The VIEW from BURGUNDY

JULY 1997

GREAT INVESTORS

ONE OF THE MAIN PURPOSES OF *THE VIEW FROM BURGUNDY* is to inform our readers of sound investment practices that we think enhance the possibility of long-term success. One of the ways to do this is to offer intelligent observation on some of the world's most successful investors, trying – where possible – to discern the factors that may have led to their success. In this issue of *The View*, we will feature an outstanding investor from time to time. Just as classical-music students would be expected to study Bach, we feel that those seeking greater success as investors would do well to study the great investors, past and present.

We think that Larry Tisch, Chairman of Loews Corporation, is one of these great investors. He is a contrarian investor who likes to buy companies that generate free cash flow. He looks at stocks as fractions of businesses and is willing to buy good assets during periods of severe weakness and pessimism, and most importantly he sticks to his discipline as a value investor.

Larry Tisch describes himself as a pragmatic investor. Here are some of his more notable trademarks:

- He performed a leveraged buyout of Lorillard Tobacco in 1966, long before the era of LBOs in the 1980s.
- He bought back about 40% of his own shares between 1981 and 1996, most of which were bought during the weak markets of 1981, 1987 and 1990. These share buybacks began long before they became popular and when they represented outstanding value for Loews' shareholders.
- He bought 100% of CBS network in the mid-1980s and sold it to Westinghouse in 1995 for a huge profit.
- He has shown an uncanny knack for buying good businesses at extremely low valuations despite predictions of their doom. For example, he bought oil-drilling rigs in the late 1980s when little or no offshore drilling was taking place.
- His capital allocation decisions have been masterly. Even though his company is considered a conglomerate, it has delivered very high return on shareholder capital.

Loews Corporation began its current corporate form in the late 1950s as a chain of movie theatres that had been spun off from MGM Studios in Hollywood. Larry Tisch and his brother, Bob, were living in Florida at that time, running a hotel they owned. Wanting to expand their hotel business, they saw a chance to gain control of Loews at a favourable price. Some of the theatres offered potential sites upon which future hotels could be constructed. Gradually they developed a chain of fine hotels including the famous Summit Hotel in New York City.

An important corporate event occurred when Loews bought 100% of Lorillard Tobacco in 1966. Lorillard was (and still is) extremely profitable as the dominant player in the sale of menthol cigarettes (Newport brand). It generated enormous amounts of cash that could be invested in other good businesses, since tobacco requires very little new capital. Larry Tisch quickly showed his mettle and became a first rate, value-oriented contrarian investor with nerves of steel. He developed a knack for buying outstanding value, especially at the bottom of an economic cycle when the opportunity for the biggest gains were the highest.

For example, in 1975 he bought CNA Financial Corp., a large property and casualty insurance

company that was nearly bankrupt. Today CNA is highly profitable and is the largest of Loews' five principal businesses.

In 1979 he bought 100% of Bulova Watch and in 1989, during a very depressed oil-drilling environment, he made a substantial investment in large offshore drilling rigs. Larry's son Jim, who is gradually taking over the helm at Loews, recently stated that the oil rigs met their "$5 million test." This "test" originated when Larry stood on the main deck of one of the $100 million rigs, looked around and said: "You mean we can buy all this for only $5 million?" The rigs were available so cheaply because drilling activity was low and the owners were greatly overextended.

A brief financial overview of Loews Corporation shows that the company has revenue of about $20 billion. The book value of its equity is $9 billion but the market capitalization of the company is only $11 billion. The market price of the stock is only 20% above the book value, an extremely low ratio in today's overheated stock market.

The company pays little or no attention to quarterly financial results, and only two analysts on Wall Street follow Loews. Management in the subsidiary companies are free to run the business units independently. Head office executives are only concerned with business strategy, capital allocation and the assessment of management.

Following is a 10-year financial review of Loews Corporation under Larry Tisch's direction:

	Net Profit ($ millions)	Shares OS ($ millions)	Earnings Per Share	Cash Flow Per Share	Return on Equity	Book Value Per Share
1985	589.0	163.0	$3.62	$3.44	20.6	$14.98
1986	545.5	161.7	3.35	3.73	18.7	18.04
1987	696.2	152.8	4.46	4.75	20.2	21.28
1988	908.5	151.4	5.97	6.48	22.1	26.60
1989	907.1	150.1	6.01	6.76	18.9	32.04
1990	804.7	139.8	5.41	6.50	16.0	36.05
1991	904.3	134.6	6.57	7.46	16.0	42.09
1992	122.6	130.2	(0.93)	0.89	(0.4)	42.45
1993	594.1	123.0	4.63	5.93	9.7	49.79
1994	267.8	117.9	2.22	3.63	5.0	45.84
1995	1,765.7	117.8	14.98	16.90	21.4	69.92
1996	1,383.9	115.0	11.91	14.51	15.9	75.92
Compound Annual Growth Rate = 15.89%						

Source: Compustat

There is a lot of value in Loews, which we think reflects the lack of extensive coverage by Wall Street, the absence of promotion by management, the conglomerate-like image of Loews and the stigma of its tobacco business.

Conclusion

So what makes Larry Tisch a great investor? We think these are a few of the key factors:

- Larry Tisch, now in his 70s, has had a lifetime of experience and proven wisdom as an investor. He buys based on value, not on fads, trends or promotion. While some think his age is a concern, we think it's a plus. (Warren Buffett says that some of his top executives only hit their stride at age 70; Phil Fisher, another great investor, is still going strong at age 89!)
- Larry Tisch recognizes the power of name brands (Newport and Kent cigarettes, Loews Hotels, Bulova Watches) and the advantages of the financial resources and leverage of insurance companies.
- The Tisch family has a large part of their own net worth in Loews. They are owners/investors. There are no stock option plans to dilute shareholder value and management compensation is fair and based upon the results achieved.

• Larry Tisch has the essential qualities of a successful contrarian investor. He has shrewd judgment, the willingness to buy when most are selling, and the courage and patience to await positive results. He is also an excellent allocator of capital, and was a buyer of his own stock well before share buybacks were popular.

Great Companies Update

In March 1996, we wrote an issue of *The View* that concentrated on the power of increasing earnings in driving stock prices and returns. We came up with a list of "super-elite" companies that had been profitable and increased their profits each and every year for six years in succession. To refresh your memories, the following stocks composed the "super-elite":

Barrick Gold Corporation
Bank of Montreal
Bombardier Inc.
Imasco Limited
Potash Corporation
Renaissance Energy Ltd.
BC Telecom Inc.
Investors Group Inc.
Franco-Nevada Mining Corp.
Loewen Group Inc.
Euro-Nevada Mining Corporation
London Insurance Group Inc.
Metro-Richelieu Inc.
Cinram Ltd.
Linamar Corporation
Quebec Telephone
Fortis Inc.
Unican Security Systems Ltd.
Sceptre Investment Counsel Ltd.
Winpak Limited
Domco Industries Limited
Gennum Corporation
Uni-Select Inc.
Lassonde Industries Inc.
Maxx Petroleum ltd.
Premier Choix: TVEC Inc.
Samoth Capital Corporation

We then applied a 15% return on equity hurdle to the resulting sample and came up with four companies that had both increased earnings each year over the six-year period, and had maintained a rate of return on shareholders' equity comparable to the U.S. stock market average. The four companies were Sceptre Investment Counsel, Franco-Nevada Mining, Investors Group and Premier Choix.

We thought that it would be interesting to revisit this subject and update the findings. First, we checked to see if our four winners had extended their winning streak for another year. All four had their record intact.

Then, we ran our six-year increasing-earnings screen for all companies in the database in order to see how the composition of the list would change by looking at fiscal 1991 to 1996, instead of fiscal 1990 to 1995 as we did last year. The following companies were consistently profitable and increased earnings every year from 1991 to 1996 inclusive:

Bank of Montreal
Lassonde Industries Inc.
Canwest Global Communications
Linamar Corporation
Cinram Ltd.
Metro-Richelieu Inc.
Euro-Nevada Mining Corp
Premier Choix: TVEC Inc.
Fortis Inc.
Quebec Printing Inc.
Franco-Nevada Mining Corp.

Quebec Telephone
Gennum Corporation
Sceptre Investment Counsel Ltd.
Intertape Polymer
Uni-Select Inc.
Investors Group Inc.
Westcoast Energy

We were somewhat disappointed that the list of trailing six-year earnings winners for 1990 and 1996 had shrunk from 27 companies on the 1996 list to 18 names in 1997. Fourteen of the companies that made the 1996 list also made it in 1997, but only four newcomers were added for 1997. The new arrivals were Canwest Global, Intertape Polymer, Quebec Printing and Westcoast Energy. The 1990s have apparently been a tough time to establish a long-term earnings uptrend for Canadian businesses.

As before, we then applied the supreme test to the 1997 sample – maintenance of a 15% return on equity (ROE). The following companies were able to both increase earnings every year over the survey period and maintain a ROE over 15% in each year of the period:

Canwest Global Communications
Investors Group
Franco-Nevada Mining Corp
Premier Choice: TVEC Inc.
Gennum Corporation
Sceptre Investment Counsel Ltd.

So, two newcomers – Canwest and Gennum – joined our four great companies. Canwest did not make the last screen because it was not a public company until 1990. Gennum reorganized in 1989-1990 and refocused its efforts on its core hearing aids business. Since then, it has not missed a beat. Gennum is a really beautiful business with outstanding management, spectacular economics and the strongest shareholder orientation we have seen in Canada. It is definitely on our "wish list" of companies to own, and we have taken a small position in the company's stock already. Canwest, of course, has been a huge winner in the broadcasting business, particularly with an amazingly profitable investment in Australian TV.

The performance of these six stocks over the last six years has been superb. The six companies averaged a total return of 37.5% annualized during that period. For comparison purposes, the TSE 300 Composite Index returned 13.6% in the same period and the S&P 500 returned (an amazing) 20.9% to a Canadian dollar investor.

Just to keep things in perspective, an investment that compounds at a 37.5% rate of return doubles every 2.2 years. To keep up this torrid pace of appreciation even for a short period of time is admirable, but to sustain it for six years is remarkable. Even allowing for a strong following wind from powerful business trends like the mutual fund explosion, niche broadcasting, and the Nevada gold bonanza, a company needs good management to build a record like that. These six businesses are great examples of how good management work together with good businesses to generate outstanding returns for shareholders.

For Whom the Bell Tolls

Those of our readers who are also clients will be aware that part of our success in Canadian equities has been due to our investments in property and casualty (P&C) insurance companies. Such stock market stars as Fairfax Financial and Kingsway Financial – and even the usually sleepy E-L Financial – have given our results a big boost in 1996-1997. Because of our great interest in this industry, we have also developed a clientele among Canadian P&C companies. This double link to the industry makes it very dear to our hearts.

But P&C companies are being fleeced by a tax grab from Ottawa, which we believe threatens the long-term viability of large segments of the industry. The law, simply put, requires financial institutions to "mark to market" their securities investments every December 31,

whether or not they have sold them, and to pay tax on unrealized capital gains. As usual, a Revenue Canada attempt to get the banks to pay more taxes has largely missed the target and scored a direct hit on a much smaller and more fragile industry.

P&C companies are really just underwriting companies with an investment company attached. These companies collect premium income from policyholders, and after some period of time, pay out a portion of the money they have received as claims. In the period between receiving the premium and paying the claim, the firm must invest premium income or "float." In order to stay in business, the firm must receive more premiums than it pays claims over the long term, and this surplus, the capital of the firm, is invested long term. Companies that are consistently successful at making money from underwriting can invest all of this surplus, as well as some of the float, in equities. So taxing them on their unrealized capital gains hits this industry particularly hard.

Why does this matter? Well, in a previous issue of *The View,* we reprinted the famous "Appassionata Van Climax" story from Berkshire's 1993 Annual Report. The story showed that taxation is a huge issue for equity investors, since the reward for the high risks of equity investment is tax deferral on capital gains. That reward is now removed for Canadian financial institutions.

A comparison of two buy-and-hold investors, taxable at 35%, with an investment that returns 10% annually, shows the extent of the damage:

	INVESTOR A		INVESTOR B	
	Warren Buffett's Buy and Hold	Rates of Return	Paul Martin's Mark to Market	Rates of Return
Initial Investment	$1,000.00	-	$1,000.00	-
1 year	1,065.00	6.5%	1,065.00	6.5%
5 years	1,396.83	6.9%	1,370.08	6.5%
10 years	2,035.93	7.4%	1,877.14	6.5%
15 years	3,065.21	7.7%	2,571.84	6.5%
20 years	4,722.88	8.1%	3,523.65	6.5%
25 years	7,392.56	8.3%	4,827.70	6.5%
30 years	11,692.11	8.5%	6,614.37	6.5%
35 years	18,616.58	8.7%	9,062.25	6.5%
Present Value of Taxes Paid Discounted at 7%	$888.47		$1,058.42	

The negative effects of this legislation will only show themselves in the long term – it's not a heart attack, it's cancer. Over the course of 35 years, as you can see, the government's take from taxes is 20% greater on a present value basis than it would be under the reasonable rules prevailing in other jurisdictions. The result will be slower capital growth for the Canadian industry, higher premiums (if you raise a highly competitive industry's costs on a permanent basis, it must raise its prices or go bankrupt) and lower employment. Some long-tail insurance businesses (types of insurance that involve claims for long periods in the future) will quit Canada entirely.

This "mark to market" legislation combines several of the most unsavory aspects of taxation, Canadian style. It is utterly arbitrary and separates what should be a consequence of a transaction (paying tax) from the transaction itself (selling the security). It taxes capital gains going right back to the time of purchase of a security, and is therefore retroactive. (If your insurers bought and held Berkshire Hathaway stock 20 years ago, they would pay capital gains tax on the whole unrealized capital gain.) It penalizes the best

kind of investor – the long-term holder – and encourages earnings management and uneconomic activity. We are already seeing the subsidiaries of several multinational insurers gutting their Canadian money management operations and transferring management of Canadian securities (especially equities) to the U.S. or to the U.K., which have sane tax laws. Exporting good jobs and peculiarly Canadian expertise to other countries – is this good public policy?

And finally, other Canadian investors in equities cannot view this legislation with complacency. One of the worst things about this legislation is that it is discriminatory, singling out the financial industry from other equity investors. Almost all Canadians, directly or indirectly, are now equity investors. One way to end this discrimination is to eliminate "mark to market", which is clearly the sane thing to do. Another way would be to apply it to all taxable Canadian equity investors. Maybe this is an overreaction and we are fearful of shadows, but remember, Canada did not even have a capital gains tax until 1972!

As John Donne wrote: "Never send to know for whom the bell tolls; it tolls for thee."[†]

Endnotes

†. Donne, John. "Meditation 17." Devotions Upon Emergent Occasions. 1624.

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