Q3 2011

"Be greedy when others are fearful"—Warren Buffett

Fellow Investors,

The fear in the markets has been palpable. On August 8th, President Obama gave a rare television address to discuss the S&P's downgrade of our national debt and the sharply falling stock market. On the same day, I sent an email inviting you to bring me questions or concerns on those same topics (the offer still stands). Only a few of you responded – and rather than being concerned, you wanted to buy more stocks. Let me tell you, money managers are overjoyed when they hear their investors talk like this!

I put Buffett's wisdom into action by buying undervalued stocks throughout this turbulent quarter. In fact, some of the stocks I purchased this quarter are again trading at prices reminiscent of 2008-2009, when it really seemed like we were entering a world-wide depression. While the stock prices are similar, the companies themselves are much healthier. The scare of the last downturn made surviving companies behave much more conservatively - they reduced their risk, raised cash and paid down debt, and planned for a period of slower growth. Today, I'm finding three sets of companies that are trading cheaply: US banks, energy companies, and multi-national companies that are headquartered in Europe. I've been selectively investing in companies from each of these categories over the last quarter.

One of those investments, in Bank of America, was followed shortly by a somewhat larger $5 billion investment by Buffett himself, who summarized his investment thesis:

> "Bank of America is a strong, well-led company, and I called Brian [the CEO] to tell him I wanted to invest in it. I am impressed with the profit-generating abilities of this franchise, and that they are acting aggressively to put their challenges behind them. Bank of America is focused on their customers and on serving them well. That's what customers want, and that's the company's strategy."

A lengthier description of our investment in Bank of America follows on the next page.

It has been a tumultuous quarter in the stock market. It's often psychologically hard to buy when stocks are dropping so rapidly but in my experience, buying in such markets leads to good long-term performance. The next few quarters may well see more market turmoil, and I'll be on the lookout for more bargains.

Sincerely,
Kai Shih

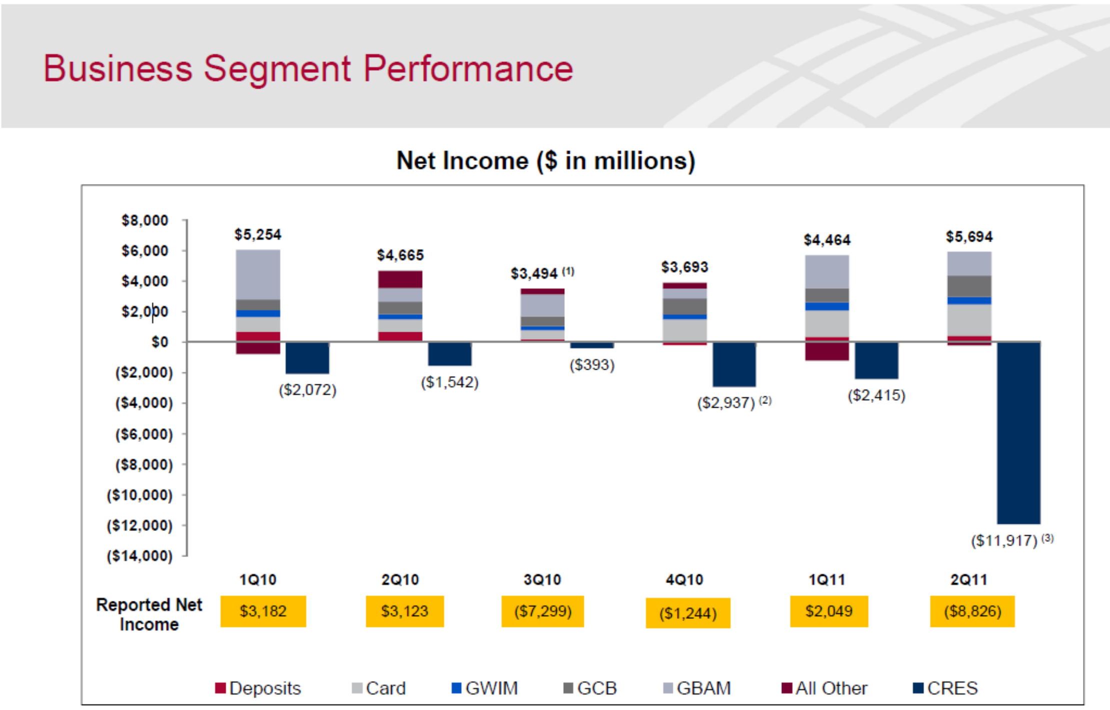
Bank of America (BAC):

The drop in BAC's stock has been extreme: its market value has fallen by about $130 billion from its 2010 peak. To put that amount in perspective, $130 billion today would buy you Costco, Netflix, General Motors, Safeway, and Dell, with some money left over. The company's stock price would have to nearly double just to be where it started a mere three months ago. As the stock has fallen, I've been a buyer. Unfortunately, my timing has been early (Buffett, too). Nonetheless, I think over the long term it's a winning investment.

In the past, we've enjoyed solid profits on two other banks, CIT and Wells Fargo. In my view, our investment in Bank of America is a better value than either of those; its short-term problems are worse but its long-term value is greater.

A simple way of understanding Bank of America's long-term potential and short-term problems is this chart of their earnings over the past 6 quarters. The stacked bars represent their operating business segments in each quarter – deposits, credit cards, wealth management, and so forth. In total, these bring in billions of profits annually (over $17 billion over the past year).

The dark blue bars pointing downward represent BAC's 'bad bank' and its quarterly losses, which are severe. Investors are currently focused on these losses. At a high level, these problems are being resolved. Over time, we will be left owning the very profitable core company that remains.



Source: Bank of America Barclay's Presentation

Bank of America's mortgage problems

The source of most of Bank of America's problems is mortgages their Countrywide unit originated and sold between 2004 and 2008. We've all heard of the awful subprime mortgages that were given out during the housing bubble; today Bank of America is experiencing the sequel to that horror movie. The complicated issue at hand is whether the purchasers of those mortgages deserve a refund on some of the soured mortgages.

There are dozens of lawsuits going on in multiple jurisdictions with multiple judges. I'm reasonably aware of all the major lawsuits, and I've been reading many legal briefs, contracts, court judgments, and law blogs. I can't get to every lawsuit here, so I'll do my best to summarize the most important points.

- The lawsuits involve mortgages sold between 3 and 7 years ago. There is a statute of limitations on lawsuits, and the clock is running out on lawsuits (some have already been dismissed for waiting too long). BAC hasn't issued poor mortgages like these in years, so the root problems are resolved even though we are still learning the size of the consequences. Most of the complaints seem to be around borrowers that defaulted soon after receiving their mortgages (say, within 2 years); since these mortgages were sold between 3 and 7 years ago, we know the entirety of the "worst case" already.

- Bank of America, so far, has not been held liable for the actions taken by Countrywide, which they acquired *after* they issued these poor mortgages. A federal district court dismissed Bank of America with prejudice (with prejudice means the ruling is final, and the plaintiff is barred from re-filing the suit) from lawsuits against Countrywide. The significance of these rulings is it opens the possibility that Bank of America might bankrupt Countrywide, in effect walking away from a majority of the problems surrounding them.

- Most investors do not have legal standing to sue either Countrywide or Bank of America. The majority of these mortgages were packaged into groups of securities called trusts. Investors in a trust do not have the right to sue unless they collectively own over 25% of the trust. So far, few groups have met that threshold. As an example, a lawsuit originally for $351 billion was reduced by the judge to $2.6 billion before litigation even began. As the article says:

  > Judges in New York, Boston, Los Angeles and San Francisco have dismissed or scaled back claims because plaintiffs lacked standing -- meaning they haven't shown how they were sufficiently damaged or that they are the right party to sue -- or failed to sue before the statute of limitations expired.

- A very large investor group (including Pimco, Black Rock, Metlife) that does have legal standing to sue negotiated a settlement with Bank of America for $8.5 billion. Various groups of investors, who generally do not meet the 25%

ownership threshold, are trying to derail the settlement. The outcome of these lawsuits is unknown.

The groups in favor of the settlement offered a framework for understanding how much Bank of America should pay. While the final cost may be higher or lower than the settlement, I don't think it will differ greatly from the original amount.

- The litigation against Countrywide mainly states they have misrepresented the bonds they sold. So, I looked at some of the prospectuses for the bonds they sold. Here are some of the things they say (their emphasis).

  > MORTGAGE LOANS UNDERWRITTEN TO SUCH [Countrywide's] STANDARDS WILL EXPERIENCE HIGHER RATES OF DELINQUENCY AND LOSS THAN MORTGAGE LOANS UNDERWRITTEN IN A MORE TRADITIONAL MANNER

  Some of their mortgages, according to the prospectus, were made without verifying any information about the borrower:

  > "Under the Stated Income Program, ... the borrower's income as stated on the application is not independently verified."

  The importance of this is Countrywide's claim that they did represent the mortgages fairly, and that investors are essentially finding a scapegoat for their own bad purchases.

The litigation is complicated and far-ranging, and the exact outcome is too hard to predict. I believe that most of the lawsuits will be settled at a price in the vicinity of the various settlements Bank of America has already negotiated. Even if they pay double the settlement amounts, the stock is cheap. And if the litigation gets much more expensive than that, I think they'll attempt to bankrupt Countrywide and walk away from the entire mess.

It's a little too complicated for this write-up, but I do have various ways of calculating their liabilities based on data on the mortgages, loss-rates and so forth. If you're interested in those details, please contact me.

The ultimate outcome of these short-term problems is unknown; but its long-term profits are secure. It's going to be a wild ride, but I think ultimately a profitable one. Warren Buffett spoke about them publicly yesterday, and he gets the last word on the topic:

> It's a great underlying business. It's a fabulous underlying business, but it's got a lot of problems from the past. [CNBC, 9/30/2011]
>
> GEICO got in trouble in the mid 70's, American Express got in trouble in the mid 60's. Those are two of the greatest investments I've ever had ... you have to look out five or ten years. [Charlie Rose, 9/30/2011]