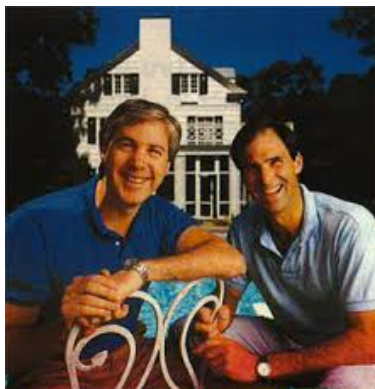


Chieftain Capital Barron's Profiles

Part 2: 1992 and 1994

Compiled by The Odd Lot : www.oddlotinvest.wordpress.com



Portfolio for All Seasons - What Two Astute Stock Pickers Like

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GLENN Greenberg and John Shapiro are two of the most astute stockpickers to be found this side of Graham and Dodd. They run Chieftain Capital Management, which has some \$400 million in assets belonging to affluent individuals, and their trademark is meticulous and cerebral analysis. They beat the market handsomely last year and are doing so again in 1992, even though a paucity of likely-looking prospects has left them with an unwonted amount of cash. But they still are high on a number of stocks, and to find out which ones, and why they like them, read on.

BARRON'S: Why don't we start with your performance?

Shapiro: In 1989 we were up 41%. In 1990 we were down 12%. In 1991 we were up 48%.

Q: And so far this year?

Shapiro: Up about 5%.

Q: Basically you guys are still doing the same kind of thing for the same kind of people.

Shapiro: Yes, we are managing more money now. It has grown to a bit over \$400 million.

Q: What did you start with?

Shapiro: Probably just under \$50 million, back in 1984.

Q: All of the increase is appreciation?

Shapiro: Most of it is appreciation. Although we had people that started with us who have given us more money over time. And we have taken on some additional clients. But we have never marketed. We have never tried to raise money. In fact we have turned down most overtures. Including from managers.

Q: You mean other money managers?

Shapiro: Maybe we are taking it the wrong way. But people have come to us as individuals who are on Wall Street and are professionals we admire and have offered us money to manage. We take that as flattering.

Q: It is flattering.

Shapiro: We will also turn down almost every approach, including those from fund-of-fund administrators who would like us to take on money for third parties we don't know.

Q: Why turn it down?

Shapiro: We prefer organic growth. We don't want to have anybody else dictate what we do.

Q: So you guys are green investors -- organic growth.

Shapiro: That is an old European term.

Greenberg: One of the biggest problems that companies get into sometimes -- and we're after all really professional students of companies -- is because of overly rapid growth. That certainly has been the history in the investment business as well. We feel our skills can grow at a certain rate. But beyond that rate it would be very disruptive.

Q: Is there an optimum amount of money you can efficiently manage? Or is it just something you will know when you get there?

Shapiro: I think it is not so much an optimum amount of money, but how much money at what rate of growth. In other words, if you had asked us when we started out with \$48 million whether we could be managing \$400 million successfully, we would have said no. But you can grow into that over time.

Q: Do you find you have to add people?

Shapiro: We just added an associate last week. At the moment that is our only addition. And we'll see how that works out. We feel that we have the firepower here to manage more money than we currently have, provided it is, as Glenn says, from organic growth.

Greenberg: Also we only invest in 10 to 12 stocks. That is how we started.

Q: So you really do have that discipline.

Greenberg: We do have 10 stocks. It is no more difficult to follow 10 medium-to-large sized companies than it was to follow 10 medium-to-small sized companies eight years ago.

Q: We understand you're heavily in cash -- heavily, at least, for you.

Shapiro: Right.

Q: Yet you profess not to make market judgments. So your relatively big liquid position suggests that it is more difficult for you to find the kind of stocks you like in this market.

Greenberg: We tend to set absolute standards of investment worthiness. And it is harder to find the kind of lower P/Es and big discounts from intrinsic value type-situations which we have grown accustomed to. We prefer not to accept the lower or negative returns which the market seems to offer today.

Q: Why don't you refresh our memory, just what are the criteria you use in looking for stocks?

Greenberg: I would say that we are soundly in the value camp. And we tend to try and find companies that are substantially undervalued, that are in relatively good businesses, or that have a strong business advantage. And that perhaps fall between a crack and don't have too much analytical coverage. And that generate surplus cash flow, and where the management owns a substantial stake in the enterprise and focuses on increasing shareholder value.

Shapiro: I would add to that, some value investing has fallen into the mechanistic school. I think we are not in that camp. We try to look at qualitative elements as well as the quantitative.

Greenberg: One of the reasons some of the value managers have performed so poorly in recent years is that they are mechanistic. We have never bought stocks on any mechanistic formula, or bought them just because they are some percentage below book. I remember when Bethlehem Steel had a book of 60 and the stock was 20. But you couldn't make money buying Bessie then. And we bought companies, in recent years, where there was no book value because they had been in an LBO and then taken public again, where they earned very handsome profits on no book value.

Q: So you're essentially saying you are fairly flexible in what you consider value.

Greenberg: Correct.

Q: The reason you have so much cash, besides the inability to find worthwhile places to deploy it, is that, we presume, you have been selling quite a bit. And that leads to the question, do you have a selling discipline?

Greenberg: The example I'd like to use is we bought the RJR PIK bonds in the fall of 1990 when they were yielding well over 20%. And we sold them in the spring of 1991 when they were just about to receive a credit upgrade and become investment quality. When we sold them, we still felt they might go up in price as they got investment grade rating. But they didn't have the rate of return that we are looking for. So while they were still attractive, they were below the kind of 20% annual rate of return which we strive for. We are unwilling to buy stocks that are reasonably valued in the hopes that they might go overvalued. We are really looking for things that we think are very undervalued, and try to sell them when they are reasonably valued.

Q: Our conversations go back to '88. Some of the things you've liked and stuck with, in retrospect, you would have been better off selling. Burlington Resources, for instance.

Greenberg: Actually we have traded around our core position. We sold over half our position in '90 when the invasion of Kuwait took place, and repurchased those shares, in retrospect a little early, about a year ago. But at prices below where it is trading today. It has not been a home run. But on the other hand, over the three years we have owned it, it has gone from 26 to 38, at a time when gas prices have collapsed and nearly everything has gone wrong for the company in its asset disposition program. So we consider this has not been a mistake, and that our reward lies ahead.

Q: What's the composition of your portfolio at the moment?

Greenberg: Right now, it is about 25% natural gas, 25% cash, and about a quarter in financial stocks, and the rest real estate and miscellaneous.

Q: Certainly the energy group has been perennially promising and perennially disappointing. What is your rationale for natural gas?

Greenberg: Since the early 'Eighties people have been talking about the end of the gas bubble. But unfortunately with so much conviction that they were willing to drill for gas, believing that there would be a shortage. We noticed a tremendous change in the tone from industry observers and industry participants in the last six-to-12 months.

Shapiro: I would tell you more than just the tone. There has been an active effort on the part of the industry to eliminate drilling for natural gas. If you look at most of the majors, they are reducing their domestic budgets, and shifting that to international exploration. They are closing or consolidating their exploration in development offices in the U.S. Whereas everybody three years ago was drilling, expecting things to improve, now they have essentially capitulated.

Greenberg: An interesting statistic is that now there are 250 rigs drilling for gas in the United States.

Q: How does that compare with five years . . .

Greenberg: That is way down. But to put it in perspective, each rig can drill about 24 holes per year. And a year ago the average well contained 1.5 billion cubic feet of gas. So if you multiply that out, you will find that we are replacing approximately half of what we are using. I think that we are absolutely drawing down our reserves as a nation.

Q: When do you think the dawn will break in terms of Wall Street's perception of the improved prospects for natural gas?

Greenberg: We made a lot of money in oil tankers in the mid-1980s. I remember at a cocktail party meeting a fellow in the shipping business, and I told him that we had a big position in tanker stocks, and he explained to me in great detail how there were five tankers idle for every one that was needed. And that our investment was premature. And within 12 months the market turned, the perception turned, and we were off to the races. And I found that calling timing on commodity markets is virtually impossible. But the psychology is now appropriate for a bottom and a turn.

Q: There is no question there is pervasive bearishness toward natural gas and not only among investors but the industry as well.

Shapiro: Well, Gov. Cuomo recently turned down a contract from Quebec because he feels that natural gas prices are going to stay low for the foreseeable future.

Q: So he is short the natural gas stocks.

Shapiro: Sort of calling a permanent depression in natural gas.

Q: Psychologically, at least, we do seem to have hit bottom.

Greenberg: There are also some fundamental factors. Every electric utility boiler on order is gas turbine today. Zeroemission cars are mandated in California and will be mandated in other states beginning in a few years. All new homes today are being built with gas furnaces. If you look at demand, which was falling through most of the 'Eighties, it is now rising even right through this recession. So there are a lot of favorable fundamental factors.

Q: And one of these winters is not going to be tropical.

Shapiro: That is right. That will focus people's psychology. I think that one point I would like to add is that the major companies, in addition to pulling back their exploration, have been producing their fields to maximize cash flow. And basically you have overproducing, which is not a sustainable condition. So you have a situation in which demand is continuing to go up, but supply cannot be maintained at these levels, especially when you are only replacing half of it per year. When that turn comes, who knows. But we really believe the forces are in place, the dynamics are in place, for that turn to happen.

Q: One of the ways you have chosen to play that, as we mentioned, is Burlington Resources. Do you want to tell us a little about the company, and what you expect from the stock?

Shapiro: Burlington has several unique attributes. It is valued today in the market at something like 60 cents an MCF of approved reserves. Almost all of those are developed. In addition to that -- and this is really unique -- they believe they have three times as much in probable reserves as they have in proved reserves. So you are talking about a company with an enormous amount of gas available when the market needs it. In addition, you have a very shareholder-oriented management that has sold off miscellaneous assets and bought in stock and owns a great deal of stock and has said publicly that they would welcome a bid for the entire company when the time is appropriate to cash in.

Q: Burlington still has El Paso?

Shapiro: It does, they took El Paso Natural Gas public by selling 5.7 million shares about a month ago. And the plan is to spin off the remainder of their shares within the next six months. But, at the moment, El Paso is trading freely in the market. The two will be separated by the end of this year.

Q: Burlington Resources came out of the old Burlington railroad, didn't it?

Greenberg: Burlington Northern took Burlington Resources public in the summer of '88 and then spun out the balance of the shares at the end of the year. And then Burlington Resources undertook a program to dispose of all its non-oil and gas related assets, which it has just about completed. And they had to overcome almost every kind of adversity since they had a gold property and land to sell, timber to dispose of. It has been a difficult job.

Shapiro: And they have used a large portion of the proceeds to repurchase stock.

Q: We do notice that throughout this rather unexciting period both their cash flow and earnings have been on the rise.

Greenberg: The detractors have mainly noted that the company sells at a higher price-to-cash flow than other industry participants. But our feeling is that it is like valuing a growth stock on its current earnings. Most oil and gas companies have to spend a lot of money to replace the reserves they produce each year. So they don't really have

growth in production. Whereas Burlington has had consistent increases, averaging over 15% in reserves and in production. And we expect that those can continue indefinitely. So we feel that a growth situation deserves a higher multiple on today's cash flow. In addition, if you do an analysis of which companies will have the greatest increase in cash flow from a given rise in gas prices, Burlington would be second on the list.

Q: The cash flow in '91 was what?

Greenberg: Taking out El Paso, it was about \$3. It's worth noting that they only received \$1.35 for their gas, whereas many companies received higher prices because they had old contracts which were at higher levels, or because they were in better markets this past year than the San Juan Basin. But we see that as another form of leverage. Some day when gas is tighter we expect the price to be uniform.

Q: We assume you sat down at some point over a beer and said to each other, "well suppose we get up to \$2 gas." And figured out what that would mean to Burlington's cash flow.

Greenberg: A \$1 increase in the price of gas would increase their cash flow before taxes by at least \$325 million.

Q: And that is how much per share?

Shapiro: \$2.50. So it would be almost a double in their cash flow. That would be based on what they could produce today. I would assume, with these great reserves, that they could produce a lot more gas a couple of years out.

Q: Given that sort of increase in cash flow, what kind of multiple of cash flow would Burlington sell at?

Greenberg: I don't know what it would sell at because I don't know that a \$1 increase in the price of gas, which would take us back in their case to \$2.35 an MCF, would be the top-or anything close to the top.

Shapiro: Another factor is that at this point in time nobody gives them any credit for their probables. Because there is the perception of, who cares? We have already got a surplus of gas. But if you got into an environment where gas prices were moving up because it was perceived that supply/demand was in balance, or in fact maybe there were some concerns about supply, suddenly this thing might not be viewed just as a multiple of cash flow, but also be given credit for those huge probable reserves. So whether this would be a 10 times multiple of cash flow is a little bit hard to say because I think the valuation method might change. Also you should keep in mind that at Burlington, you have at the moment about \$5 of El Paso underlying a share of Burlington. So you are paying about . . .

Greenberg: . . . about \$31 for the shares of Meridian Oil, which is the gas subsidiary of Burlington.

Q: Burlington, in the past, has sold above \$50. So that is not an impossible number. Greenberg: We are actually looking way beyond that. If you took \$3 gas, which again would be back to where you were in 1986, that would give them cash flow of something like \$7 or \$8. That is assuming they didn't use any of their surplus cash to buy in more shares. I think you would be looking beyond \$50 a share in the price of the stock. In addition, our feeling is that at some point the majors will want to come back into the U.S., if the U.S. gas business begins to seem like it has a bright outlook. And rather than set up regional offices everywhere, and try to establish a land position, which they have given up in 1990 and 1991 and 1992, probably they will be looking for just such a company as Burlington, and may be willing to pay a very substantial price to get back into the market.

Q: If a major oil and gas company were to buy Burlington, on what would the price depend? A multiple of cash flow or book? Or reserves? How are natural gas producers valued?

Greenberg: Ultimately you can base it on cash flow or you can base it on reserves in the ground, which are tied back into expectations about prices and cash flow. But people have become so conditioned to thinking of \$1 gas as being the norm, not recognizing that in 1986 or '87 the price was \$3. And that 10 or 12 years ago people were paying \$5-\$8 because we were running out of the stuff. So it is very difficult, when you are sitting at the bottom, to imagine such things as \$3 or \$4 gas. But we don't find it inconceivable.

Q: And should it get to that level, given the nature of the human beast, people would start dreaming of \$8 gas again.

Greenberg: We were basing those cash flow estimates on just a change in price, but not on the company's increased

production volume. Right now they have one of the longest reserve lives in the industry. As a result they could increase their production very substantially. So the cash flow might be increased by 20% or 30% three years from now, simply by increasing their production.

Q: And the irony is that if all this came to bear, the fact is that people would pay a higher multiple of higher prices.

Greenberg: Correct.

Q: How about the other energy interest you guys have Anadarko Petroleum.

Greenberg: We have two other interests. One is a producer, which is Anadarko, which is not as exciting a company. But it still maintains its posture, and is a pure gas producer. What we were looking for are the companies which have the biggest increase in earnings for a given increase in gas prices. And Anadarko's earnings, with a \$1 increase in gas prices, would double. Their cash flow would double from \$2.50 or so this year, to \$5. That is assuming that they could produce at 100% of their capacity. It also has a conservative balance sheet, and is well run. And then we have a third entry into the industry, which is Tidewater.

Q: That is an interesting company. They supply, as we recall, all kinds of marine services to offshore oil and gas operations. They recently took over Zapata Gulf Marine.

Shapiro: They really merged with Zapata. The merger became effective probably a month or so ago.

Q: Are they basically in non-U.S. waters at this point?

Shapiro: Right now about two-thirds of the fleet is international, and the balance is in the Gulf of Mexico. And they are the largest fleet in the world at this point. They have 30% of the market. The next largest competitor probably has 4% or 5% of the market. And obviously this business has been extremely depressed with the low level of drilling in the Gulf of Mexico. And yet despite that, this company, we feel, will report \$1.20 a share for last fiscal year ended March.

Q: For March '92.

Shapiro: Yes. They have \$1.60 on top of that of depreciation. So you really have \$2.80 of after-tax cash flow, for a \$13 stock. They cleaned up their balance sheet.

Q: They were 50% debt a couple of years ago.

Shapiro: Now they have \$45 million of net debt, and \$550 million of equity. So you have a company that, in the absolute worst period of oil drilling or oil and gas drilling, not only has a clean balance sheet, but is selling at about 4 1/2 times after-tax cash flow, and has a tremendous leveraged exposure to any upturn in rates. By way of example, a 10% increase in rates would translate into a 60-cent-pershare increase in earnings.

Greenberg: You might want to mention how much rates would have to go up before it would trigger a reordering.

Shapiro: One of the interesting points here is that you need over \$5,000 a day to justify purchase of a new ship. And internationally, where the rates are highest, the rates are currently around \$3,300. You need a 50% increase internationally, and they would need to more than triple domestically before you could justify new building.

Q: What you are saying is that you don't have any real threat of competition coming in.

Shapiro: That is right. And in fact, when you control 30% of the industry you basically can control the supply. If a guy who has 3% of the industry decides to expand his fleet by 20%, it doesn't mean that much.

Q: You mentioned before your buying the stocks when tankers were at rock-bottom price. Larry Tisch made a lot of money buying them directly, and he's now into rigs in a big way.

Shapiro: These areas are depressed. Where else can you buy a company at 4 1/2 times after-tax cash flow at the bottom of the cycle with a terrific balance sheet? In addition to that, you have an interesting share ownership.

Because of how this was put together, you currently have Corporate Partners, Bessemer Capital Partners and Zapata each owning 15%.

Q: Who are Corporate Partners?

Shapiro: It is run by Lester Pollack. They are clearly there to maximize value for their fund, as is Bessemer. Zapata is a company that has had financial problems of its own, and their block in Tidewater represents a major source of liquidity. So I think that you have a shareholder complexion here which is quite interesting, along with what we think is an extremely exciting fundamental story.

Q: Why don't we turn to something else besides energy?

Greenberg: Why don't we shift into financial stocks?

Q: You have one that certainly has been an enormous winner. Freddie Mac.

Shapiro: Freddie Mac has been an enormous winner. But the company and the industry continue to evolve in a very attractive fashion. First of all, to get to the numbers, we believe that they will earn \$11 a share in '92 and \$13 in '93.

Q: And the stock is about 125 or 126.

Shapiro: That is right. It is going to be splitting 3-for-1 the split was effective last Thursday. So obviously everything will have to be divided by three at some point.

Q: Tell us again what they do and how they differ from Fannie Mae?

Shapiro: They both engage in the securitization of residential mortgages. That means they take a package of mortgages, which they basically purchase from a bank, and they package it and convert it into a debt security which is then sold to a variety of people. And they provide the credit insurance on the mortgages in that package. They do not take the interest rate risk on those packages. So that is the securitization business. In the past that has represented the bulk of Freddie Mac's

(See related letter: "Barron's Mailbag: His Father's Son" -- Barron's April 27, 1992)Q: And Fannie Mae?

Shapiro: Fannie Mae, on the other hand, has also owned mortgages. In other words, they would buy the mortgages and keep them on the balance sheet. In that case they would take both the credit and interest rate risk, but they would collect a much greater spread on funds. For instance, on the securitization, you probably end up making 30 basis points, whereas when you own the securities, you make about 80 basis points. One of the significant changes which has occurred in Freddie just recently is that they have indicated that they will start to increase their own portfolio. And basically their own portfolio today represents about 5% of their total asset exposure. They have indicated they were going to at least double that within the next five years.

Q: One area of concern has been that Congress has been fretting about both these companies, about the adequacy of their reserves and the like. Do you think that is no longer a significant consideration?

Shapiro: I don't think so. I think it has been examined. I think some of the key confusions on Congress's part have been eliminated. And I think that as Congress dithers, these guys have continued to earn money and build up their equity base, and their reserve, so that it becomes less of an issue. It is interesting that they are about to issue a preferred, which was given a AA rating for a junior security which would imply a AAA rating on a senior security. And that was the type of saber rattling that Congress was engaging in, that they wanted these companies to qualify for AAA rating.

Q: Suppose interest rates start to go back up?

Shapiro: Actually I think in Freddie Mac's case that could be a bit of a boon. Because they are right now beginning this process of putting on securities which they will own, or mortgages that they will own. So they will be able to add debt at higher rates and increase their spread. Barring extremes, which have impacts that go far beyond the simple mathematics of earnings, I don't think rising rates would have any negative effects.

Greenberg: In fact if the rising rates were because of a strong economy it would imply their credit reserves, which appear to be overabundant, would be very overabundant.

Q: They would reverse those?

Greenberg: Last year they had \$315 million of losses and provided \$431 million of reserves. So they provided \$116 million of extra reserves. Not including the \$743 million that they have got in general reserves.

Shapiro: I was starting to note this increase in the retained portfolio. Let's say securitization of mortgages will provide you with 10% growth -- although it has been higher. Let's be a little conservative. By increasing their retained portfolio, assuming they take the full five years and I think they will do it in less -- that alone would add about 60 cents per share per year. And the other thing is that I think Freddie Mac has been extremely conservative in their reserve policy to the extent that they are getting to a point of being grossly overreserved. And I think that, not in '92, but looking out at '93 and beyond, you can see them reduce their loan loss provision, still be very conservative, and yet reduce that. And that could add another 60 cents per share, per year. We see in Freddie Mac a company with \$11 this year, \$13 next year, and that can probably grow their earnings in the 13%-15% range.

Q: Do you think that will merit some multiple expansion?

Shapiro: I think you can get some multiple expansion. I think that clearly two things that are still weighing on Freddie and Fannie are credit concerns and government concerns. And at some point the government will sign off on whatever they are going to do. And we believe the economy is strengthening. That seems to be borne out by the rate of delinquencies and chargeoffs. And as credit concerns are less of an issue and the government becomes less of an issue, I think the multiples could expand.

Q: You are also in Ambac. What's the attraction?

Shapiro: Ambac is a relatively new position. Ambac is in the business of insuring municipal debt.

Q: Is that a good business? There is going to be a lot more municipal debt for sure, but financially municipalities are not exactly in the pink.

Shapiro: There are several factors. First of all there is a lot more municipal debt. Secondly, because of the tax laws, more individuals have been buying municipal debt than in the past. And individuals who cannot research Tallahassee water bonds or something, look towards insurance. Unit investment trusts or muni funds market themselves by making the claim that they hold AAA guaranteed or insured debt. What has happened is that not only is municipal debt going up, but the percentage of that municipal debt which is being insured is increasing.

Q: But, as we say, a number of state and local governments are in serious financial trouble. Doesn't that increase the exposure of a company like Ambac?

Shapiro: Well it does increase the exposure. But I think there is a critical point here you have to focus on. Most of us are used to corporate debt. In the event of a municipal default, you don't get a foreclosure type of process. What Ambac is on the hook for is only any particular payment that is missed. And if there is a restructuring they are only on the hook for the difference between the new restructured amount and the insured amount.

Q: They have been public since July '91. How long have they been in business?

Shapiro: They issued their first municipal bond insurance policy in 1971.

Q: So they have a history?

Shapiro: They do have a history.

Q: How has their loss experience been?

Shapiro: They stubbed their toe by writing industrial bond insurance. In 1986 they put in new credit standards and since that time they have not had a single loss on any business they have written. I think since 1986 they have

written \$54 billion par value of insurance. And the interest on that would probably double that. In other words, the bulk of their book of business today, which is \$104 billion, has been put on since 1986. And so far they have not had a single dollar of loss on any of that business. But there is something interesting here. The purchaser of the insurance is really a consumer who is not educated beyond wanting AAA insurance. And you have a sophisticated seller. And you only have three sellers of this insurance. So that you have unusually wide pricing. They get very good prices for their insurance because they are selling to a disparate group of purchasers.

Q: How about earnings?

Shapiro: They are currently earning about \$3.30. The stock is \$35. And we think the earnings can go up to \$3.80 next year. And continue at a 13%-15% growth.

Q: The stock came at \$20. So it has had a very good rise. But in terms of its earnings it still seems relatively cheap.

Greenberg: People were concerned that, given the level of competence that Citicorp has shown in managing its businesses, if it was coming out of Citicorp, it must be damaged goods. Then people got more comfortable. We bought the stock on the second offering at 31 3/4 about two months ago.

Q: Citicorp still owns . . .

Greenberg: No, they sold their first 50% in July of 1991 and the balance of their stock in this year's underwriting.

Q: So they are out of it completely.

Greenberg: I would like to point out that this is a funny business. Last year they had \$80 million of net premiums earned, and they have five years' worth of net premiums sitting on their balance sheet right now.

Shapiro: The interesting part is that -- let's say you are insuring a municipal bond that is a 10-year bond that pays 10% interest. So it is \$100 million of principal amount, plus you have \$100 million of interest payments.

Q: In other words . . .

Shapiro: The thing is, you take on a \$200 million exposure and you charge 40 basis points. You get that entire amount of money up front. So you get to hold the money for the 10 years. However, they accrue that in their earnings over the 10-year period. So, you actually not only get the use of the money, but you have a substantial unearned premium that sits on your balance sheet that really is a multiple of what your annual earned premiums are.

Q: Big comfort factor, you're saying.

Shapiro: Right. In terms of forecasting the business, if one year happens to be a little bit slower or a little bit faster, it doesn't really affect the business too much.

Q: And they have a pretty diversified portfolio that they are insuring.

Shapiro: It is fairly diversified both by type and by geography. Although, of course, California probably represents a large share of that. Where a company like this could be hurt would be if you had a major catastrophe that really permanently obliterated an area's ability to ever pay off any debt. If you had one of the total severe earthquakes that people have been forecasting for California for years, I suppose they could take some losses then. But barring that . . .

Q: How about bankruptcies?

Shapiro: You know it is interesting that Bridgeport tried to go bankrupt and they weren't allowed to. Basically they just have to go back and increase their taxes so that they can pay. I mean, you might have people who fall down in the credit ratings and they might even miss a payment. But remember Ambac would only be on the hook for that one payment. And, if the municipality restructures or sets up a new taxing authority and gets itself back on to current basis, then Ambac doesn't have to pay any further.

Greenberg: Our biggest worry here is not about the book of business they have written, but the worry that management might take the surplus cash flow which the business throws off and get into other kinds of insurance -- like asset-backed securities, which some of the competition have done. And, we don't feel as confident in the kind of quality of those kind of issues.

Q: Has there been any indication that they might do that?

Greenberg: Well, they are certainly considering it. And, we hope that they'll consider share repurchases instead.

Shapiro: Fortunately, they got burnt in the industrial revenue bond business. And, sometimes when you have sort of moved a little bit away from your core and you get hurt, you are a lot more careful and cautious before you take the plunge again.

Q: You guys also own a bank. Which one is that?

Greenberg: It is not really a bank. It's a thrift called Boston Bancorp, which dates back to 1883. They are in Boston as the name suggests and they have done a great job. They stopped lending up there when others were lending as fast as possible. They stayed away from commercial for the most part. They stayed away from lending on second homes and high-priced homes and home equity. They have just stayed a plain vanilla, low-cost organization. And, as a result they have come through a difficult period up there and will have record earnings this year of approximately \$4. It's an October year and earnings will be higher again in '93. The competition in Massachusetts banking, as you might expect, has been greatly reduced. Boston Bancorp keeps cutting their deposit rates and people keep flooding them with money, because they're more concerned about the safety of their principal than getting some kind of exotic return.

Q: They have maintained surprisingly good ratios, particularly in the non-performing department.

Greenberg: It's a depression up there, as you know. Look at the reserves the other banks around them have had to take. And, if you can look at a list of the new issues that came public during the '80s, you will find that Boston Bancorp is up from \$4 to 26 and virtually every other one has been cut in half or worse. I think that it is important that the management has all their net worth in the bank and I guess as a group probably owns about 20% of the stock. Losing money was just something that they didn't want to do.

Q: Which they didn't.

Greenberg: Which they haven't done. The chairman of the bank can tell you about every problem loan they have. I mean, it's something that they are focused on, that they think about ways to avoid and it has been demonstrated in their performance.

Q: Even in 1990, looking at their record, which was a disastrous year for thrifts, earnings held up relatively well. They went from \$2.50 to \$1.94.

Greenberg: Right, and actually if you broke that down further, you would find that the major difference besides a little bit of rate compression was that they had fewer capital gains. They have a very astute chief investment officer who has maintained investments in preferreds and utilities and invested ably in the bond market. But he also owns a sizable chunk of Freddie Mac and other investment-worthy securities and each year they have between \$3 million and \$7 million of capital gains.

Q: How big a portfolio do they have?

Greenberg: I think it is about equal to their net worth, which is about \$100 million. I think that is sort of their mental limit. They have also, if you noticed over the years, retired stock.

Q: And that, of course, is one of the things that you guys like.

Greenberg: We like that a lot. Because it is a discipline forced on management to compare every other investment alternative with a repurchase of their own shares. And, I think the question in my mind is why Boston Bancorp should sell at six times, when some of the other high-quality thrifts around the country sell at double that multiple.

Q: You're forecasting around \$4 this year. And what did you see for October '93?

Greenberg: Unless rates drop or the yield curve changes, you know, flattens dramatically, I would accept that they can maintain a \$4 level of earnings for some time because they are still providing very generously to their loan loss reserve, since they tend to be very conservative fellows. And, even when rates rise because the economy is improving, they will be able to cut back their loan loss provisioning dramatically, which will cushion their earnings. And, in addition, they still have an opportunity to pick up branches of other banks and expand their franchise. Each time they do that, they pay almost nothing to take on the deposits of another bank and then they invest usually in mortgage-backed securities and make a very nice spread.

Q: Okay. What next.

Shapiro: MCI.

Q: The stock is 31 1/4, down from 48 1/2 in '89. What exactly do you like about it?

Shapiro: We basically believe that the long-distance telephone business is an excellent business with tremendous potential in the future. I think first you can envision a high rate of internal growth, domestic growth. You know, the use of data, the use of fax machines, the increasing networking which is going on, has allowed and should continue to allow minutes of use to grow at a much faster rate than the economy. There has been some arguments made that as you get video conferencing, it grows, that could replace some travel and that could be another factor in growth. But even beyond that, you have an industry which in a decent economy can grow at a double-digit rate. And, in a year such as last year where the economy is basically in a recession it was able to grow at about a 6%-7% rate. On top of that, you have a tremendous potential internationally and this gets a little bit complicated. But basically the foreign telephone companies are all monopolies.

Q: So?

Shapiro: They charge unusually high rates. And, that depresses the amount of calls coming from the foreign countries into the U.S. relative to the number of calls going from the U.S. out. And, the U.S. phone companies only make money on the incoming phone calls. With the Europe '92 process going on and some of these other pressures that exist, the monopolies internationally are becoming more competitive. And as their rates come down you would expect to see an increase in the volume of calls coming into the U.S.

Q: Does MCI also invest directly in foreign telephone companies?

Shapiro: No, they really don't. There has been some speculation that maybe some foreign telephone companies would want to invest in them to put together sort of a global network to more effectively compete against AT&T. But they don't really have to do that. They do have to invest in cable that gets you under the ocean. But then they would hook up with the various country monopolies that exist over there.

Q: There's no lack of competition in the long-distance telephone business, though.

Shapiro: There is tough competition. It is sort of self-inflicted, I mean, the fact is that MCI still believes they can pick up market share profitably. So they are spending to do that and obviously AT&T doesn't want to give up market share without a fight. So they are spending in opposition and there is that competition. But interestingly enough, the pure rate competition is not as strong as it might appear. Most of the competition is coming because of marketing efforts, not because people are doing radical rate cutting.

Q: It's been suggested that with MCI taking over Telecom for over a \$1 billion and AT&T taking over NCR for a bundle, the two companies might have to try to conserve cash by stopping whacking away at each other.

Shapiro: Well, despite a bad economy in '91 and despite heavy new marketing expenses, MCI still generated over 20% return on equity and excess cash flow, after capital expenditures. The fact of the matter is that the long distance business is a profitable business, it's growing. There is a very interesting dynamic here. When MCI put their first fiber optic line from New York City to Washington, D.C., it cost them approximately \$1,000 per circuit mile. I

don't know what a circuit mile is but that's . . .

Q: It sounds very long -- does that help?

Shapiro: It is very long, whatever it is. When they went to double that capacity, through the use of computer compression, they were able to do that at \$1 per circuit mile. How many fixed-cost businesses that you know can double their capacity at one-thousandth of the price? Most fixed-cost businesses, when you want to double your capacity, you have to pay three or four times what you paid the first time around. So you have a business where the marginal cost of production is going down.

Q: One way they tried to expand their capacity, and this of course also has generated some criticism, is that they paid \$1.25 billion for Telecom, which had kind of nominal earnings of \$40 million, let's say, at the time.

Shapiro: You are right, they overpaid for Telecom. They feel that there were some software benefits and some cost savings and things of this sort that would reduce the apparent price. But, yes, we would agree with you they overpaid for that. But that's behind us now.

Q: They have made progress in reducing their leverage.

Shapiro: Oh, quite dramatically.

Greenberg: Why is leverage bad when you are only paying 7 1/2 % . . .

Q: Because people were worried about it, that's why.

Shapiro: I think that they are now a \$9 billion company with a 20% return on equity. This not a company that is hemorrhaging cash. That has changed quite dramatically from where they were in the mid-'80s. Basically we see this company as one that in a poor economy and despite heavy marketing expenses can grow earnings at 10%. In a better economy, still investing heavily in marketing, it can grow at 15%20% and at some point in time, and I am not going to say that's in the next year or two, it will settle into a more benign relationship with AT&T where they will be able to reduce their marketing expenses and will be able to grow their earnings at 20%-plus.

Q: Meanwhile, they also have a substantial cash flow. Shapiro: Have a substantial cash flow and a diminished need for capital expenditures. So basically their earnings are free cash.

Greenberg: You also have 20-25 cents of amortization of intangibles which we would add to their earnings per share.

Shapiro: So we are looking for around \$2.20 of earnings this year and \$2.60 in '93, and their cash earnings would be more like \$2.45 and \$2.85.

Q: Why don't we leave MCI and go to another M you own -- Manville, which I noticed today got put on the credit watch.

Greenberg: Yeah, but what do those guys know?

Q: Good question.

Greenberg: They are not equity guys. The story basically in Manville is that, as it has been widely reported in the newspapers accurately, Manville no longer has any responsibility for sufferers of asbestos exposure.

Q: Instead they set up a trust to handle such claims.

Greenberg: When they came out of bankruptcy a trust was established and an injunction against any further lawsuits against Manville was made. It has been upheld on numerous occasions.

Q: How does the set-up work?

Greenberg: The important factor is that 80% of the stock of Manville Corp. is held by the trusts, set up for the people who are sick from this exposure. In addition the trusts hold a significant debt instrument payable over 24 years and

in addition they receive 20% of net profits from Manville going forward. Our belief is that those people want to receive some cash. And, at the moment it's clear they are not receiving any cash. And the reason is, the assets of the trusts are not adequate to pay off all the claims, at least at the kind of levels that people who are sick from asbestos were receiving four or five years ago.

Q: So what does that suggest to you?

Shapiro: One of the reasons the payouts have not been adequate is because over 60% of the payouts have gone to lawyers.

Q: None of whom have been exposed to asbestos.

Greenberg: I am not an expert on this but Judge Jack Weinstein from Brooklyn has basically taken on the plaintiffs' lawyers and we are behind him 100%. And what he is trying to do is turn the Manville situation into a class action suit which would cut down the plaintiffs' lawyers' participation. And he can do that on the basis that the assets that the trusts hold are inadequate to settle all the claims and therefore it requires a kind of class action-type settlement where an equitable method is devised by a judge such as him. Not surprisingly, the lawyers are challenging his decision and he will hear within the next month or two whether his view of things is upheld. If it is, it would go to the Supreme Court and if the Supreme Court were not to hear the challenges, then basically Manville Trust can proceed with the distribution of cash to the people who are ill. The only way they could do that would be by selling off the stock in Manville and the bonds that they hold. Our belief is that -- and it has been said publicly in speeches to shareholders and in the annual report -- Manville Corp. will be sold so that the cash can be used by the trust to settle the claims, once this current litigation is finished. Which we would hope would be by the end of this year.

Q: And to whom would they sell it?

Greenberg: Well, they have two businesses. They have the building products business, which is insulation and roofing materials, and then they have the much more attractive and interesting Riverwood International Division, which makes up beverage carriers and linerboard in Brazil.

Q: They are trying to go public with part of Riverwood, right?

Greenberg: That's right. Well, they and Mead are the only two producers of this beverage pack which is enjoying very rapid growth in the United States. But even more so in Europe because of the environmental movement and in the rest of the world, including the Far East, because the methods of distributing soft drinks are being changed. And, in addition to that, people are tending to drink more Coca-Cola and bottled drinks as opposed to liquor and water, I suppose, so that the demand is very rapid and more capacity is required. Mead recently brought on a new machine and a brand new mill for nearly \$600 million and so it's Manville's turn. They appear to be able to create the same kind of capacity for about \$400 million if the deal that they recently announced is brought public to help finance it. They are going to take part of Riverwood International public, as you suggested. And, it appears to us that it is an extremely attractive business. The president of Riverwood, Tom Johnson, has said publicly that he believes the growth over the next five years will be in excess of 15% in earnings per year . . .

Shapiro: In revenues, and the earnings will exceed that.

Greenberg: And in the packaging part of their business, I believe that their earnings were actually up in '91, which would be practically unique in the industry. So we perceive it as an extremely attractive business. The reason why another paper company couldn't get into this is that your customer uses your packaging machinery and your board, strangely enough designed only to run on that particular kind of machinery. So, if someone were to decide to get into the business they could make the board, but they would have to go out to thousands of customers around the world and convince them to toss out Mead or Manville's equipment and install their own.

Q: If they decided to sell Manville Corp. to liquify the trust, how would that work?

Greenberg: I haven't thought through all the ramifications. My guess is a buyer for Riverwood International would not be interested in the building products.

Q: So they would sell . . .

Greenberg: Right now the company is organized coincidentally in two divisions, Schuler International . . .

Shapiro: Actually it is two corporate entities with a holding company.

Greenberg: So it already has in effect been divided in half. And, I suppose it will be possible for Manville to sell off Schuler to someone interested in building products and to sell Riverwood, or Manville, whose only asset is Riverwood, to someone else. We might also point out that there is a unique net operating loss that will, because of a quirk in the tax law, be created when the trust actually makes payments to claimants. So somebody could actually buy Manville and then, when the money is distributed to the sick people within the next, say, 12 to 24 months, a huge NOL of \$2 billion or \$3 billion would be created and the buyers of Manville could actually take advantage of that NOL. That NOL on 120 million shares that Manville has outstanding could be worth on a present value basis \$2 to \$3 per share alone.

Q: What do you see in terms of a price for Manville, however it's eventually divided up and sold?

Greenberg: Our feeling is today that the two businesses are worth approximately \$15 per Manville share not including the NOL. But with this expansion, which is now in the advanced planning stages, looking out a year or two, the Riverwood International side of the business could be worth very much more. For example, Riverwood will have approximately \$280 million of cash flow this year, 1992, and this expansion we estimate could add another \$100 million.

Q: That's quite a bit.

Greenberg: Quite a bit. And that \$280 million will grow through price increases over the next couple of years before the expansion comes on. So you may be talking about a company which in three years would have \$400-odd million of cash flow.

Q: Are you looking out several years before you anticipate this will be taken over?

Greenberg: No, I think if Judge Weinstein has his way, the Supreme Court will sign off on this before the end of 1992. And then I would think that the trustees of the Trust would move fairly aggressively in '93.

Shapiro: The trustees just announced a couple of weeks ago that they retained Goldman Sachs to evaluate how to optimize their investment in Manville.

Q: That sounds like they are putting Manville on the block.

Shapiro: Well, they didn't say they were putting them on the block. They used the word optimize.

Q: Terrible word. Like finalize.

Shapiro: Yeah.

Greenberg: One issue is, if you are a trustee, would you want to have all your assets in one basket under any circumstances? And I would say probably not because if something should happen to go wrong with Riverwood International, you would have a hard time fending off the lawsuits.

Q: You also own Newhall Land & Farming.

Shapiro: The basic value in Newhall is an area called Valencia, which is 35 miles north of Los Angeles . . .

Q: It's real estate and anything in California is suspect these days and real estate even more so.

Shapiro: That's right, it is real estate. They own an area which is about 38,000 acres, which for comparative purposes is about twice the size of Manhattan. This is not farmland.

Greenberg: 125,000 residents.

Shapiro: 125,000 people live there now. There are businesses. There are industrial parks and they are about to open

a major shopping center by the end of this year. California is finally putting in a commuter railroad and it will go right to Valencia.

Q: California also has been experiencing a pretty weak residential real-estate market and a pretty crummy economy. How has that affected Newhall?

Shapiro: The weakest link is that the developers are not available to build. What Newhall ideally would like to do is do all the work to get the land zoned and titled and then sell zoned parcels, you know, where a developer can build multiple units. Ideally, they would like to be selling 200-unit parcels to different developers and . . .

Greenberg: 200 acres.

Shapiro: Sorry, 200-acre parcel to various developers. What's happening is, you just don't have the developers. Developers can't get financing, so Newhall is either having to do some of the development themselves or simply is selling less property. In fact, on the demand side there is decent demand, especially for the lower-end houses. And, by the end of this year, they will have a substantial pool of entitlements to build lower-end houses. They happen to have an impeccable balance sheet. So, there has not been a credit concern regarding them. California real estate -- you put those words together and everything goes, even though you have property which, granted, in better times, people felt was worth \$45 - \$50 a share. And, this is relatively an unleveraged company. So even if you say the value of their property is down a third, it would argue for \$30 a share and the stock is trading at around \$18. But you are under the California cloud and it's hard to get people interested. But they have an excellent management. They bought in stock periodically. They've created entitlements. They have a good balance sheet and they are really located in the only direction that Los Angeles can expand.

Q: They still have agricultural interests?

Shapiro: They do. I mentioned Valencia which is 38,000 acres. In total, they have over 100,000, I think close to 130,000 acres of land scattered around California. A lot of that is agricultural. And, what they have been doing is selling off pieces of the agricultural property and putting the proceeds into higher return types of prospects. So they have been pretty sophisticated and actually agricultural land never ran up the way that residential land or commercial land did, so it hasn't had the same type of decline.

Q: When do you see earnings turning around?

Shapiro: I think by the end of this year, you will start seeing a turn. And next year is sort of built-in because of the shopping center they have coming on and some other projects which have been in the works, which will all start up towards the end of this year. Home sales, of course, have been picking up as well. They had run out of entitlements on low-end homes. And, although the demand was there, they simply couldn't sell the lots until they received the entitlements. And they will be getting those by the end of this year.

Q: Let's go on to Pope Resources. You guys are the largest single holder in the company.

Greenberg: That's right, we wish that the general partners would take note of that. They have 66,000 acres of timberland, second growth, in Washington quite near Seattle, within about an hour's drive. And, because of the environmentalists protecting the owls out there and because of state laws prohibiting exports and federal laws prohibiting exports, the log market has strengthened from about \$150 in 1985 to approximately \$700 right now for export logs.

Q: Go on.

Greenberg: And it has made their property, the timberlands out there, we have had them valued by professional timber people . . .

Shapiro: Who we hired . . .

Greenberg: Who we hired and paid good money to get their thoughts on. They valued it at \$70 or \$75 per share. And in addition to that, they have a second home development, resort home development, which they have done a great job with. Outside builders are coming in and buying developed lots. And, they believe that will be built out in the

next eight years. And that probably means \$2 to \$3 million annually of free cash flow, which is \$2 to \$3 a share, just from the build-out of this Port Ludlow, Washington, project. So the whole company is probably worth somewhere between \$90 and \$100 a unit.

Q: How do the restrictions on logging affect Pope?

Shapiro: The owls don't live on their lands.

Q: How did you guys arrange that?

Greenberg: I went and inspected the trees. The sad part of it is to see a company where the units are selling at \$40 and the value is \$100. And it has got a wonderful balance sheet and will have substantial earnings the next few years anyway, and they haven't taken an opportunity to retire shares. It seems like such an obvious move to us.

Q: And do you think they will?

Greenberg: I think that it is under active consideration at least. It is hard for them to ignore all the noises that their East Coast shareholders have been making. And, it is getting hard to hide the money. As I mentioned, Port Ludlow will throw off \$2 or \$3 a share, I believe, going forward and their logging operations, in which they are very conservative, should throw off depending on prices another \$2 or \$3. And then there are their land sales you see, the ultimate plan is to hold these timberlands and then when Seattle spreads further and further in their direction that will be put into residential and commercial development. And, instead of the timberlands being worth \$1,000 or \$1,500 an acre, they are selling today for \$10,000 an acre to a builder. And, of course, they expect that in 10 or 15 or 20 years the price of that land will be like California, it will be \$30,000 or \$40,000 or \$50,000 or \$80,000 an acre.

Shapiro: There has been active interest in their timberlands. Those can be easily liquidated at the type of numbers we are suggesting if the company was willing to consider that.

Greenberg: The managing partners, first of all, they have a shark repellent which makes it virtually impossible to remove them. And, secondly, they can afford to take a long-term view since they are not responsible for managing money for anybody. And, I just don't think that they are very financially ambitious. Peter Pope is one of the managing partners, he is chairman of Pope & Talbot and that's really his full-time job. This is just a passive holding for him.

Q: How long have you guys been in this?

Greenberg: We started buying in 1988 and we have been buying ever since. We now own over 20%.

Q: On the other hand the stock hasn't really done all that bad since you bought it.

Greenberg: Well, no, but it hasn't done all that well when you consider how well the fundamentals have done.

Q: Glenn and John, thanks.



Picking, Choosing and Waiting – Chieftain’s Low Risk Style Produces Gains

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STOCK-PICKERS just don't come much more astute or patient than John Shapiro and Glenn Greenberg, the main men at New York City-based Chieftain Capital Management.

Their firm, which just completed its first 10 years in business, has compounded its clients' assets at a 25% annual rate over that stretch, vs. 15% on the S&P, while taking a lot less risk than many others in the Street. Specifically, without using leverage, without shorting, with only very rare forays into derivatives, and with very low turnover. In fact, Glenn and John recently went for the better part of a year -- from the fall of '92 until just a few months ago -- without establishing any new positions at all.

These are a couple of very picky stock-pickers, indeed. Which has worked out just fine, thank you, for the well-heeled individuals and two institutions (their alma maters) lucky enough to be among those for whom the pair now shepherd some \$775 million of assets.

John and Glenn aren't taking on any new clients -- grouching that it's plenty challenging to find enough good ideas for the accounts they have. But when we called them up last week, they generously shared their thoughts on the few good but -- in their view -- grievously mispriced stocks they've recently found to tuck into their portfolios, and about a couple of longer-term favorites, as well.

-- Kathryn M. Welling

BARRON'S: Are you guys back in the stock-picking business?

Greenberg: Never left it. But we actually went one year -- between the fall of '92 and this past fall -- without buying a new security. We were unable to find stocks that met our risk and reward criteria. In fact, during that period, we ended up selling quite a number of stocks, which we felt had appreciated to levels that represented fair value. So we sort of defaulted into a much higher cash position than we normally would like to have.

Q: How high?

Greenberg: We probably, at the peak, were at 35% cash.

Shapiro: That was two months ago.

Greenberg: Our cash position has since come back down, as we have made a couple of purchases. But this has been a difficult period to find attractive values.

Q: And you didn't give in to the temptation to revise your notion of what constitutes an attractive value?

Shapiro: We haven't changed our criteria at all.

Q: So you're still looking for what, specifically?

Greenberg: Most people think there is a trade-off between risk and reward. That is, that you have to take higher risk in order to get a higher rate of return. In general, that is true. But our belief is that by carefully reviewing lots of good companies, we may be able to find ones that are so mispriced that -- for very little risk -- we have a chance of getting a very large reward. Unfortunately, we never can seem to find very many of these terribly mispriced securities. So we usually hold approximately 10 stocks in our portfolio at any given time. But our efforts remain focused on finding stocks that have very little risk, yet offer some opportunity for a very significant gain, if a few variables turn out right.

Q: Your approach requires a considerable degree of patience.

Shapiro: It definitely requires patience. It is not unusual for us to hold stocks for many years, although we are mindful of trying to attain a rapid compounding of our assets under management.

Q: In other words, you don't let yourselves forget that performance is the name of your game?

Shapiro: Exactly! We don't buy things which we think will lie fallow for a long time. You don't compound people's money at 25% by buying something that looks statistically cheap -- and then holding it while it remains statistically cheap for a decade.

Greenberg: What often happens is that we purchase something which doesn't do anything for a while -- and over that period we may even add to the position. Then, when it moves, it tends to take a leap. So if you look at it over a two- or three- or four-year holding period, it may have a great compound rate of return. Yet most of the time, it probably did nothing -- until there was a catch-up in the valuation. It's one of the frustrating things about holding stocks for a long time. We held a stock called Gotaas-Larsen Shipping for . . .

Shapiro: For 6 1/2 years.

Greenberg: That all? It seemed like a decade. Subjectively, it seemed like that stock never did anything. It either was flat or going down. And yet it went up 12 times between when we bought it and when it was taken over. Still, on most of the days that it traded, it didn't do very much.

Shapiro: But the times when it moved up, it would triple.

Greenberg: Another thing we do is try to find good companies that can do well for extended periods. That allows us to sell some of our holdings when the stocks run into a period of enthusiasm and perhaps get a little ahead of themselves. And conversely, to buy back stock when they fall a little bit out of favor. This has the effect of enhancing the return we get in the same security. We did this very effectively with Burlington Resources over six or seven years. And we have done it with Freddie Mac Federal Home Loan Mortgage Corp., which is our largest holding, by occasionally selling some when the stock has gotten to a lofty P/E. That's worked quite well, particularly back in '89.

Shapiro: It was five years that we held Burlington. It only seemed like six or seven.

Greenberg: Studying the companies closely gives us the ability to make better judgments about when to lighten and then when to add back. Freddie Mac is the kind of stock we like to find because -- after making 3 1/2 times our money in five years -- the stock is still only trading at 11 times this year's earnings. It continues to be undervalued, in our judgment. And that allows us to stay with it. Of course, nowadays, the capital-gains tax rate is lower than that on short-term gains. Which means it is somewhat more advantageous for us to be able to find holdings that we can keep for at least 12 months.

Q: That doesn't cramp your style much, does it -- considering the kind of research you two do? You practically have to be willing to marry a stock before you buy it.

Shapiro: We have to have a high level of confidence, because our strategy is to not go into something unless we feel comfortable putting a minimum of 5% of our money into it. Then, too, the research doesn't end the day you buy your stock. It continues. And over time, either you get greater levels of comfort, or maybe the stock backs up, so there are opportunities to add. Or, sometimes, subtract from that position. I would guess our average holding period is over three years.

Greenberg: In the meantime, we are not shy about expressing ourselves to management, in light of the fact that we

very often control in excess of 5% and sometimes as much as 20% or 30% of the outstanding shares of the stocks we are investing in. Because we remain long-term holders, I think, managements tend to take our comments seriously, even though we are a small firm.

Shapiro: Frankly, a lot of managements appreciate it, when you make a commitment to them, or if they feel that you are interested in more than simply trading their stock. That you have an interest in how their business works, and what they are trying to do, and are willing to take some of the bumps in the road, and be there. People want you to understand what they are trying to accomplish.

Q: Let's get down to brass tacks. What changed a couple months ago to permit you to buy stocks again? Certainly, the market's multiple didn't get any less rich.

Greenberg: What changed this fall is that we decided to buy a position in Philip Morris, after the stock had come down from 82 to 46.

Q: What made you willing to bet Philip Morris's slide would reverse?

Greenberg: The domestic tobacco business had become the focus of 110% of investor and analyst concern, whereas it only represents something like -- under the worst case 20%, and under the better case, which holds today, maybe 30% of their earnings. And investors, we felt, were ignoring the very positive fundamentals for the rest of the business. In order to get a 15%-20% rate of return on Philip Morris, we figured, starting with a 5% dividend yield, we only needed to see the stock recover by 10% or so a year. Of course, it has recovered almost 30% since we bought it. But on the other hand, the fundamentals of the tobacco business domestically look a lot more favorable now, with the changed leadership at Reynolds Tobacco RJR Nabisco emphasizing earnings growth and returns rather than market share. Also, the industry has very determinedly reduced its cost structure and now seems to have a much more rational price structure. So the generic brands are not taking market share from the full-priced brands.

Q: Sure, but there's still the specter of higher tobacco taxes.

Greenberg: We have factored that into our estimates. If they manage their pricing properly, even with a 15%-16% decline in unit shipments and some trading down from premium brands, we feel that the domestic tobacco earnings can modestly increase or at least be held flat. Meanwhile, their international tobacco business will continue to grow rapidly. Their international foods business will probably grow around 10% or so. And their domestic food business will probably grow at a lesser rate. But this gives you a very attractive stream of earnings and cash-flow growth.

Q: Could you be a little more precise about how attractive Philip Morris's earnings will be?

Greenberg: We see them reporting \$5.20 or so this year, and \$6 a share next -- in both cases before about 60 cents a share of goodwill amortization, which we'd add back in. And, of course, there is not a great deal of need to reinvest earnings in the business -- beyond their depreciation. So we expect the company will be able to once again establish a share-repurchase program and dividend increases. And the other thing that was quite interesting is that we subscribe to a service that tells us what smart money managers are doing.

Q: So you can do the opposite, we presume?

Greenberg: You're the one who said that! But we received the June 30 report in September. And it indicated that every manager who had \$1 billion in assets and was covered in this survey had liquidated his or her position in Philip Morris. That helped give us the courage to step up to the plate. Another thing that helped -- we often come back to the quality and dedication of management. We like to invest in companies where the management has the same interest as the shareholders. We had a meeting with the chief financial officer at Philip Morris last summer. During it, he ran out of the meeting room to go back to his desk and pull out the 30-year price chart of Philip Morris, then came back in to show it to us. He was clearly concerned with the drop in the stock, and really dedicated in seeing that this was not the end of the long bull run in Philip Morris but, rather, a major downdraft, but one which would ultimately see corrective steps taken and the stock driven to new highs. I don't think that is impossible in the next couple of years, by the way.

Q: You realize, of course, that you're stepping way outside the bounds of Wall Street fashion with this one. Not only because of Big Mo's tobacco exposure, but also because its foods are all brand-names -- just the stuff the analysts

have trampled in their rush to embrace generics.

Greenberg: Wall Street likes to generalize. I will tell you I would much rather, over five or 10 years, be in the branded consumer-goods area than in capital goods or much more cyclical and much more competitive fields. I am not so sure that, through their cost-cutting and their exposure internationally, they won't have tremendous opportunities. Of course, you realize that 45% of the world's smokers live in China. And Philip Morris has enormous cigarette opportunities there, not to mention in the former Soviet Union. They have established formal relationships in both countries.

Q: The only problem is what those people are going to use to pay for their smokes.

Greenberg: Well, they are going to be manufactured by cheap labor in cheap plants in low-cost areas. The profitability per pack of cigarettes outside of the U.S. is much lower than in the U.S. I imagine that will also be true of cigarettes sold in those areas of the world. But there still will be very rapid growth in international tobacco.

Q: Philip Morris, as you noted, is up some 30% since you started buying it. Are you still chasing it here?

Greenberg: We bought what we wanted to buy at 46. But if we got a new account, we'd continue to purchase it. If you put a 13 multiple on the non-U.S. tobacco business, and an eight multiple on the U.S. tobacco business -- and this is a multiple of cash earnings (we add back goodwill amortization because it's a non-cash charge) -- then the company is fairly valued on next year's earnings at 75, and on 1996 earnings at 90 -- which would represent a new high in the stock. And those are reasonable multiples. We are likely to see those, I think.

Q: So, is Philip Morris the only thing you've bought lately?

Shapiro: You made the comment that the market didn't get any cheaper in the fall. That is certainly true. The market has been onward and upward for a couple of years now. But within those broad indexes there have been a number of stocks that have been taken out and shot. Philip Morris was clearly one of those cases where they had some rather substantial problems. But we just felt the stock overreacted. There is another stock that Glenn will talk about which is similar.

Q: Okay, Glenn, let's hear about it.

Greenberg: We also put 15% of our money into Mellon and Dreyfus. I believe Mutual Shares Corp. President and Roundtable panelist Michael Price mentioned them in one of your recent Roundtable issues Barron's, Jan. 24. We bought our position mainly through Dreyfus because there is an arbitrage discount. Also, the acquisition, at \$1.8 billion, seems to be very cheap. When the acquisition is completed, Dreyfus will have about \$850 million of cash. That means that the operating earnings of Dreyfus are being valued at only about 10 times, after tax. Mellon thinks they can increase that operating income by 50% in the first two years of ownership. So we see the possibility that some other institution might come in and make a cash offer. That's what led us to build our position in Mellon through Dreyfus.

Q: Suppose some other bidder doesn't materialize, though.

Greenberg: Fine. Mellon, if it can complete this acquisition, will have dramatically transformed itself from a large regional money-center bank into a fee-driven, very modern institution. In fact, 60% of their aftertax earnings, we compute, will be coming from fee-driven business -- not spread business. In addition, since they have made a number of acquisitions to get into this field -- the Boston Co., for example, last year -- they've incurred quite a bit of goodwill. Which is unusual for banks, which are usually so conscious of tangible equity. As a result, Mellon's earnings are burdened by about \$140 million of goodwill amortization, which bank analysts tend to ignore. But we, thinking like businessmen, tend to count that as cash in the till, just as much as reported earnings. So most of the estimates you see for the company are for reported earnings. But we add back, on today's share basis, over \$2 per share of non-cash earnings. If you look at institutions that are somewhat comparable to what Dreyfus/Boston Co./Mellon will look like -- Northern Trust Corp. and State Street Boston, for instance -- they sell at 12-14 times estimated 1994 earnings. For Mellon, 1994 will probably be a curious year, because they will be completing the acquisition in mid-year. But we expect their reported earnings to be around \$6, and their cash earnings to be about \$7.40. And each of those numbers will increase by about \$1 in 1995. So at \$54 -- or \$51, if you buy it through Dreyfus -- you are buying a company comparable to those other fee-driven institutions for about half the multiple. In addition, Mellon has

stated very explicitly that it plans to achieve, after 1994, a 17% return on equity and to pay out approximately 40%-45% of earnings as dividends. Which leads us to believe that, a year from now, you will be looking at close to a 6% yield on the stock, based on today's stock price.

Q: Are you implying that Mellon's new-found fixation on fee income is something other banks should emulate?

Greenberg: Well, it is interesting to note that, a decade ago when John and I started Chieftain, less than 10% of household assets in the U.S. were held in mutual funds. Today, that number is approximately 40%. I would argue that banks and other financial institutions with the traditional orientation of collecting deposits on street corners are going the way of buggy whips. Mutual funds are really the roach motels of savings, because once the deposits get in there, they are going to stay within the funds. Mellon's acquisition of Dreyfus is an extremely intelligent purchase, particularly because Dreyfus really didn't depend heavily on equity-oriented assets. Less than 10% of its assets under management today are equity. Probably on only 5% does Dreyfus collect a full equity fee. So they have an opportunity, considering Mellon's successful track record in mutual-fund management, to grow the equity side. But they are not too exposed, if this is the end of the great bull market and people start shoving their money back into the money-market funds. And I just don't see people taking their money out of the funds and putting it back in the banks.

Q: Suppose they simply lose it? Banks typically buy at the top of the cycle.

Shapiro: I would like to distinguish one point here. Dreyfus was perhaps criticized for not developing more of an equity fund business. Fidelity, of course, has done that in a dramatically successful fashion. But basically today \$70 billion out of \$79 billion of Dreyfus's assets are in money-market or bond funds. They have a very small exposure to the equity market. So, in Mellon, you don't have a situation where a bank is buying into the equity fund business at the top of the market cycle. Keep in mind Mellon had a large trust business of its own. And there is a big processing component here. Actually, there is a lot of cross-fertilization. Mellon has over \$1 billion of trust revenues, pro forma the deal, and only \$300 million of that comes from Dreyfus. So it is well-established in these businesses. It is not getting into a field it knows nothing about or has no expertise in.

Q: Besides, as you say, if Mellon completes the deal, it will get Dreyfus for what looks like a bargain price.

Greenberg: They are getting Dreyfus at a bargain price, but they are giving up their stock at seven times cash earnings to do so. Certainly, Mellon is enduring quite a bit of earnings dilution -- and cash earnings dilution, particularly -- by giving up their stock for Dreyfus. The burden will be on Mellon's management to prove that the dilution was worthwhile in terms of growth and stability in the earnings stream going forward.

Q: Since we have skated around it a bit, we might as well come right out and ask what you guys make of the equity market here?

Shapiro: We have never tried to be market timers. We view ourselves as stock-pickers. Of course, we were raising some more cash because the valuations were getting too high for us. But I can say that last week Jan. 31-Feb.4 -- early in the week -- we purchased a put on the S&P 500, when it was at 482. Given our inability to time the market, I would be shocked if that represents the high. So the market will probably go above that. This was a 10% out-of-the-money put. In other words, it really doesn't kick in unless the market goes down more than 10%, although there is a bit of a time premium because it's a one-year put. However, if the market were to go down more than 10%, this put -- for which we basically spent 1% of our portfolio -- would cover close to 65% of our market exposure. So we felt it was a very inexpensive way to protect ourselves in the event of a catastrophe. We're not predicting that is going to happen. But we wanted to have some protection.

Greenberg: Earthquake insurance.

Shapiro: To be topical.

Greenberg: We are not worried if the market goes down only 10% in a minor correction. We are worried if the market goes down 30% or 40%. This particular instrument will help offset the effects of a dramatic decline.

Q: You're talking, obviously, about a synthetic put of some stripe. Not your common everyday listed variety.

Greenberg: You will have to ask Morgan Stanley about that.

Q: So you bought it from the rocket scientists over there?

Shapiro: Yes, but we shopped around first. They offered a good price.

Q: What other stocks are you holding a little more comfortably now that you've purchased that downside protection?

Shapiro: Another controversial stock -- or one that some people might find controversial: Reebok International. We have a substantial position in it.

Q: The knock on Reebok is that everybody already has more athletic shoes than they need -- or even want.

Shapiro: Certainly, the sneaker market, or the athletic-shoe market, in the U.S. was extremely exciting and explosive during most of the 'Eighties. As it hit the 'Nineties, it sort of slowed down and, of course, had the overlay of the recession. But we have studied this market extensively over the past year. We went so far as to retain a firm called Kurt Salmon Associates, one of the premier consumer-products consulting firms, to do an extensive study of the industry, by age group, by category. They sliced and diced the data every which way. They also surveyed retailers amounting to close to \$4 billion in revenue, which is about one-third of the business in this country. It was quite an extensive study.

Q: What did you discover?

Shapiro: What we found is that there has been some change in fashion, some change in purchasing habits. The business has slowed down from what it once was. But it continues to grow at a moderate rate. I am only talking domestically now. There is an opportunity for the top companies, of which Reebok is one, to gain market share. So we feel that a lot of the hysteria is just unsupported by the facts. In addition, internationally, there is not the same sort of per capita penetration. In fact, depending on the countries you go to, the penetration is extremely low. And yet the appetite for these types of products is extremely high. Like a number of the consumer-products companies, there are tremendous opportunities for Reebok, not only to increase penetration in Europe, but to really make major forays into South America and Latin America, into Asia and, of course, Eastern Europe, China. Just imagine two billion feet shod in Reeboks. It is a staggering thought.

Greenberg: Let's just imagine one billion.

Q: They could probably only afford a Reebok on one foot. Doesn't a pair of Reeboks cost more than most Chinese earn in a year?

Shapiro: There are segments in all these societies that can afford the shoes. I am not saying that China is going to be a huge market tomorrow. But Europeans can clearly afford them. Mexicans can afford them. South Americans can afford them. Reebok opened up a 1,800-square-foot store in Moscow, and people were lined up around the block for hours, coming in with \$100 bills to buy shoes. There is an appetite. Obviously, over the next five years, most of the international growth will be in European, Asian and South American countries.

Q: Don't you mean most of Reebok's growth, period?

Shapiro: No. There are other parts to this story. Reebok, frankly, had stumbled in the past few years, through some misguided acquisitions, and simply taken its eye off the ball at a time when Nike was doing everything right. But they have sold off some things they had purchased which didn't make sense in their portfolio of businesses.

Q: Like Boston Whaler.

Shapiro: And Ellesse. And they have focused themselves very aggressively. Reebok Chairman and President Paul Fireman, who really has been a genius of the industry, has returned full time and focused himself aggressively in redefining their product mix. For instance, they didn't even make cleated shoes until this past year. They just gave that entire market up to Nike and others. Well, now they have a cleated product. It is not going to revolutionize the world, but it is an add-on. It adds growth. They had basically given up most of the basketball market to Nike, which

did a great job in it. But now they have hired Shaquille O'Neal and a number of other players, and have come out with a new line of basketball shoes. They are making a real push. Most important, perhaps, is what Reebok is doing in the domestic apparel business, where they had foundered. They finally just closed down what they had. Then they bought a small outfit out on the West Coast for a couple of million dollars, mainly to get the expertise of the people who worked there. And they have developed a very successful apparel line, which basically went from nothing to doing \$125 million in 1993. We expect it to get to \$180 million, perhaps, in 1994.

Q: What kind of apparel is this? We've evidently missed it.

Shapiro: That was sort of a problem in the past. Reebok's apparel effort was all over the place. But now it is really athletic, performance-type apparel. Sweatsuits and T-shirts and soccer pants and caps, and tennis gear, really the type of apparel that anybody who is performing athletically would like to wear.

Q: No wonder we've missed it.

Shapiro: Or anybody who would like to look like they are performing athletically -- which probably describes 80% of the purchasers.

Greenberg: And from what I read in Vogue magazine, you can even wear these things out on the town.

Q: Are you a faithful reader of Vogue, Glenn?

Greenberg: Only when they are touting athletic wear.

Shapiro: I leave it to Glenn to comment on the latest styles. But Reebok has a fairly broad line, which they are working quite aggressively to expand.

Because once you have marketed the Reebok name, you don't have to do separate advertising for the clothing. So it is very profitable. In fact, people become walking billboards. Once again, this is an area where -- up until a couple of years ago -- Nike was running away with the business. And Nike currently still has substantially more business there. One of Reebok's hidden values is that it has always had its classics line, a fairly plain-vanilla shoe, basically the same shoe they have had for 10 years. They do update it every year. But it is a real cash cow for them. And actually, in today's value-oriented market, that business has regenerated.

Q: Enough to give its domestic shoe biz a lift?

Shapiro: It's a start. The more major piece is Rockport, which is the casual shoe and the outdoor shoe look. It is a business that they've owned, but basically ignored. But now Reebok is refocusing on Rockport quite aggressively. They really feel that five years from now, perhaps, this could be a \$1 billion business. You could have Rockport and Timberland as the Reebok and Nike of the casual shoe business. So, basically, there are many ways that Reebok can grow their revenue base. In addition, as part of their refocusing, when they withdrew capital from the businesses that they sold off, they looked very hard at ways to deploy that capital. And they have come up with a strategy which we applaud, and which is very effective.

Q: Don't keep us in suspense.

Shapiro: To take their free cash flow, which is basically 100% of their earnings, and reinvest it in their stock. They have not only authorized a substantial share-repurchase program, which is currently \$200 million a year, but they have actually purchased shares.

Q: It is not one of those empty announcements?

Shapiro: No. In fact, they first repurchased about 24% of their stock, I believe from Pentland, several years ago. Then, 1 1/2 years ago, they announced a \$200 million-share repurchase plan. They completed that back in July. Then they announced a second share-repurchase plan, which they are probably 40% through. So they are actually purchasing the shares. They feel it is a very good use of their cash. And, of course, what this does for you is that -- even if their net income were to be flat, the share repurchases alone would increase earnings per share between 5% and 7%.

Q: Is that your estimate?

Shapiro: No. In fact, at the end of '93, their backlog was up 14%. But let's say that sales only grow 7% for the basic footwear business. Of course, the apparel business, Rockport and Avia, which is another small business in Reebok's portfolio, may grow a bit faster than that, so that is fairly modest assumption. We believe they can earn \$3.20 a share this year. Then there is an additional 12 cents a share of goodwill amortization. So you have \$3.30 of cash earnings, all of which is free cash flow, because their depreciation is sufficient to meet their capital-expenditure needs. And we see continued strength in '95, which could get Reebok's earnings close to the \$4 level. This is all, by the way, assuming only moderate growth in the U.S. So as we look at the stock today, you are paying less than 10 times earnings for a world brand with an excellent balance sheet and with substantial growth potential. And its large share-repurchase program both enhances that growth and gives you some downside support.

Q: Let's switch gears, and talk about Freddie Mac. Is your ardor cooling, now that rates are rising?

Greenberg: Hardly. It's our biggest holding. We have about 20% of our money in Freddie Mac. We really don't understand why it sells at 11 times this year's earnings, which will probably be about \$4.85 a share, and not even 10 times next year's estimate, which is \$5.70 or so. Management has publicly and openly stated that they see midteens earnings growth for the next several years. And to know this management is to know that they are extremely conservative. I suppose what has given us the opportunity to remain shareholders for so long is that people don't understand what they do. They aren't nearly as rate-sensitive as people think.

Q: They aren't?

Greenberg: No. About 65% of their earnings come from insuring mortgages against default. And about one-third of their earnings come from the spread business, where they purchase mortgages, sell debt to finance that, and take some interest-rate risk. The interesting point for this company is that they earn about three times as much in fees when they take the interest-rate risk as when they simply insure the credit of the mortgage. So their traditional business of insuring mortgage credit brings them about 33 basis points a basis point is 1/100 of a percentage point of revenue on every dollar of mortgages that they insure. But when they actually buy the mortgage and sell debt to finance it, and hold it in portfolio, they keep approximately 1%, pre-tax. Of course, they are taking no additional credit risk by holding the mortgage. But they are taking interest-rate risk.

Nonetheless, the development of the callable debt market for Fannie Mae and Freddie Mac, in the last six years or so, has allowed them to manage this interest-rate risk -- we think -- very effectively. And as a result, Freddie Mac announced about a year ago that they were going to increase the amount of mortgages that they were going to hold in portfolio and collect this much-higher fee on. Last year, they surprised everybody by increasing their portfolio from \$30 billion to \$54 billion. By contrast, Fannie Mae has \$200 billion held in portfolio. So just to put this in perspective, if -- for the foreseeable future -- Freddie Mac buys \$24 billion of mortgages and sells callable debt to finance it, at about 65 basis points after-tax profit, that works out to about 85 cents a share of earnings growth, if they do nothing else. Most people think that their pool of sold mortgages, those that they just insure the credit risk on, will grow somewhere around 10%-12%. So there is more modest growth in that segment of their earnings. But as long as there is the opportunity for them to add mortgages to their portfolio, at around a 100-basis-point spread, which has been historically the case, then they can grow their earnings a lot more dramatically.

Q: Even in an environment in which interest rates are rising?

Greenberg: The curious thing is that last year's drop in interest rates and the major refinancing boom really hurt the growth in Freddie's assets. While they are able to buy as many mortgages as they want to, their sold portfolio, or the portfolio of mortgages that they insure, grew only 8% last year because so many mortgages prepaid. Compare that with 14%-16% growth in their sold portfolio over the prior three years. So actually, there is a misunderstanding among investors who think this company fits into the interest-sensitive group, and therefore that its earnings are accelerated by lower interest rates. In fact, Freddie Mac's business is pretty insensitive to interest rates. It is even hurt when there is a steeply positive yield curve, as was the case last year. In addition, their loan losses from the '89-'91 real-estate crash have begun to moderate very substantially. Their multifamily losses dropped very dramatically last year, and will be winding down much further in the next year or so. And their single-family losses look like they have crested as the economy now is finally picking up. As a result, they are not going to have to increase their loan-loss provisions. In fact, they are probably overcapitalized. In addition, the company's cost-reduction program is

beginning to pay off, and it shows up in their recent quarterly figures. They are going to cut their administrative expenses from eight basis points of assets to about seven over the next few years. So this is a company that -- after a few stumbles after going public -- has become very shareholder-oriented. Why a company like this should sell at 11 times earnings, when it is growing in the mid-teens, when it has only one competitor, and when it has really many years ahead of it in which to grow, I don't really know and don't really much care. But that is why we are holding such a large position.

Shapiro: If you look back, we first mentioned this in an interview in December 1988. If you split-adjust it, the stock then was at about 16. It is now in the mid-50s. So it has had a compound rate of return over the five years, with dividends, of over 30%.

Greenberg: Another thing nice about this company is that when Fannie and Freddie become mature, which I don't think is for many years, they will be in a position either to take their retained earnings and retire stock, or pay dividends. Because they really don't have to invest any capital in order to continue to generate these levels of earnings. It is a quality that we like in Reebok and really like in Mellon. It is one we look for in almost all the companies we invest in. Philip Morris has it, too.

Q: Tell us about another stock.

Greenberg: Here's one off the beaten path. A company called Tidewater Inc.

Shapiro: Tidewater is the world's largest provider of offshore supply vessels. These tend to range around 180 feet, and they go back and forth to the offshore drilling rigs; they supply platforms. They sometimes tow them about, or bring people out there. Tidewater, in fact, probably has, depending on how you calculate market share, somewhere around 30% of the market. And in some markets, substantially more. In a sense, our theory here is somewhat simple. Obviously, drilling is a function of oil and gas prices. And their rates are a function of drilling activity. Today, drilling activity is high in the Gulf, but low in many places in the world. And rates are okay, but not great. What is happening is that the world fleet is aging. Currently there are about 1,350 of these boats around the world, and there's demand for about 1,100. But as these boats reach 20 years of age, they basically have to be retired. Especially since most owners have not been able to maintain them -- and they become very costly to maintain as they age. So if you simply look at a chart of the age profile of the fleet, you will see that by mid-1995, there will only be 1,100 boats, probably, available. In other words, there will only be 1,100 boats less than 20 years old at that point.

Q: Of course, if rates go to the moon, some of the old ones might stick around -- and be joined by new ones.

Shapiro: No, it actually costs more -- to justify purchasing a new boat, you'd need to see sustainable rates probably at \$6,000 per day.

Q: Which is about twice current rates, isn't it?

Shapiro: Actually Tidewater, around the world, is averaging about \$2,900 a day -- but they're getting \$4,500 a day in the Gulf. Obviously, you don't get increased rates until you first get increased utilization. Then the rates move up. But the leverage is quite significant. I will give you some numbers. Today Tidewater is earning roughly \$1 per share, and they have about \$1.60 of depreciation. So they have \$2.60 a share of cash flow. If day rates got up to the \$6,000 level in a tight worldwide market, with a commensurate increase in utilization, that would add over \$5 a share to their earnings and cash flow. So you have something going from maybe \$2.60 of cash flow up to the \$7-\$8 range at a peak. Right now, the stock is trading at 21. The company has more cash than it has debt. It has a substantial net worth. My expectation is that if cash earnings went to \$6-\$7, you could easily justify a stock in the mid-40s.

Greenberg: Another thing that is interesting about it is that the boatyards in the U.S. that could be building replacement vessels are currently experiencing a surge in demand for riverboat gambling vessels. So it is not clear, with this tremendous boom in riverboat gambling, that there will be enough construction capacity to replace these ships in any short time frame. It is not as if you could simply go down and put in an order for a boat tomorrow and have it delivered in any reasonable amount of time.

Q: But when the riverboat gambling boom goes bust, there will be a lot of those boats available to ferry roughnecks out to drilling rigs.

Greenberg: Well, they could gamble on them, maybe. I don't know whether they could carry much pipe or drilling mud.

Shapiro: Or whether you'd want to be towing around jackup drilling rigs with those things. Especially off the coast of West Africa or Thailand or some such place.

Greenberg: Are you suggesting that maybe Tidewater should redeploy their fleet and start taking on passengers interested in gambling?

Q: Maybe they should just put a half-dozen roulette tables on each boat, along with a little red-flocked wallpaper, a few mirrors, and some one-armed bandits!

Shapiro: Well, absent that, as you may remember, back in the mid-'Eighties, we had some substantial investments in the oil tanker business. And there is some similarity here. You have an aging fleet. Even if demand doesn't increase much, eventually, you are going to reach equilibrium.

In this case, we view that as happening sometime in 1995. And you will get a tremendous pick-up in rates as you approach that time. This is the premier company in the world in this. There is no competitor of any size. And that is significant because as long as Tidewater stays disciplined -- and we believe they will -- it will be very hard for the market to get overbuilt. When you have a 30%-market-share gorilla, and everybody else is sort of 1% or 2%, it is hard to overbuild the overall market, if the gorilla maintains its discipline. In the meantime, there is always is the possibility that oil prices can move back up again, and activity can pick up sooner. In which case, you reach that equilibrium point even faster.

Q: Yet you clearly don't see day rates going high enough to bring a lot of new boats into the market anytime soon.

Greenberg: Domestic gas-drilling activity is already very strong, as you can imagine. And the day rates in the U.S. Gulf are very strong. Rates outside the U.S. are pretty weak. But at their peak, they were around \$4,500 a day, which still doesn't justify what a new boat would cost. And, if you are going to order a new vessel, you need to have very high rates for more than one day. You need to have them for many years. You just can't do it off the spot market. What is interesting is, despite the strong rates in the Gulf -- which have almost doubled off their lows -- and the talk about shortages there, there has not been a single new boat order announced by the industry. In fact, there hasn't been a new boat ordered in this industry since 1980 -- the last time oil prices were really strong, so the newest boats are 13 years old. That is very positive.

Q: But you're talking about boats -- assets that can be moved to where the business is.

Greenberg: It's not that easy, because of government regulations on where flag boats can operate. And there is a cost to moving the boats. There are limits. Size and the engine capacity, a number of factors. It is not like moving rental cars around the country. These are not Boston Whalers.

Q: But what's to keep any reasonably sophisticated shipping company from getting into the field, should rates look attractive enough?

Shapiro: You have to know how to train the people. You are towing around \$150 million drill rigs. If you are Shell Oil, are you going to hire XYZ & Co. that just got into the business to pull your rig? If you are Exxon, or any of these large companies, you are very concerned. You have \$1 billion projects which are being serviced by these vessels in many different fashions. It is critical that you have those services. Everything you do in a drilling operation is basically on a per-diem rate. So if your drill boat breaks down, and they can't bring the pipe in, and you have to shut down a drilling operation for even a day, it can be enormously costly. Dependability is crucial -- especially when you are talking about operating all over the world. It is not necessarily as if you can quickly get a replacement someplace. Anyway, oil is sort of under a cloud now. Drilling vessels don't capture people's imaginations. But we think there is a tremendous opportunity here.

Q: What about other sectors of the oil patch?

Greenberg: The last time we talked April 13, '92, we'd added a large position in natural gas stocks -- Burlington Resources and Anadarko -- which was rather controversial at the time. We've since sold them.

Q: How come?

Greenberg: Really because the multiples they got to, on after-tax cash flow, just seemed to discount a lot of the good things. The multiples got too high, the expectations got too high. And we felt gas prices would have a collar put on them by depressed oil prices. In fact, gas prices are way above oil prices now. But there is some sort of a collar, and we just decided to sell. As I recall, when we sold Burlington at 48, it was supposed to have \$3.75 of aftertax cash flow. And it was going to \$4.25. We couldn't see gas getting much above \$2.40 or \$2.50 an mcf, with oil prices at \$20. Now oil is at \$15 a barrel. They just didn't seem to have outstanding potential left, unless some sort of worldwide shortage developed, which we didn't see. We just thought they were fully priced.

Q: How about the oils? Aren't they getting just a little tempting, now that crude isn't mentioned in polite company?

Greenberg: Actually, we are commencing a private oil-drilling program, because we want to build oil reserves now, with prices low and while you can get any lease that you want. All the majors were exiting the U.S. two years ago, just in droves. And our theory is that whenever you can follow in where they are leaving, you can pick up great opportunities. Nobody is looking for crude in the U.S. right now. Therefore, you can get rigs, you can get crews, you can get leases -- you can explore very cheaply. Some day, there will be an emergency, the price of crude will go way up, and hopefully, by then, we'll have lots of reserves. But that's just a private deal we're doing.

Q: Care to tell us about anything else?

Greenberg: This is the bell lap. We have an investment in something called Bell Bancorp. In fact, our clients own 20%-plus of Bell Bancorp.

Q: Quite a sizable chunk of a little bank.

Shapiro: A decent-sized bank. It has \$1.9 billion in assets. It has 14 locations in Chicago and the surrounding area. There are 5.2 million shares outstanding. We own it because we feel it is an extremely attractive acquisition candidate. A week or so ago, the BankAmerica bought Continental Bank. But even before that there have been acquisitions in that neighborhood. There is still tremendous consolidation potential and interest in the Chicago market. In fact, I would note that the Bank of Montreal, in its annual report that just came out, mentioned that -- and this is a quote -- its "strategy in the U.S. is to triple our market share over the coming decade. And the driver of our growth will be Harris Bankcorp. We will meet the challenge of growth by investing heavily in retail banking and small-business banking in the Greater Chicago area." They are just one example. I believe there have been other banks that have indicated a desire to get into the Chicago market, where there are just very few attractive candidates. And we feel that Bell is one of them.

Q: What's the bank worth?

Shapiro: The stock currently trades at about 47. We feel that an acquisition would probably be in close to the \$65-\$70 price range. It has a \$56 fully diluted book. Basically, acquisitions have been at 1 1/2 times fully leveraged equity, and then dollar-per-dollar for excess equity. This bank has substantial excess equity. In fact, its equity-to-assets ratio is approximately 16%. On that basis, it works out to about \$71 per share.

Q: Why do you single Bell out, though? There are lots of little financial institutions around the Windy City.

Shapiro: There really aren't that many of a size that would be attractive to a sizable institution -- that have \$2 billion of assets or so. What makes Bell Bancorp very attractive to a large bank -- and what has been happening in a number of these acquisitions -- is that an acquirer could come in and eliminate a substantial amount of overhead. They can consolidate deposits in branches and perhaps shut down redundant branches. In addition, they can often reinvest the assets in higher-yielding ways. In the hands of a larger bank, this group of properties could generate substantially higher earnings.

Q: In other words, the assets of this bank could be made to work a lot harder?

Shapiro: Exactly. In the case of Bell Bancorp, an acquirer might ultimately be able to squeeze out \$7 a share in earnings, once they had taken the steps we have alluded to.

Q: Why is this stock trading for less than book value?

Shapiro: They have a little bit of a problem with some loans in California. But quite modest, relative to their loan-loss reserves and their equity.

Q: California? What was a little Chicago bank doing in California?

Shapiro: They have been in the business of purchasing residential mortgages. Obviously, over the course of the later part of the 'Eighties, a lot of residential mortgages were written in California. So Bell Bancorp ended up purchasing blocks of mortgages of that sort. It has come back to haunt them a bit now. But all it has really done is impede earnings a bit. It doesn't have any impact on the bank's soundness or stability. So we feel that it is probably one of three likely candidates in the Chicago market -- N.S. Bancorp and St. Paul are the other two that are reasonably sized. And we feel that the chairman is of reasonable mind towards being acquired.

Q: Who owns more of the bank -- you or he?

Shapiro: Well, he owns a big chunk. When they came public, it was a typical deal, management and directors got somewhere around 10% -- they're incentivized. And they have been buying in stock on a regular basis, which is something, as we noted, we like to see. The chairman is of reasonable mind. And I would say that we are extremely open-minded about it being acquired.

Greenberg: Maybe where we and he have some disagreement is that we have been through other cycles for banking and for the stock market, such as 1987 and 1990, when it was very difficult to sell a financial property no matter how sound it seemed to be -- when the acquirers simply lost their appetite. Things have been good ever since this bank converted. So there may be a little bit of a tendency to feel that the window of opportunity will stay open for an extended time. We -- being a little bit more experienced in this area -- say you should take the money when you can get the money. And not potentially wait for the equity markets to take it on the chin, or -- for some reason -- for a big black cloud to appear on the horizon. Certainly, when there is a consolidation in process, it is a game of musical chairs. At some point, all the chairs get filled. Clearly, the oil companies that sold out in the early 'Eighties commanded much higher valuations than they have been able to command since. We just feel that, in today's climate, the savings banks are able -- for a lot of strategic reasons -- to command high prices. You don't know how long that window of opportunity will be available. So we've pushed them a bit to accelerate the process.

Q: Dare we ask what kind of numbers this bank reports?

Greenberg: Horrible. Annualizing the nine-month figures gets you a 6% return on equity. They are way overcapitalized. Here's a thrift that was in great shape, converted, and since it's converted, its assets have gone way down. They didn't lever up the equity they took in. They immediately turned around and started buying in stock -- they retire 5% of their stock every six months. So why did they convert? It was a way to get some stock in their own hands. Now, it's time to cash it in, in our view. They were overcapitalized when they were private and they are certainly more overcapitalized now.

Shapiro: The return on equity is so dismal for two reasons: No. 1, they are very under-leveraged. No. 2, it is very hard for a \$1.9 billion operation to get economies of scale off an expense base, when you have 14 branches. You need more business flowing through that network to make it work.

Greenberg: Also, they have decided to take very little interest-rate risk. So they own almost all adjustable-rate assets. Which, of course, gives them a very narrow spread over their costs. They don't have the ability, like Freddie Mac, to sell callable debt. So they have to keep adjustable-rate assets, which have very low spreads. These guys are quite insensitive to the fact that when you're only earning 6% on equity, the increase in the book value is not that great -- a few bucks a year on a \$56 book. It's not like the value of this is going up rapidly. Nobody is buying it for earnings -- it earns \$3-\$3.50 a share. If they announced tomorrow some new way to prevent takeovers, so this bank couldn't be taken over for 25 years, this stock would trade at \$25. Why would anybody want to own it?

Shapiro: They have done a good job getting it to where it is. We just feel today it would be more valuable in somebody else's hands.

Q: So you hope you hear ringing bells for Bell.

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Shapiro: Something like that.

Q: Is that a wrap on your portfolio?

Shapiro: Pretty much. As Glenn said earlier, we don't own many stocks. And basically the ones we discussed here represent . . .

Greenberg: About 90% of our equities.

Shapiro: We have 20% in Freddie Mac, 15% in Reebok, and 15% in Dreyfus/Mellon. Then 9% in Tidewater and 6% in Bell. Philip Morris is 6%. That's 71%. And we are probably 82% invested. So we've discussed about 90% of our invested position.

Q: Are you sticking the cash in anything exotic?

Shapiro: Just cash.

Q: Plain vanilla greenbacks?

Shapiro: Well, in the money market. The point is to have it when there are better values.

Q: Thanks, guys.