Our Difference Explained

1. We're a Company – Not a Managed Fund

Leithner & Company Limited (hereafter "Leithner & Co") is an unlisted public company, limited by shares,[1] established in 1999 and based in Brisbane. It specialises in the purchase and long-term ownership of securities.

Leithner & Co isn't a managed fund (unit trust). Its structure as a company has vital implications. *Its investors are shareholders, and shareholders own Leithner & Co.; accordingly, they're co-investors with Directors – that is, in a practical sense, partners – rather than mere clients or customers.* A corporate structure also facilitates long-term and businesslike investment operations. Our focus isn't the shares, bonds or other securities we own; still less is it the fluctuations of their prices from day to day, month to month, etc. Businesslike investment operations emphasise the businesses (or loans, etc.) to whose earnings (or payments of interest) our ownership of shares and bonds entitles us. It also directs our attention to those businesses' development over time. Hence Leithner & Co's primary activity isn't the *management* of businesses or *trading* of securities: it's the *part-ownership* (that is, selection and monitoring) of businesses and loans.

Once they've been purchased and until they've been sold, Leithner & Co records assets on its balance sheet at their historical cost; hence the short-term ebb and flow of their prices don't affect our cash earnings – and, accordingly, don't affect the dividends we pay to owners of RPSs. This arrangement encourages owners of RPSs to:

- view Leithner & Co as a business whose progress they gauge through its Annual and Half-Year reports (including audited financial statements) and regular receipt of franked dividends;
- focus upon the operations of the companies of which they are (indirectly, through their part-ownership of Leithner & Co) part-owners or part-creditors; and

1 The Company comprises two classes of shares. Entities controlled by its Directors own its Ordinary shares; investors such as individuals, companies, family trusts and self-managed superannuation funds own Redeemable Preference Shares (RPSs). The Company's Directors are major owners of RPSs. Point 4 below describes how the Company's profits are allocated among these two classes of shares.

- ignore (except when it allows us to buy more cheaply, or sell at a profit) the fluctuations of those securities' market prices.

In sharp contrast, most market participants – including major institutional investors – obsess about market prices and their ups and downs from one day, week or month to the next.

Finally, and given its corporate structure, Leithner & Co will never be obliged to sell assets during a market panic – unlike most managed funds, which can (and typically do) face requests for large redemptions at such times. Whilst we provide more-than-adequate redemption facilities for our shareholders (generally speaking, 20% of the RPSs on issue at the beginning of a calendar can be redeemed during that year), our shareholders' orientation is long-term and we maintain more than adequate cash and at-call balances to meet redemptions.

2. Businesslike Measurement of Results

Leithner & Co's structure as a company also has fundamental implications for the measurement of its results. Here, too, the key term is "businesslike." Unlike a managed fund, our results have everything to do with the dividends, payments of interest, etc., generated by the businesses of which we are part-owners – and nothing to do with the price volatility of the stocks or bonds, or their level at any given point in time. As a business, our results are gauged like that of any other business: in terms of earnings, return on equity, etc.

Our shareholders acquire (redeem) a part-interest in Leithner & Co by purchasing (selling) RPSs at their Net Tangible Asset ("NTA") backing – which is calculated at the end of each month. During their ownership period (which we are happy to observe, is for most shareholders indefinite), owners of RPSs derive their returns from the receipt of dividends paid to them by Leithner & Co. It is through the reinvestment of these dividends that investors' returns compound over the years.

Leithner & Co has paid a dividend to its shareholders every six months since it commenced operations in 1999. Four sources of income finance these dividends:

- Dividends and distributions from the shares Leithner & Co owns;
- Interest from the loans it has extended;
- Premiums from options it has written; and
- Capital gains from the securities it has sold at a profit.

The redemption of RPSs will usually produce a capital gain or loss. If your purchase price (which is based upon the RPSs' NTA at the time of purchase) is lower than your redemption price (which is based upon their NTA at the time of disposal), then your sale produces a capital gain; if your purchase price is higher than your redemption price, then your sale produces a capital loss. Since inception the vast majority (at least 95%) of shareholders' total returns have been generated by the dividends we've paid to them rather than by movements of the RPSs' NTA.

3. Graham-and-Buffett "Value" Investment Philosophy

Leithner & Co adheres strictly to a businesslike, long-term, "value" approach to investing. We are value investors in the manner practiced by Benjamin Graham and Warren Buffett (for details, see our Investment Principles). Value investors:

- invest on the basis of securities' value, and never on the basis of their popularity with other investors, commentators or other "experts";
- buy at prices which provide a significant "margin of safety";
- strive to hold securities for the long-term (typically five years and often much longer); and at all times
- embrace logic and reject emotion, popularity, fashion and conventional wisdom as a basis for their decisions.

4. Sharing of Risks and Rewards

Graham-Newman Corporation (1926-1955) and Buffett Partnership Ltd (1955-1969) shared risks and rewards in a unique way that harmonised the interests of their stewards of capital (who were also investors) with those of other investors. We have adapted the sprit and structure of Graham-Newman Corp. to Australian legal and taxation conditions.

> *Most importantly – and unlike virtually all other Australian investment vehicles – Leithner & Co levies no management fees. Its Directors' rewards derive almost solely from the dividends they receive from the shares they own; accordingly, they derive no benefit from the Company's investments unless and until the owners of RPSs do so, too.*

Leithner & Co's half-yearly cash earnings exclude unrealised gains from increases of the prices of the securities it owns. It pays these earnings to shareholders as follows:

- 80% as a franked dividend (either as cash or additional RPSs according to their preference) to owners of RPSs; and
- 20% as a franked cash dividend to owners of ordinary shares.[2]

Directors' rewards, in other words, stem directly from the Company's results. The contrast of this arrangement to typical investment management arrangements is stark. Managers almost invariably charge a management fee; moreover, they charge a fixed percentage of the trust's assets – regardless of results. *Accordingly, these managers shoulder relatively little of the risk and yet obtain much of the reward from the management of other people's money.* Moreover, they seldom invest large amounts of their own capital in the funds that they manage. Figuratively speaking, they don't eat their own cooking; accordingly, they have surprisingly

[2] As owners of the Company's ordinary shares, its Directors typically use a majority of these proceeds to purchase additional RPSs on standard terms, i.e., at NTA per RPS. As a result, interests controlled by the Directors are the largest owners of RPSs, and these RPSs have been bought with Directors' cash.

little incentive to cook nourishing meals. Perhaps that's why surprisingly few of them consistently feed their investors well.

5. Sticking To Basics

Leithner & Co's structure provides to its Directors a strong incentive to invest conservatively, in a disciplined manner and for the long term. This discipline also encourages it to stick to basics. Although it tends to buy securities that others avoid, it doesn't short-sell, use Contracts for Difference, futures contracts and other popular – and, as Graham once contended and Buffett continues to believe, speculative and dangerous – financial instruments. (At opportune times it does, however, sell call and put options.) Nor does it borrow. These constraints cause it to forego what others regard as exciting short-term opportunities. At the same time, however, they reduce the risk to shareholders' capital and thereby facilitate reasonable long-term.

6. Transparency of Operations

Twice each year, after the conclusion of the financial year on 30 June and also at its half-way point on 31 December, Leithner & Co reports to its shareholders the results of its operations during the most recent half-year.

Directors write each year's *Annual Report* and *Half-Year Report* as if their position and that of the other owners of RPSs had been reversed. We want you to know everything that we'd want to know if we were in your shoes. Absent from these reports, therefore, are costly irrelevancies and distractions such as glossy paper, colour photos, self-laudatory prose and catchy but misleading graphics. Present, instead, are extended descriptions and explanations of Directors' actions – which shareholders require in order to understand our current and future operations and the results they might produce.

7. Frugality of Operations and Avoidance of Hidden Costs

Leithner & Co's approach to investment provides its Directors a strong incentive to act frugally. Value investing entails independent thinking and analysis of financial statements (which are difficult and painstaking but cost little money). These things don't require attendance at conferences, sporting events and entertainment, hosting lunches, lobbying politicians and undertaking company visits and "fact-finding" missions.

We believe that fat dividends and thin carpets at corporate headquarters go hand in hand! Hence the frugality of an investment vehicle's operations is as important as its transparency. Expenses reduce shareholder's returns; moreover, because Leithner & Co's Directors are major shareholders and are rewarded solely from its results, any excess expenses hit their pockets as well.

As Directors, we don't just have an incentive to act frugally; we also possess the strong desire to treat our shareholders more than fairly. One example of several: whilst it would be normal for us to have to pay rent for the office premises we occupy, in our case those premises are owned by our Directors. They haven't and won't ever charge rent or other occupation expenses to Leithner & Co.

8. Defying the Institutional Imperative

Points 1-7 allow Leithner & Co to ignore what Warren Buffett has dubbed "the institutional imperative" – that is, the lemming-like tendency to imitate others' behaviour, no matter how silly or self-destructive (see also Principle #5 of our Investment Principles). At first glance it seems reasonable to suppose that managers within large organisations, who typically have greater resources and expertise at their disposal, will achieve better results than their counterparts in smaller organisations. Alas, as with lemmings so too with many large-scale institutional investors: each moves regularly (and occasionally irrationally) in response to the behaviour of his peers. Buffett has noted that periodic wild swings of share prices have much to do with the lemming-like actions and reactions of institutional investors.

Most decisions within large organisations are made by groups or committees. Committees, in turn, tacitly encourage their members to conform to certain norms, standards and articles of conventional wisdom. Within a closely-knit group, adherence to standard practices tends to be rewarded; and independent thinking – no matter how firmly logic and evidence justify it – which challenges the group's cohesion, its leader's authority, ego, etc., is discouraged. *As a result, what investment managers in large organisations ultimately fear isn't so much the possibility of being wrong but of being out of step with peers. Within large organisations, in other words, "failing conventionally" is rational and sensible.*

Richard FitzHerbert, in a paper presented in 1998 to the Australian Institute of Actuaries, provided Australian evidence of "investment groupthink." He found that the environment in which large Australian funds managers work virtually precludes dispassionate analyses and decisions about investments as they tend to give more weight to their own interests and careers than their clients' money. FitzHerbert finds that institutional managers "know that they risk losing clients and their jobs if their portfolios are significantly different from [those of] their peers" and concludes that sensible investment decisions are short-circuited by managers' self-interest.