TILSON CAPITAL PARTNERS, LLC

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Dear Partner:

While I do not believe that month-to-month or even quarter-to-quarter results are meaningful, I am writing this, my first letter to investors, after only one month of operation because were I in your shoes, having invested in a new fund, I would want regular progress reports. I also want to make you aware that I am investing a significant portion of the Fund in one stock, Berkshire Hathaway, and want to explain why I believe this is a compelling opportunity and a prudent thing to do.

But first, the short-term results: in its first month, the unaudited returns for the Tilson Growth Fund (after fees, but unadjusted for performance allocation) versus major benchmarks (including reinvested dividends) are:

	January
Tilson Growth Fund	9.7%
S&P 500	4.1%
Dow	1.9%
NASDAQ	14.3%

The Fund's returns were primarily driven by the performance of a few blue chip technology stocks, which benefited from (and helped fuel) the NASDAQ's best month in 24 years.

The Fund began with initial capital of $1.1 million, which includes the majority of my net worth. I will be eating my own cooking. With appreciation and new investors, the Fund is now at nearly $2 million. I am actively seeking capital, so additional investments or referrals of potential investors would be much appreciated!

The Fund currently holds 15 stocks, of which the top five account for more than 50% of its value and the top 10 account for more than 75% of its value. You should expect that the Fund will continue to be highly concentrated in my best ideas.

Consistent with my goal of starving Wall Street of commissions and Uncle Sam of taxes, the Fund has yet to sell a single share of stock. I seek to keep turnover to an absolute minimum.

Nearly every company in the Fund reported quarterly earnings during the month, and I am pleased to report that not one company disappointed. In fact, some dramatically exceeded my (and Wall Street's) expectations. For example, consider Microsoft, one of the Fund's largest holdings, which was up 26.2% in January. Compared to the same quarter in the previous year, Microsoft's:

- Revenues increased 38% to $4.94 billion
- Net profit margin increased from 32% to 40% (the highest in the S&P 500 by nearly 9 percentage points)
- Earnings per share increased 74%
- Cash increased from $10 billion to more than $19 billion, with no debt (Microsoft has nearly three times the cash surplus, net of debt, of any non-financial company in the S&P 500; consider that Microsoft could generate nearly $1 billion of profit this year merely by investing its cash hoard at a risk-free rate of return)

These results have further reinforced my belief that when the history of corporate America in the 20th century is written, Microsoft will be included among Standard Oil, General Motors, and IBM in their heydays as the most profitable and dominant businesses of their time. I also continue to believe that long-term shareholders will be richly rewarded for holding Microsoft stock, despite its high current valuation.

While the performance of Microsoft and the other companies in the Fund is heartening, I am unhappy about their stock prices and the general high valuation levels in the market. While it is a natural human reaction to be happy and feel smart when one's stocks go up, my reaction is the opposite: I would much prefer a bear market because the Fund will be a net buyer of equities for many years to come and I like to buy at bargain prices. As Warren Buffett notes, "You pay a high price for a cheery consensus."

Speaking of Buffett, of all the companies I follow, the one that I believe is trading at the greatest discount to its intrinsic value is Berkshire Hathaway. Given its bargain price and extremely bright long-term prospects, I have made it the Fund's largest holding, and will be increasing this position as long as it remains substantially undervalued relative to its intrinsic value and relative to other stocks that I might purchase. Please read my analysis below if you are interested in learning more about this extraordinary company and why I believe its stock represents such a compelling opportunity.

Should you wish to discuss Berkshire Hathaway—or anything else—please don't hesitate to call me at (212) 755-3554.

Sincerely yours,

Whitney Tilson

BERKSHIRE HATHAWAY—BACKGROUND

Berkshire Hathaway is an unusual company and possibly the most talked about yet least understood business in the world. It is a diversified conglomerate whose Chairman, Warren Buffett, is one of the world's most famous and successful investors. Berkshire Hathaway directly employs more than 45,000 people worldwide, has the highest net worth of any American company (#2 in the world after Royal Dutch), would rank #23 in the S&P 500 by market capitalization were it included in the index, and was named one of *Fortune* magazine's "10 Most Admired Companies in the U.S. and the World" in 1998.

Nearly 80% of Berkshire Hathaway's revenues and earnings are from a wide range of insurance operations, of which GEICO auto insurance is probably the best known. In general, insurance companies make money in two ways. First, like any other business, they can make an operating profit by charging more than they pay out in expenses (in this case, claims plus overhead). Today, with increased competitive pressures, the best insurance companies are lucky to break even on their operations. Second—and this is where insurance companies can become fabulous businesses (and investments)—they can invest the float—the premiums charged to customers, but which have not yet been paid out in claims—and pocket the returns as profit. I discuss float further below.

Buffett has invested the float from the insurance operations (and the high levels of excess cash generated by Berkshire Hathaway's other businesses) very successfully over time, accumulating large holdings in blue-chip companies such as Coca Cola, Gillette, American Express, Walt Disney, Freddie Mac, Washington Post, and Wells Fargo. Though these holdings are substantial, they represent less than 30% of Berkshire Hathaway's market capitalization, so Berkshire Hathaway is not, as many people think, similar to a closed-end mutual fund.

Beyond insurance, Berkshire Hathaway is comprised of a range of wholly owned companies such as Flight Safety, Executive Jet, Dairy Queen, Borsheim's Jewelry, See's Candies, and Nebraska Furniture Mart. As a group, these businesses are growing rapidly and, more importantly, generate high returns on capital and a great deal of free cash flow, which Buffett then invests wherever it will generate the highest returns.

COMPETITIVE ADVANTAGES

Berkshire Hathaway has very powerful and sustainable competitive advantages. In the interests of brevity, I will focus on the insurance operations, in particular the two largest components: GEICO and the reinsurance business.

GEICO, which was founded in 1936 and was one of Warren Buffett's first major stock purchases in 1951, is the 7th largest auto insurer in the U.S. and is growing rapidly (over 15% annually since 1995 versus 5% for the industry). Its primary competitive advantage is that it sells directly to consumers, cutting out the brokers and other middlemen used by almost all of its competitors, and thus it can offer lower prices while making higher profits. (In many ways, Dell has applied GEICO's model to the computer business). GEICO's float has grown at nearly 11% annually for the past decade and, importantly, GEICO's operations are profitable so the cost of this float is negative.

Berkshire Hathaway's reinsurance business includes both General Re (a recent acquisition, discussed below) and National Indemnity, which specializes in "super cat" policies ("cat" stands for catastrophe). A typical super cat policy might be written when, say, Allstate insures homes on the Florida coast against hurricane damage. Allstate's total exposure could be billions of dollars, so it will sell some of its exposure to reinsurance companies such as Berkshire Hathaway. The economics of the reinsurance business are volatile: a reinsurer will likely pocket millions of dollars in premiums in most years with no claims, but in some years will have to pay out very large claims. The competitive advantages of Berkshire Hathaway's reinsurance businesses are its willingness to write very large policies, unsurpassed capitalization to back up them up, longstanding presence and unsurpassed reputation in the market, global reach (especially with the acquisition of General Re), and ability to make quick underwriting decisions.

But Berkshire Hathaway's primary competitive advantage in the insurance business is how it invests the tremendous float it generates (now more than $23 billion). Consider 1997, which was a typical year: Berkshire Hathaway had 85% of its excess capital (most of which was float from its insurance operations) invested in equities, so the dividend yield of the entire amount was only 2.6%, but the total return was 21.8%. In contrast, the average property-casualty insurer invested only 44% of its float in equities (with the balance primarily in bonds), resulting in a 5.8% yield, but dramatically lower overall returns of 9.2%.

This raises the obvious question: why don't other insurers invest their float more heavily in equities as well? The reason is that the float is needed to pay claims, so insurance regulators, ratings agencies, and investors will not allow most insurance companies to invest more of their float in equities, which can be quite volatile. But Berkshire Hathaway is an exception, due to its track record of superb investing and superior capitalization (relative to its potential claims, Berkshire Hathaway has far more excess capital than the average insurer because of the cash generated by its non-insurance businesses). Because no competitor has, or could develop in a reasonable time horizon, an investment record or capitalization similar to Berkshire Hathaway's, the company's ability to invest flexibly is a powerful and nearly permanent competitive advantage.

Warren Buffett's legendary investing prowess is also a major competitive advantage for Berkshire Hathaway. Even if other insurers could invest their float with as much flexibility as Berkshire Hathaway does, it is unlikely that they would be able to consistently generate 20+% returns.

Berkshire Hathaway has many other competitive advantages in its other businesses and at the corporate level, which I hope to address in subsequent letters to investors.

HISTORICAL PERFORMANCE

Berkshire Hathaway has been one of the most extraordinary investments of all time: $10,000 invested with Buffett in 1956 (prior to Berkshire Hathaway) would be worth $250 million, AFTER TAX. That's a 25,000-fold return during a time when the S&P 500 index increased 130-fold (pre-tax). Had one invested the same amount in Berkshire Hathaway in 1965 after Buffett took over the company, it would be worth $60 million today, a 6,000-fold return (29% annually), versus a 50-fold return for the S&P. As late as 1983, both the Dow and Berkshire Hathaway were trading at 1,000. Today, Berkshire Hathaway is at $65,000 (as of the end of January) while the Dow is slightly above 9,000.

And the company's performance has been extremely consistent: in the past 34 years, its book value per share (which is a good proxy for its intrinsic value) has NEVER declined (its worst year was a 4.7% increase), and has only trailed the S&P four times (the last time was in 1981). Nor, despite Buffett's warnings, has size diminished Berkshire Hathaway's returns: over the past 10 years, the stock has compounded at an annual rate of 31% versus 19% for the S&P, which would place it in the 93rd percentile of the S&P 500. $10,000 invested in Berkshire Hathaway 10 years ago would be worth nearly $150,000 today versus less than $59,000 for the same amount invested the S&P.

MARKET INEFFICIENCIES

In spite of this extraordinary track record and Buffett's fame, Berkshire Hathaway's stock is not widely followed or owned. There are many reasons for this:

- It is a very complex company that is difficult to understand.
- Berkshire Hathaway does not try to manage earnings so that they increase smoothly and steadily. In fact, Buffett highlights the fact that one of the company's competitive advantages as an insurer (especially when writing super cat policies) is that Berkshire Hathaway, unlike its other publicly traded competitors, is willing to accept the risk of periodic large claims in exchange for a higher level of overall profitability over a long period of time.
- Berkshire Hathaway's A shares trade at $65,000/share and the B shares at 1/30th of this amount (slightly more than $2,100/share). This high price intimidates many buyers and makes it impossible for small investors to purchase the stock.
- Wall Street does not cover the stock (in fact, until last week, a major Wall Street firm had never covered the company) because Buffett does not try to promote it, refuses to play the quarterly earnings game, and has little need for investment banking services. Also, the stock's high price and low turnover discourages brokers from promoting the stock since their commissions are based on the number of shares traded.

These factors (and others) create a market inefficiency that has tended to keep Berkshire Hathaway's price at a much more reasonable level than the handful of other extraordinary companies to which it might be compared.

But the stock is now selling at an even greater discount to its intrinsic value than usual because of Berkshire Hathaway's recent acquisition of General Re, the largest direct-writing reinsurer in the U.S. based on premiums and surplus, and the 3rd largest reinsurer in the world. This $22 billion acquisition—by far Buffett's largest—is a huge win for Berkshire Hathaway, as the synergies between the two companies are enormous and it triples the float (to $23.8 billion) that Buffett can invest. As Buffett, who is not known for hype, says: "We're creating Fort Knox here."

Yet at precisely the time that Berkshire Hathaway's intrinsic value has soared, the stock has stagnated due primarily to selling pressure that the all-stock acquisition triggered because many General Re shareholders did not want to own Berkshire Hathaway stock, S&P 500 index funds had to sell their Berkshire Hathaway shares (since General Re was in the index and Berkshire Hathaway is not), and funds that are required to hold stocks that pay a dividend had to sell as well.

VALUATION

As a result of these market inefficiencies, Berkshire Hathaway shares are trading at $65,000, far below their intrinsic value, which is conservatively estimated at $85,000-$95,000/share. One can calculate this valuation using any of three methods: a "float-based" valuation, a book value-based valuation, and an earnings-based valuation. (It would take many pages to go through of each of these, so if you're interested in the details, please call me). Note that these estimates do NOT assume excess returns that perhaps only Buffett could be expected to generate; 6.5% annual returns are assumed—an extremely conservative estimate, given the 20+% returns that Berkshire Hathaway has consistently generated for more than 30 years.

Another way to think about Berkshire Hathaway's valuation is to look at its enterprise value to invested capital ratio. In general, a ratio below 1:1 means that the market expects that a company in the future will not generate a return on capital equal to its cost of capital. Similarly, a ratio above 1:1 means that the market expects that a company in the future will generate a return on capital above its cost of capital. Berkshire Hathaway's ratio is slightly above 1:1, which means that at its current price, the market is implicitly saying that it expects Berkshire Hathaway to only earn slightly above its cost of capital. This is a ludicrous assumption, given that Berkshire Hathaway's cost of capital (primarily from the insurance float) is usually zero or negative, and its return on capital has consistently exceeded 20%.

RISKS

There are a number of factors that could cause Berkshire Hathaway's stock to continue to stagnate for a time (e.g., a general market decline, a number of large reinsurance claims, a worsening of conditions in the insurance industry), but the risk most people focus on is Warren Buffett's demise. The stock would certainly take a short-term hit, but I am not overly concerned about his inevitable passing for three reasons: 1) I met him last year, and he appears to be fit as a fiddle. I would guess that he has another 15-20 years left in him; 2) while Buffett has been tight-lipped about Berkshire Hathaway's succession plan, it is inconceivable that such a rational and non-ego-driven person could fail to have a solid plan in place; and 3) the valuations noted above do not include a Buffett premium (e.g., they do not assume that he and his successors will continue to make highly successful stock purchases and acquisitions of companies). I suspect Buffett is right when (assuming the stock drops upon his death) he says: "When I die, buy!"

CONCLUSION

It is only fitting to conclude with a final quote from Buffett:

"You just have to make a few good investment decisions in a lifetime. But the important thing is that when you do find one where you really do know what you are doing, you must buy in quantity… Charlie and I have made a dozen or so very big decisions relative to our net worth, although not as big as they should have been. And in each of those, we've known that we were almost certain to be right going in. They just weren't that complicated… That's what we look for—a fat pitch."

I believe that I have found a fat pitch in Buffett's own company, and plan to continue taking advantage of this opportunity.

(Note: some of the information above was drawn from a recent Paine Webber report on Berkshire Hathaway, which I would be happy to share).