart guy with a bad reputation or a dumb guy, I think I'd go with the dumb guy who's honest. Of course, you can't always protect yourself there, either. I guess the mistakes we've made are probably in those areas.

Sometimes, we may also be a little too greedy. For example, we may sometimes get into securities where there's too much leverage. When leverage goes against you, it can be very dangerous. We try to stay away from those kind of situations.

Actually, Graham didn't do that as much. He was buying companies with very little debt. In those days, there weren't takeovers. They'd be cheap, but they weren't very good. Because they didn't have debt, they didn't get into a lot of trouble.

But most companies now have debt - partly so they won't be taken over. It isn't quite as easy as it would have been just buying a working capital stock with no debt. And when you buy a company that has some debt, things can get worse, they can borrow more money when business gets bad.

Steel companies would be a good example of what happens. When a terrible industry turns down, a huge amount of debt can lead to bankruptcies like LTV and others. The leverage can destroy the companies in a downturn - whereas if they had very little leverage, they would be more likely to survive it.

OID: Have you invested much in bankruptcies?

Walter Schloss: Not really. Penn Central was an exception. And, of course, we did quite well with it.

OID: Why haven't you done more?

Walter Schloss: I think the main reason is that we didn't know enough about them. If you're going to do a job on knowing enough about them, you really have to spend an inordinate amount of time at it.

To do them intelligently, you really have to know a lot about it - which means you have to pore over the legal cases and the background of it and court rulings.

OID: Why don't you look at business quality more closely?

Walter Schloss: I don't think I'm capable of it.

OID: I find that hard to believe.

Walter Schloss: ***Warren understands businesses - I don't.*** Warren understands insurance businesses - I don't. And he understands banking and publishing companies.

We're buying in a way that we don't have to be too smart about the business....

OID: Because of the asset protection?

Walter Schloss: That's right. If you buy a great business, how much do you pay for it?

The reason Warren did so well with the newspapers is that he analyzed the values of the individual units. I don't know how much he knew about the newspaper business, but he knew at what price each of a company's holding could be sold. I don't think I would be really good at that.

Also, Edwin and I like the idea of having a little action. That may not be good from a logical point of view, but it's good from an emotional point of view.

If we owned the same 5 companies for the next 10 years because we believed in the businesses and all we did was to sit here and look at each other, it would be no fun. It may be a profitable way of investing, but you have to have some fun in what you do.

If you're going to be on a baseball team and you're sitting on the sidelines watching, that's not good enough. You have to enjoy what you're doing. I really feel that Edwin and I like the idea of having a little competition out there. By buying stocks, you're competing with the market in effect and you're doing something.

OID: With your feverish pace of turning over your stocks at the torrid rate of once every four years.

Walter Schloss: That's right, but we have a lot of stocks. If we only had 4 or 5 and we only bought and sold one stock a year - while it may be great

for some people, I wouldn't like it. I like a little action in what we do. We like to have a little fun.

OID: Speaking of fun, what's the story behind the picture of Babe Ruth on your wall.

Walter Schloss: I always liked Babe Ruth and I saw him hit home runs back in 1927. And Edwin's brother-in-law knew that I liked him. So when he met somebody on a plane who had taken the original pictures of the Babe, he made a copy and gave it to me.

But the thing about baseball is that most people who played baseball originally back in those days didn't do it for money. They did it because they loved baseball. If they had wanted money, they would have done better in some other field. It was fun.

Today, I suppose it's a business. But it wasn't back in those days - it was a sport. And I think investing should be fun. Of course, it's much more than fun. It's also a business.

The other satisfaction I have is that the partners that I have, at least most of them, are not that wealthy, so I can give them some money. If you buy five stocks and you distribute very little to them, theoretically they can trade in their units. But most people don't do that. They want to get a return.

Back in the '70s or late '60s, Yale and a lot of other colleges tried buying growth stocks and selling off a certain percentage each year - Harvard didn't do the same thing. It didn't make any sense to Paul Cabot, their investment manager.

But many people fell for it. Many college endowment funds suffered. The Ford Foundation lost 1/3 of their capital. Why? Because they bought growth stocks which paid very little in the way of dividends. They were supposed to get it back in increased appreciation, but it didn't work that way.

And most people like to get the cash. Some get it and use it for living. Then you have a lot of stocks, and you buy things that are not growth oriented, which are undervalued and you tend to sell them when they work

out and you move into something else. It gives you some realized gains and it creates a certain amount of pressure on us to get something else.

OID: And have some more fun.

Walter Schloss: I think you have to invest in a way that's comfortable for you.

We like to own stocks. It's very exciting.

If I retired, I doubt very much if anybody would call me because they couldn't sell me anything. I'd kind of disappear into the woodwork.

I think people in business are friends of people who are in business. And when they leave or retire or disappear nobody's going to look them up and say, "Come on over. We've got some things to buy."

There's a kind of a camaraderie about people in business.

Some people may prefer to retire to Florida. I'm sure many people enjoy life there, going out to restaurants and playing tennis and golf. But I'm not willing to do that.

OID: And we hope you never will. Thank you again, Messrs. Schloss.