Pabrai Investment Funds
2005 Annual Meeting Transcript

Note: This is the transcript of the Sept. 17, '05 meeting held in Rosemont, Illinois and the Sept. 24, '05 meeting held in Huntington Beach, California. Mohnish's presentation style is extemporaneous, hence there were some differences in the two presentations. The questions differed significantly. Some similar questions were asked at both meetings. In such cases, it was blended into one question and one answer. The transcripts of both meetings were merged to produce this single document. The transcript has been edited for readability.

The transcript should be read in conjunction with the Annual Meeting presentation slides handy. They can be accessed at: **http://www.pabraifunds.com/website/2005_PIF_AM_Slides.pdf**

Slide 1 & 2

Welcome to the Pabrai Funds annual meeting. This is the sixth time we are meeting. At our first meeting in 2000 seven brave souls showed up. It's gradually increased over the years. It's a wonderful event for me – I get to meet many of you just once a year at this meeting. Preparing for the meeting is a time for introspection and reflection for me. Invariably, I always learn from the preparation and the questions.

The presentation will recap the year and what we might expect going forward. I'll go through some specific examples of investments we've exited over the last year. It's a post-mortem of sorts. I'll start with an investment that didn't go so well and then end with some winners. I'll delve into why we bought, why we sold and what the gains, losses and timeframes were. Finally, we'll open it up for questions. I appreciate everyone coming out.

Slides 3 & 4

Pabrai Funds is over six years old now. PIF2 is the oldest of the funds and it's going to complete five years at the end of this month – that's a milestone of sorts as I believe five years is the minimum period over which performance ought to be analyzed. Since inception, PIF2 has averaged and annualized return of about 32% a year – and that's after my outrageous fees and all expenses. It's worked out far better than what I would have thought. $100,000 invested about five years ago is worth about $380,000 today.

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Our goals are to beat the best of the three indexes: the Dow, the S&P and the NASDAQ whichever one does the best. Over the last six plus years, PIFI/PIF2 has averaged about 31.7% a year. The best index over that period is the Dow – it has been flat for the last six years and we've outperformed the Dow by 30+%

a year – which is stunning even for me to grasp. I would never have forecasted that and certainly I would not expect anything like that going forward.

Slides 6, 7 & 8

PIF3 is our offshore fund. It's also the fund that takes all the IRAs, Family Foundations, Foundations and Endowments. It's about 2½ years old and has averaged about 24% a year. Again if you put in about $100,000 at inception, it would be worth about $218,000 today. The best index delivered about 4% annualized over the same period – so about a 20% annualized outperformance. It would be prudent to expect substantially lower outperformance numbers in the future.

Slides 9, 10 & 11

PIF4 is the newest fund. It will complete two years at the end of this month. It's averaged 15.7% a year after all fees and expenses. Slightly better results than the best index – the S&P 500 – has delivered over the same period. $100,000 put in a couple of years back into PIF4 is worth about $131,000 today.

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The three funds have virtually identical investment styles. They are in three different buckets because there are three different classes of investors. PIF2 is for U.S. Accredited investors, PIF4 is for U.S. Qualified investors and PIF3 is for Non-U.S. investors, IRAs and Foundations/Endowments. The only difference is tax considerations which don't exist for the offshore fund but they do have an impact on sell decisions for PIF2 and PIF4.

There are significant differences in all three funds on two fronts – fund inception date and inflows. If you look at PIF2 which is the oldest fund, it's been closed for the last couple of years. Its number of units outstanding has increased about 30%, and it has increased in value by about 74% per unit over that period. PIF3 has seen about a 436% increase in units outstanding which means more than a four-fold increase of assets. It's up about 45% over the last couple of years. PIF4 which is the newest fund has seen more than a 12-fold increase in assets and has increased in value by 31%.

The timing and the amount of money that comes into each of the funds can lead to significant performance differences – as we've seen in the last 2 years. When we started PIF4 about two years ago we had less than $6 Million in total assets and it's about a little over a $100 Million today.

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It should temper off because going forward, I don't expect 12-fold increases in any of the funds over the next few years. The asset inflow differences between the funds will not be anywhere near as pronounced as they were in the past. I would expect that all three funds, over the next five to ten years, will be pretty close in the way that they perform. I have no idea which one will do better than the others, but they should be pretty close because they follow the same style. They are all long only, there's no leverage, there's no shorting and no use of derivatives. In addition, they are all very concentrated.

I just touched on one of the reasons which is the difference in inflows, but there are other differences like tax considerations, size and the widely differing start dates. I have discussed this subject in some detail in the April '05 and June '05 letters to partners. They are archived on the website for your perusal.

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Assets have grown considerably, way beyond what I would have expected. Pabrai Funds started as a hobby in 1999 with $1 Million from eight investors, and it's about $260MM today from about 360 odd families from all over the United States and the world. Almost all of the assets have been allocated directly by these families. Institutional money is very small - probably less than 2-3%. Most of the investors have very long time horizons and are in sync. with our focused value approach. I feel very privileged to serve as the steward of some of the assets of this august group.

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There are two ways to beat the market. First, minimize fictional costs. The minimization of fictional costs are something you can completely control and the other is the appropriate selection of investments that are likely to outperform the various indices. The expense ratios that investment funds incur are well within the control of the people that run investment funds. At Pabrai Funds, right from the beginning, there has been a very strong focus trying to make sure that these expense ratios are as low as possible because that's half the battle.

Here are the expense ratios for the three funds. This data is right off the most recent annual audit reports that PriceWaterhouseCoopers prepared. For PIF3 and PIF4, these numbers are as of December 31, 2004. For PIF2, it's as of June 30, 2005. The expense ratios for all three funds are between 9 basis points and 34 basis points over that period. That is, 0.09% to 0.34%.

Going forward, I'd expect the U.S. funds which are larger to have expense ratios under 10 basis points, and the offshore fund which has about $50 Million in assets to have

about 20 basis points in expenses. These ratios are pretty much among the lowest across the entire industry – thousands of funds.

Since we also don't charge a management fee - we just charge performance fees - the total fictional costs that you as investors incur by participating in Pabrai Funds are among the very lowest across the entire hedge fund industry. I'm happy about our ultra-low frictional costs and am focused on keeping that low going forward. Frictional costs do begin to rise as we deliver over 6% annualized, but they are still below a typical "1 and 20" hedge fund (1% management fee with 20% of profits). Only when we deliver over 50% annualized are we more expensive than a 1 and 20 fund. And if we delivered over 65% a year, we begin to get more expensive than a 2 and 20 fund. As an aside, please don't fantasize about our future annualized numbers being anywhere near those levels.

When we have bad years which I'm sure will happen, the expense ratios being low will temper some of that negative impact. All three funds have thus far met the stated objective of outperforming the best of the three indices. PIF4 has had the lowest out-performance margin – although with PIF3 and PIF4 one has to let more time pass before we can do an intelligent analysis.

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John Bogle wrote a very good book called *Common Sense on Mutual Funds* and it's a very good read. He gave a lot of empirical data about how typically less than half a percent of money managers over the long haul beat the S&P 500 index by more than 3%. That is, less than 1 in 200 managers. When you start looking for money managers who beat the index by say 5% a year or 7% a year or 10% a year. It gets to be very, very rare. You'll be approaching numbers like 2 or 3 in a 1000.

If investors in Pabrai Funds have an objective that we will slightly outperform the best of the three indices over the long haul after all fees and expenses that's a good set of objectives to have. If we achieve that then participating in Pabrai Funds would have been worth it. The typical choice most investors have would either be to go into a few actively managed funds where 80-90% will underperform the index or you could put it all in the S&P 500 index where you'd beat 90% of the managers but there are still 10% of managers that will outperform it. If we achieve a 3% annualized out performance versus the best index over long haul, I would consider that a stellar performance.

One of the things that I'd encourage all of you to do is to review all the previous annual meetings, slides and transcripts – they are all archived on the website. It's worth going through them to get a better understanding of the funds and philosophy. I don't go back and repeat a lot of that stuff. I assume that the base level is well understood so that I don't bore you anymore than I have to.

Slide 17

As you know, we are a long only concentrated fund. Typically when I make an investment, it's slated to be with 10% of assets. Ideally we'd like to have 10 diversified businesses, in different industries to be part of the portfolio – all bought at a 50+% discount to perceived intrinsic value. We have no idea when these businesses will get to their intrinsic value, but we do believe markets are mostly efficient and eventually (a few years at most) virtually all businesses get fairly valued.

The common theme is that I try to buy them at half off and try to sell them at 90% or better of intrinsic value. Here is a little bit of insight to look at how a concentrated value portfolio might perform. So typically in a year, if I can find three to five good investment ideas that's pretty much all we need. Trying to focus on businesses that I understand well, businesses that are hated and unloved at the time I'm making the investment and businesses that are trading well below what I believe an intelligent private buyer would pay for those businesses.

So, let's assume that we bought 10 businesses and invested $100 in each of them. And let's assume that it plays out in one to three years, let's say in one business we lose 90% of the money we put in, second business we lose 50% of the money we put in, the next two we break even, the next three do what we are thinking it will do which is buy at .50 cents and sell at .90 cents, then we have a couple that double and one that triples.

If that is the mix of the way things play out then that $1,000 will eventually turn into $1,500. If it takes three years we would have generated a 14½% annualized rate of return. If it took two years, it would be 22½%, and if it took a year it would be 50%. If you map that against what's happened at Pabrai Funds over the last six years, the Funds have done almost 32% a year, but that's after my outrageous fees. Before fees, it's over 40% a year.

Since inception, we've done about 40% a year. I wouldn't suggest we'll do 40% a year going forward. What it seems to indicate is that the bets have played out better than what I've laid out. Bets seem to play out mostly between 12 and 24 months. The best index over the next 10 years isn't going to do 14% a year. It isn't even going to do 10% a year. My best bet is that the best index will be mid-single digits. So, even if convergence takes three years, we are in good shape.

Of course our error rate could be much higher, we could have uninvested capital for extended periods of time and convergence to intrinsic value could take longer. All of these would reduce annualized returns. However, I do have some confidence that this approach is likely to trump the broad indices over rolling five year and ten year periods.

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Every year I go through three or four examples of businesses that we made investments with in the past. Some that worked and some that didn't. I'm going to talk about four businesses we've partially owned in the past. They are Exide, Sunrise Senior Living, Embraer and Stamps.com.

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I'll talk about the losers first. Exide is an investment where we lost money, and there were three others businesses that made money. We bought the senior unsecured bonds of Exide in early-2002. We did not make an equity investment. We bought the debt of the business. We first made this investment at the beginning of 2002. It's a ways back. In fact, PIF4 never participated in this investment because it wasn't even around, and PIF3 had a very small stake. Most of the stake that we bought was in PIF2 at the time. We finally got rid of the last bit of Exide towards the end of last year. Total amount we invested in Exide bonds was about $2 Million. The total amount that we recovered was a little over $400,000, so almost an 80% loss of invested capital over 34 months.

We bought the Exide bonds in January of 2002. In April of 2002 they filed for bankruptcy. That wasn't part of my proposed game plan with this ill-fated investment, but that's what happened. Two years later, after a lot of legal fees, they exited from bankruptcy. When they exited from bankruptcy, our Exide senior debt position was converted into a combination of Exide stock and warrants.

If we had sold the stock and warrants on the day we got them, our overall loss would have been about 50%. When they exited bankruptcy, they had eliminated most of their debt and were in good shape.

There is research that indicated that stocks of companies right after the come out of bankruptcy tend to do better than the market if they are held for a year. This is because there is no IPO and the folks who get the stock (creditors and bond holders) aren't typical equity investors. They are pretty disgusted with the pennies on the dollar recovery and the two-plus years to get to this point. Management gets re-priced options and has a tendency to sandbag the numbers, so the strike price for their options is low. In addition, debt loads are usually much lower than competitors and the company thus has an unfair advantage.

So I thought, let's give Exide a chance to show what it can do and maybe our loss will be less than 50%. Over the next few quarters, the business did terrible and the stock dropped in value. Finally in November, I threw in the towel and we exited our position entirely. In fact had we held on, we would have lost even more. The business continued to slide, it never really came back.

Slide 20

Founded in 1888, Exide is almost a 120 year old company. It's the largest producer of lead acid batteries. Most of you in your cars probably have an Exide product, especially if it was made in the U.S. They have about $2½ billion in revenue. They've got many leading brands, Champion and so on – all over the world. They operate in many sectors. Obviously autos are big, defense is pretty big, aerospace, etc. Exide has a monopoly on submarines batteries, and they recently went into providing battery backup solutions to telecom providers, wireless infrastructure and so on.

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In January of 2002, when I was looking at Exide, what piqued my interest was their senior debt. At the time the business was losing money, Exide had senior notes that were trading at two-thirds off face value. I wanted to look under the covers and see what was going on. If you took out all their secure debt and took out their assets that backed the secured debt, they had about $530-odd million in assets. Against that, they had about 1.6 billion in unsecured senior and subordinated debt.

It looked like a .30 to .35 cent recovery on the senior debt in the event they declared bankruptcy – about where the bonds were trading. On the other hand, there was a serious turnaround effort underway. Management understood very well that they needed to hunker down, cut costs and quickly get to profitability. If they succeeded along those lines, then that senior debt obviously gets paid at par - and we get about a 40% annualized rate of return over a three year period of holding that debt. So the bet was simple: head I win, tails I don't lose much or break-even. A classic Dhandho type bet. Of course, it didn't quite work out the way I had it planned.

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Exide's businesses had operated at about a 25-30% gross margin historically. They need a 23% gross margin to break even. At the time I was looking at them, the gross margin was at 20% with all the intense focus on cutting costs. I believed they'd be able to raise margins by 3-5% and get back on track. Reality was different.

About three months later they had a liquidity crunch, couldn't raise more debt and filed for Chapter 11 bankruptcy protection.

Slide 23

After that Exide went through three CEOs, a lot of senior management changes, and a lot of spending on the whole bankruptcy process. They continued to hemorrhage cash in the business. Over the next three years when we held it, the $550MM cushion that

protected our investment in the bonds gradually started to erode. In 2003 and 2004, the tangible assets of $550 MM were reduced down to about $200 odd million.

When they exited Chapter 11, most businesses have an unfair competitor advantage because they shed all the debt versus all the competitors. Usually businesses right after Chapter 11 do much better, but these guys, in spite of getting rid of all the debt, just continued to slide. The key to beating the indices is to minimize loss of capital in investments. I am very reluctant to sell a business at a loss – I usually only do so under two circumstances:

1. It is absolutely clear that our thesis is wrong or developments have changed the facts the thesis relied upon. In this circumstance, if present intrinsic value is below present stock price, we will sell.

2. We can sell any losers after the holding period exceeds two years.

In some cases, I may be wrong about intrinsic value and never realize it. #2 allows us to exit such situations. Two years seems like a long-enough time for market efficiencies to get a stock close to its intrinsic value.

With Exide, the picture on what our investment would be worth eventually was murky throughout the bankruptcy process. We got some clarity when they exited bankruptcy and I gave the business the benefit of the doubt and some time to try to get to a full recovery of invested capital. Over the next few quarters, it did not look like the ship was sailing in the right direction. More than two years had transpired and we sold.

At one point during the bankruptcy process our senior notes were trading at 1.5 cents on the dollar. So we had bought at .35 cents and the quoted price was 1.5 cents – over a 95% drop from our purchase price! The secured creditors had proposed a plan for the distribution of stock that favored the secured very heavily over the unsecured creditors. The plan was very unlikely to pass, but the bonds traded down as if those would be the accepted terms. That was the time to buy Exide bonds!

I had endured so much pain on this holding by that time, that I simply could not bring myself to place a buy order. I remember having a long conversation with Ajay at Merrill about it then. He verified that that we could pick up significant quantities of the bonds at those prices if I wanted to. It was difficult to just look at the bonds in the portfolio - much less buy them. Mr. Market did deliver a very fat pitch and all I could do is stare at my belly button!

That was our adventure with Exide.

Slide 24

Another investment that we made, this was a long time back. This was in 2000 before the birth of PIF2. It was first made by PIFI in September 2000. Sunrise Senior Living is a senior assisted living housing developer and operator. One of their facilities was in Buffalo Grove which was very close to where I worked and lived at that time, so I went into the facility and kicked the tires. We first bought it at $21 dollars a share.

Sunrise went through a business model evolution in the four to five years that I held it. The thesis changed mid-stream when the company changed strategies, so I look at what they were trying to do and got more interested and looked at the intrinsic value again. The approach to figuring out intrinsic value changed dramatically as a result of this shift.

We sold just recently in the last few months at about $51 dollars a share. On average we held for about two years. On average we made about a 100% return on the holdings. We invested about $5 Million and made about $5 Million on the overall position – a 100% gain.

Slide 25

Sunrise's business is developing and providing assisted living housing and services to seniors. They have a whole range of services. You could be someone who is physically pretty fit maybe eighty years old and might need some assistance. They also serve people who are in debilitated health and need a lot of hand holding and services. Sunrise was one of the first businesses to focus on assisted living as a scalable business and they are among the very best. Today they are the largest player in the senior assisted living space.

They acquired Karrington Assisting Living in 1998 and about 10 months later they figured out they'd been taken for a ride. It was a bad acquisition. Karrington was a poorly managed business and they were having a hard time getting that business to function the way they wanted it to. They were losing a lot of money on those acquired properties. They had a really bad quarter. When the news came out, the stock instantaneously dropped from $30 to about $10 on some 25 million shares of volume. I got very interested in Sunrise because their core business model is wonderful.

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Sunrise is two distinct businesses and both are very profitable. They are a developer of real estate, and they are a provider of senior living services once that real estate is leased up. They build assisted living facilities and then get it leased up. Usually most of the facilities are 80-90% leased. When they are done leasing it up, they sell some of these facilities to investors and they retain a contract to manage the facilities. Typically

the facility is sold at about at a 50% premium to the book value of the facility. So they make a very healthy gain once they develop and lease the facility. In addition, they usually retain about 25% ownership in the real-estate. Sunrise manages the facility with a cost-plus contract, so they can't lose money. They get paid 7% above the total cost of running the facility.

On the management side, it is a bullet proof model for making money. On the development side they do better. If you think of it in terms of home building, it's a better business model because of the margins. Once they build a facility and lease it up their gains are significantly higher than virtually any other type of developer of real estate.

It's a wonderful business and they have executed exceptionally well with it. When I made the investment in 2000, their business model was very heavily skewed towards property development. The 7% they made in management contracts got mostly eaten up in corporate overhead. There was 5.5-6% in corporate overhead so they made hardly any money on the management contract and most of the money was with these sporadic real estate sales.

Wall Street would always tell them that their real estate sales are not recurring revenue. The Street felt they should be treated as one-time gains. The company insisted that even though it was lumpy, there's a definitive pattern and solid recurring business model.

They build facilities and they own some of them and every few months they sell a few. It's a pattern even though it's not quarter by quarter. Eventually what Sunrise did is they yielded to Wall Street and segregated out the two streams and hunkered down on lowering their corporate overhead. When I first bought the business, I was looking at the arbitrage between the book value of the business versus the implied value of their real estate. I did not ascribe much value to the earnings stream that the management side produced as it was dwarfed by the real-estate values and gains.

If you go through the last few annual reports and look at the notes on the real-estate assets on the balance sheet, they were depreciating these assets when they were actually appreciating. In addition that market value was typically 50% over book at the time it was developed. The stock was trading for well below adjusted book value, and I just wanted to capture that spread. Effectively, the business was trading for well below the liquidation value of its hard assets.

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Let me give you a little background on the people who run Sunrise. The founders, Paul Klassen and his wife are pioneers in the assisted living industry. Klassen has a Dutch background. They built Sunrise around a terrific model for caring for seniors that

originated in Holland. The Klassens are very passionate about providing seniors with a dignified approach to living. That was what led them to form Sunrise and still is part of the core ethos of the business.

To sum up Sunrise, it is a real-estate developer that has higher margins than virtually all real-estate developers. They are also like a hotel operator, but with guests that stay for several years instead of a day or two. It's a very tough business to run well. Caring for seniors isn't easy. Sunrise makes it work so well because of the passion the founders had and that has permeated the organization. Just as an example, Marriott was in the space as well, and Marriott finally gave up. They concluded that it was very different from their hospitality business and they were looking for a company who would manage these facilities well and they sold all of them to Sunrise and J.W. Marriott, Jr. went on their board.

They have a terrific management team and they run a very good shop. They have a huge demographic tail wind working for them as the population ages and life expectancy increases. Most of the money they get is not from Medicare or Medicaid. It's mostly private pay.

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Sunrise's focus is on the upper echelons of the U.S. and European population and most of their communities are in affluent areas. So, the typical model is there is a son or daughter who's paying for it and the parent is in the neighborhood of where the son or daughter live - maybe five, ten miles away. It's a very good business. It has a huge runway up ahead because the rich are getting richer in the country and they are also getting older. Both the demographics play out for them. They also just started expanding in Europe. Over many years, Sunrise will do very well, but we sold because it got to 90% of intrinsic value. It's already trading 25% above the price we sold at - so much for my brilliant timing.

That's the Sunrise story, and I still love the business – even though we are no longer shareholders. It's a great business.

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Another company we bought, about three weeks after 9/11 was a Brazilian company called Embraer. It's one of Brazil's premier companies – the pride of Brazil. Embraer is a manufacturer of regional jets. That's the primary business. They also make defense aircraft, private jets, etc. Their main business is regional jets. These jets are 30-110 seats and primarily serve short haul routes between an airline's major hubs and all the small towns and cities within 700 miles of that hub.

There are only two manufacturers of regional jets in the world. One is Embraer and the other is Bombardier in Canada. Embraer has a vastly superior product to Bombardier and a wonderful business. So we bought it right after 9/11 when anything to do with airlines and airplanes was severely distressed. We sold earlier this year. About an 18 month average holding period. About a 61% return. We had a gain of about 43% annualized, and made over $5MM overall.

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Right after 9/11 the stock went from 40 to 11. They took a very massive hit, 75% drop in stock price because of 9/11. They faced a huge number of orders being cancelled or pushed out to the future. Airlines were in bad shape. When they got down to $10 bucks, I think they had about $5+ a share in cash on the balance sheet. Literally, you were getting the business for nothing. They are traded on the New York stock exchange as an ADR so it made it easy for me . . . US GAAP reporting, NYSE traded, etc.

I bought first at about $12 bucks and then they went into some more turbulence. You see in early 2003 they dropped below $10 – it was another period of high uncertainty for Embraer. Swiss Air which is a very large customer of theirs went into bankruptcy then. US Air, also a large customer, went into bankruptcy.

On average we paid $18 over the years and we sold at about $30.

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They have a duopoly but for all practical purposes it's a monopoly. If you are an airline looking for a 50-100 seat jet, you cannot go to Boeing or Airbus. The products they have aren't that great. You're left with Bombardier or Embraer, and Embraer has a vastly superior product. So, for all practical purposes, Embraer is a monopoly.

Embraer has a huge advantage because the jets that they are selling now, the 145 to 195 series are brand new. They just redeveloped all of them. They are very nice. They are much better than the old regional jets most of us have flown in. Embraer is a low cost provider with a vastly superior product – a phenomenal combination. In many ways Brazil and India are a lot alike - which helped me in the analytics.

The best engineers in Brazil love to work for companies like Embraer and seek them out. Whereas in the United States, for example, the very best talent we produce, would like to go to work at Google. They wouldn't go to GM and they probably aren't even going to Boeing. The same in Canada, you don't get the best talent going to Bombardier. Embraer ends up with exceptional talent. Embraer has the advantage of superior technical people with the huge advantage in cost. Cost of living and the

salaries are much lower than the United States, but all the sales are in U.S. dollars so you have some of the best of both worlds. Best talent at very low cost.

Several emerging carriers have only recently got their first Embraer jet – so there is a huge runway ahead. In India, Jet Airways is going through the process of placing an order with them – and so are some of the best airlines all over the world. Most of the major airlines are customers: American, Continental, US Air, Italia, Jet Airways, China Eastern, Saudia, Jet Blue, etc. They have a very wide customer base. Even the Indian government just bought a bunch of private jets for government use.

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This is a great business which hit a couple of large air pockets and we could step in to take advantage of the bargain offered. The question I asked myself after 9/11 was: Were people going to fly on airplanes like they did before 9/11? I could not look at the next year's cash flow or the cash flow of the following year. I had to look at what the long term demand for their airplanes. I felt confident that in over two to three years their production and order book would get back to pre 9/11 levels or even higher. Based on that, Embraer looked exceptionally undervalued.

The difficulty I faced with Embraer throughout that period that we held it was the intrinsic value would shift around a lot. In 2003, Swiss Air filed for bankruptcy and cancelled a huge number of deliveries, so their production schedule changed dramatically which affected cash flows dramatically. Similarly when US Air filed for bankruptcy protection, it again led to production declines. They produced close to 200 airplanes a year before 9/11, and that went down to about 120 a year and sometimes just 25 planes a quarter after 9/11. When you cut your production in half and your overhead stays the same, it's a very significant hit. So intrinsic value was a moving target because every quarter I had to look at it, estimate it, and recalibrate based on the likely production 2-3 years out.

We've completely exited Embraer. I still love the business. It's a great business, and we will probably regret selling it – especially when Jet Blue orders more jets from them.

Slide 33

Stamps.com is another company we bought in January of 2004 for about $11 dollars and change. We sold for $20 and change. We made about 75%, holding period of about 14 months, an annualized return of 61% a year and overall made about $4.5MM in PIF2 from it.

With Embraer and Sunrise, you can see most of the money in both of them was invested before PIF4 was even around, but here we made the investment in Stamps.com after PIF4 was operational – PIF4 was very small at the time. We had

around $20MM, in assets in PIF4. At the time we made the Stamps.com investment. We put about $2MM into STMP from PIF4. Subsequently another $80MM of assets came in, so that $2MM gain did not move the needle that much. Whereas, in the other funds, it moved the needle significantly. Fund asset growth crimped the NAV per unit for the funds that were growing the most.

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Stamps.com had an excellent business model, but was very poorly executed during the years of the dot com boom and bust. They went through the usual dot com cycle of euphoria and then bust. At one time STMP traded at over $150 a share.

Stamps.com had no discipline at the time. They had a good core product and technology, but they were spending and losing boatloads of money. The stock eventually went from $150 to $3-4 a share. They brought in new management, hunkered down, and committed to building an enduring profitable business. At its core, Stamps.com is a great business. In fact, it's a fantastic business.

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My interest in Stamps.com came from being a small business entrepreneur for about 15 years. There are services virtually every small business needs. For example payroll service provider, business Credit Card provider and postal meter provider. The dominant businesses that serve this very large market are ADP, American Express and Pitney Bowes.

You find that these three businesses are not only great businesses, but they have massive runways and they do exceedingly well. And if you look at their stock performance over many decades, it reflects the power of the underlying business.

All three businesses are virtual monopolies or tight oligopolies. You usually don't have a way around ADP. Entrepreneurs quickly learn that processing payroll in-house is very cumbersome and quickly move to ADP or Paychex. For many decades, ADP used to be a virtual monopoly but now they share the market with Paychex. Besides these two, the rest of the market has no national brands or dominant providers. And because the market is so fragmented, both businesses have huge runways ahead to grow.

ADP's stock over the last 40 years has done extremely well. If you look at a small business doing $2-$3 MM in sales ADP charges a $100 bucks every payroll period. It's not enough money to even bother with. So most small business owners never even think about it. They set up their payroll service and forget about it. It's a wonderful business from a shareholders' perspective. Recurring revenues are high and the only time you can leave ADP is at year-end. You can only move exactly on year-end, December 31. If you do it at any other time your W-2s are a mess, so it's a very sticky

business. When a business thinks about getting a payroll service provider, there are only two brands that come to mind – ADP and, to a lesser extent, Paychex. Once you sign up, it's very hard to change. Awesome business model for them.

Most small business owners quickly learn the many benefits of having an American Express Corporate Card. AmEx has a big part of the small business market.

Most small business owners are doing a wide range of transactions with AmEX, but because they have a travel business, AmEx has a pretty decent customer service. ADP, however, is terrible because they have a monopoly, and Pitney Bowes is the worst. Pitney Bowes owns 80% of the market and they don't have to deliver any sort of customer service – you have virtually no choice but to deal with them. They have competitors like Postalia, but most small business owners have only heard of Pitney Bowes.

I view it as Darwin's laws at work. These businesses don't have to be very good because they are virtual monopolies/oligopolies. As a small business owner for 15 years, I hated Pitney Bowes they were the worst of the three. I am not in love with ADP's customer service as a client, but ADP gets the job done.

Virtually all small businesses with even low mailing volumes have no choice but to get a Pitney Bowes meter. The alternative is having a staffer spend valuable time going to the post office frequently. Stamps.com offers a way out for small business owners who are just sick and tired of Pitney Bowes and all of the onerous rules. They charge ridiculous amounts for the lease, ink and supplies. Any time you want to change anything there are all sorts of fees and onerous charges.

The first thing I did when I started looking at Stamps.com was to become a customer. Peter Lynch queried his wife on which stores were hot at the mall and my analyst on Stamps.com was Julie Shiposh – our previous office manager. I used the product myself and asked Julie a zillion question on her experience. She thought it was awesome. The price was about 1/3 of what Pitney Bowes was charging us, we could terminate anytime with no termination fees, no special ink was required and Julie loved the fact that she could do it all from her PC. Stamps had a number of features that the Pitney Bowes traditional low-end meter did not – automatic address checking, calculating postage, direct link with Microsoft Word, etc.

When we switched to Stamps.com, all our mail had "stamps.com" etched on the postage. I gave you all a stock tip right on the envelope – to buy Stamps.com. I hope you backed up the truck on that rare event – a stock tip from me! I repeatly put this stock tip on every piece of mail we sent you!

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I looked at Stamps.com and thought that this is a company that can make a dent in Pitney Bowes' unique franchise. Despite the trend towards email communication over mailed letters, non-standard postage is increasing in the United States. What's going down is personal mail. Personal mail is down to less than 1% of total mail, and what's also going down is the standard .37 cent first-class mail. Non-standard mail is rising in usage. The internet has led to a huge surge in online shopping and the USPS has seen rising package volumes along with UPS and FedEx.

If you look at the various eBay and Amazon zShop merchants, it is a category undergoing spectacular growth. These merchants need the ability to ship goods using a variety of services offered by the USPS – media mail, priority mail, parcel post, etc. And for this they either need a Pitney Bowes meter or better yet a Stamps.com subscription at a significantly lower price point with a far richer feature set.

Pitney Bowes has 80% of the market and on average with all their inks and lease charges range from $77 to $168 dollars a month. Stamps.com has less than 2% of the market. Stamps.com costs $16 to $25 a month with no lease, no special inks, no special paper, cancel anytime and better functionality. The challenge for them is to just get the message out to the millions of small business owners. As people get to know about Stamps.com it's really easy to convert them. Once they convert, it's a solid recurring revenue pipeline. $16 a month and they have no cost associated with it - virtually 80%-90% is pure gross margin profit. It's a very nice business. An intelligent private business owner would switch because of the superior product and a dramatically reduced price. The company's growth is only constrained by their ability to get their message out.

They have been growing very rapidly and Pitney Bowes is not willing or able to compete with them at that price level because they would destroy their entire revenue model. So they have no choice but to let this other player nibble at their base. They are not willing to cannibalize themselves. They won't go against Stamps.com with a similar product.

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Stamps.com also has a whole bunch of patents that protect their technology. Whenever there have been attempts to violate their patents, the company has sued and prevailed – even though they went up against giants. EBay violated their patents; Stamps.com sued and finally eBay paid up and settled. Pitney Bowes violated their patents; they also lost and settled. So these patents are pretty solid and have heldup very well in court.

Everyday, when more businesses sign up, their moat increases in size. They also developed a product called PhotoStamps. If you get married or you have a new baby or whatever, then you can put that picture on a postage stamp and its proper U.S. postage. So that's another patented product they own.

I sold as Stamps.com exceeded my perception of 90% of its intrinsic value. It's a fabulous business with a solid moat and a huge runway. I suspect Stamps.com will be valued significantly higher in the years ahead as they grow their revenues and underlying intrinsic value. However, holding on would mean little to no margin of safety as we'd be holding a fully priced or overpriced business. This is risky and would hurt us if their growth engine faltered.

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Over the last few years at the Pabrai Funds annual meetings I've gone through three or four examples of past holdings like the ones I just went through. Here is a cross section of past holdings we've discussed – the slides and transcripts covering these are all on the website. You can go through any of these businesses in detail by looking at the online archives.

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If you just look at this smorgasbord of businesses, two or three things ought to jump out at you. First of all, they are not typical S&P 500 businesses. Secondly, they don't correlate with each other. That's by design, so when I have nine businesses in a portfolio, and I'm adding a tenth one, I think very carefully about the correlation the tenth one has with the other nine. I want the correlation to be as low as possible so when we have Stamps.com and Embraer in the portfolio at the same time that's a good thing because they are probably not going to have the same set of macro events affect both in the same way.

The common theme across the board is that we fixate on buying businesses that are either distressed and/or misunderstood – resulting in a wide disparity between price and value. Distressed Investing and Insurance are mirror images of each other. With insurance you figure out the odds of ugly events happening before they happen. But distressed investing is much easier. With distressed investing, the ugly event has already occurred and the price has already collapsed. Now you just have to estimate how a more benign future plays out. For example, Sunrise buys Karrington, the acquisition fails and the stock prices collapses. Now you can look at the event that already took place and try to estimate future value two to three years out.

Again the correlation between Sunrise and Exide or Stamps and Embraer or between all of them is very little. I'm very confident that there are no single events that have a worse impact on our portfolio long term than that same event has on the S&P 500.

Even when ugly things happen we are likely to do better than the S&P 500 index because of diversity. We've also got very good geographic diversification. That's why I have had a slew of ADRs in the funds in the past like Embraer. Because not being in the U.S., but reporting in the U.S. and having all sales denominated in dollars eliminated much of the currency risk. Plus having a low cost structure by being outside the US was an advantage.

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We went through three amendments recently to the partnership agreements for the U.S. funds. We changed the general partners to an LLC from an S Corp. That was approved by 100% of the partners. The only impact it has is that it reduces my tax liability in California. California has a 1½% franchise tax they impose on the S Corp which goes away with the LLC structure. So that has no impact on partners, but it's a little better for me. We also voted for a two-year lock up on all new money that comes in 2006 and beyond. More than 97% of the units of PIF2 and PIF4 voted in favor of the two-year lock up. Subscriptions that are made after January of 2006 are subject to the two-year lock up. Which means you cannot redeem until at least two years have past. It has no impact on present money in the fund or present investors except the ones who add more in the future.

We added an Advisory Board to two of the Funds, and plan to do that for the offshore fund as well. 100% of the partners voted in favor of that. The Advisory Board really has no day to day role. The only role it has is that if I die or get disabled and cannot perform the function of liquidating the Fund, the Advisory Board would take over and oversee a systematic liquidation and disbursement of proceeds to partners.

My job is simple because most of the functions of the Funds are outsourced. It should also give you more comfort because they are high quality fiduciaries that take on and manage these critical functions, so I can focus on security analysis, portfolio selection, and investment research. These are things I enjoy doing. PriceWaterhouse does our audit and tax work for all the Funds. Merrill Lynch is our custodian and Ajay Desai is here from Merrill. Ajay is our man at Merrill Lynch. Folio Administrator in the British Virgin Islands manages the offshore fund – PIF3. Michael Liccar administers and does the accounting for the U.S. Funds, PIF2 and PIF4. Sonnenschein is our legal counsel for all the Funds. Finally my wife Harina does the updates to the website for free - so the price is right. She does it very quickly. Usually I'm looking for a couple of hours turnaround and I usually get that - which is great. There's a friend of mine with a business called Source4 in Chicago. Pat could you stand up. Pat Fitzgerald's company does all the shirts and pens and printing and everything else that we do and send out to all of you.

Isabelle Secor is the 0.5 employee at Pabrai Funds. 0.3 has gone to up to 0.5 now. She works about 20 hours a week keeping me and the office well organized. Isabelle did much of the heavy lifting to ensure we had a successful annual meeting and dinner.

Because of all of them in the picture, my life is very easy and I appreciate that. Any questions?

Q: In one slide you compared PIF3's performance to the S&P 500 and in another slide you compared PIF2 to the Dow. Why are you comparing with different indices for the different funds?

A: I look at the best of the three indexes over that period for that fund, so in one case it was the Dow and in the other case it was the S&P, so we just looked at which of the three were the best in that period.

Q: Has Katrina created any distressed investing opportunities? Would you take advantage of that? What is your moral stance on this?

A: We're not ambulance chasers, but if there was a business that was inappropriately priced after Katrina, we wouldn't have a problem looking at it and possibly investing in it. We are not wishing for Katrinas to happen. I haven't made any investments since Katrina specifically because of Katrina.

Q: Mr. Buffett used to run a partnership and subsequently got control of Berkshire Hathaway and then morphed it into an insurance and investment company. Do you have any plans along those lines?

A: I have a couple of comments on that. First of all, with Pabrai Funds there is no grand strategic plan to grow by a certain amount. The objective for me personally is to passionately pursue what I enjoy doing on a daily basis so as long as I have fun doing what I am doing I'll continue doing it.

Second, there are no plans to move to a Berkshire Hathaway type model. There is a very good reason for that. I have tried to learn from Warren Buffett and Charlie Munger. Studying their writings and speeches to become a better investor is relatively easy to do and anyone with above average intelligence could learn from them and significantly improve there results.

Buffett the CEO, however, is a very different human than Buffett the investor, and Buffett the CEO is very hard to replicate. I would say impossible to replicate, so the notion of moving to a holding company, etc. requires a skill set beyond investing. It would require leadership and management skills that are very different.

That's one layer. The second layer is that investing in insurance is very dangerous. Buffett and Munger make it look simple because they are so good at it. However, if you look at property and casualty insurers in the country and around the world, the history shows that large numbers of them go bankrupt - virtually all of them have regularly underestimated their loss reserves. For example, they wrote policies when there were no asbestos-type issues and then asbestos came up and caused large numbers of insurers to go bankrupt. When 9/11 happened and insurers had no terrorism exclusions, it hurt them terribly. They had never charged premiums to cover that risk, but did not think to exclude terrorism coverage. As a result, an event out of left field led to big losses. It is a mine field. So I focus on distressed value investing - handicapping the events that have already occurred as opposed to ones that are going to occur.

Q: President Bush is going to spend about $200 billion on Iraq and over $100 Billion on Katrina. What effect does that have on your thinking and the investments you're looking at?

A: I'm a bottoms-up stock picker, so I look at a business like Stamps.com. What impact does Katrina have on Stamps.com. Not much. In a few public companies Katrina probably has a big positive or negative impact. And if I were aware of these and their stock prices did not reflect the new reality, it's worth looking into.

However, for most businesses, the micro issues trump the macro. If you owned a neighborhood gas station, whether or not another one opens up across the street has a lot higher impact than if gas prices go up or down 20%. So, I virtually never look at a macro event and then go looking for a business to invest in.

Q: There's lot of capital going into hedge funds and private equity. Private equity is looking more and more at public markets as a place to invest. Are you concerned about the market being overheated and overvalued?

A: Since 1999, when Pabrai Funds started, I operated in an overvalued market environment for the most part - other then a couple of dips in the last few years. The U.S. Equity markets are less overvalued today than they were in 1999, but they remain overvalued.

Given this environment, the modus operandi is to do only anomaly based investing. I'm 100% focused on investing in distressed or misunderstood businesses - like with Stamps.com or Embraer. We usually invest without a specific catalyst other than value and have a time frame that is typically longer then most investors have. The combination of those usually gets us decent results. There are thousands of stocks listed in the U.S. and we need three or four good ideas a year. I haven't had trouble finding that number over the last six years. I suspect that it will continue in the future but it won't be smooth. It will happen in unpredictable clumps. We might find three in a month and then none for six months, etc.

Q: Mr. Buffett has stated that Berkshire Hathaway's future returns are handicapped by its size. What are your thoughts on fund size and would you close to new money at some point in the future?

A: There is an inverse correlation between fund and performance so the larger the size of the fund, in general, the performance will go down. At Pabrai Funds I don't get compensated based on assets under management. So there is no plan to mindlessly keep adding assets. With under $300 Million under management, I don't believe we're too big yet. We could be a few hundred million dollars bigger and still not have much difficulty in getting funds invested in good ideas over time. Unless markets got severely undervalued, the plan is to close the funds well before we get to a billion under management.

There is likely to come a time when we'll need to reduce or shut-off inflows. We can stage the seal off. We could start sealing off specific funds to new and/or existing investors. And we could also do it for all funds at the same time. It depends on the circumstances at that time. We also have natural seal-offs. PIF2 has been closed to new investors for over two years due to all the slots being taken, so inflows are naturally small there already.

Market levels affect this as well. For example, if the Dow went to 3000, we could put $50 billion to work quickly. However, if the Dow went to 30,000 we probably would have an even harder time investing what we have under management today.

Q: Have you been investing in debt securities lately?

A: No. We've had a total of four investments since 1999 in distressed bonds – Budget, Exide, Level 3 and one we hold presently. All four investments were made as proxies for equity investments. The risk/reward equation made it far more attractive to be on the debt side and be higher on the balance sheet. So we haven't done a whole lot - less than one investment a year in distressed debt, on average. It's a proxy for equity, so anytime I take a look at a business which has a leveraged balance sheet, I always take a look at debt to see if we want to be there versus the equity.

Q: Have you considered adding some modest leverage like you used in the past?

A: If Pabrai Funds ever decides to go down the path of using leverage, I'd first inform all of you and give you at least one opportunity to get off the bus. Buffett says it well. He says, that it doesn't make sense to marry for money in most cases but it absolutely makes no sense if you're already wealthy. There are six sigma events when you are levered which will force you to liquidate at times that are the absolute opposite of the time the you want to liquidate. I don't want to be in a situation, especially with other

people's money where we are looking at forced liquidations at the worst possible times. We don't want to deal with a margin call - ever.

Q: With increased volatility have you considered buying long term options like LEAPs?

A: Pabrai Funds is not allowed to buy derivative instruments – and that is by design. So we have never delved into derivatives. In any case, we wouldn't want to go into LEAPs because, generally speaking, when we make investments we don't want a forced time constraint. Markets can do very unusual things for very long periods of time. We don't want to have a permanent loss of capital because time was not on our side.

Anytime you're buying a LEAP, your paying a premium for time. If the LEAP expires and the stock didn't budge or declined, you have a 100% loss of capital. That's not a scenario that I'm very excited about.

Regarding volatility, it has never bothered me. Volatility is our friend. I have never tried to reduce short-term volatility – we've hopefully assembled partners who are looking at long-term results, not short-term volatility. There is no energy or time or dollars expended by Pabrai Funds to temper volatility.

Q: I have a follow-up on the team size question. So it seems as though Buffett decided that the ideal size is two not one - if you include Munger. Do you ever feel like you really would want to or feel the need to have discussions about what your ideas are with other people? Do you feel you'd prefer to bounce ideas off your Charlie Munger?

A: Every few months I get a phone call from someone who says, "I am your Charlie Munger." Some how I get the feeling that when the real Charlie Munger calls he would never say that. That is not how he would begin the conversation. I'm still waiting for the real Charlie Munger to call and would add him to the mix immediately.

At Pabrai Funds I have several times leveraged the partners on specific investments because we have so many entrepreneurs and CEOs in our midst with deep domain knowledge. Many times when I have looked at an investment, I have looked at the list of partners and then presented it to one to three of them with my analytics and said to them: "Please don't go buy the stock, but could you tell me if I'm thinking about this the right way; What's your take on it or what insight do you have that I may not know?" What I've found is that many of these partners are probably better than any Wall Street analyst in that space because they know the industry so well and many times they have come back to me with data points that I would have never have thought about.

So for now we have a "distributed Charlie Munger algorithm." It's spread out among all the partners. Buffett and Munger have a very unusual relationship in the sense that it's not a consensus based relationship. Many times Buffett acts without talking to Munger.

Sometimes he acts when Munger disagrees, so it's not a team making a decision. It is a person acting on his own and once in while probing to get an opinion from another person. It's very different from a traditional investment team.

Case in point, I talked to a couple of folks with deep domain knowledge in the battery/transportation business. They encouraged me to go into Exide. Charlie Munger failed me then.

Q: What's your investor mix like right now between institutional investors and individual investors and how much time do you devote to marketing your fund?

A: Pabrai Funds does not have much in the way of assets from traditional institutions. Pabrai Funds rules come across as quirky from an institutional perspective. They take a pass very quickly after they understand some of the rules. For example, we don't discuss holdings, you can only redeem once a year, we don't report monthly or on even quarterly boundaries, so institutions have problems with these rules.

I am not unhappy about the lack of institutional assets. I'm delighted to have 100% of the investors be individuals and families that are focused on the long-term.

As far as marketing goes, we are in what I call inbound response mode. We're not allowed by SEC rules to advertise or solicit, so if someone refers someone to us or someone contacts us, the modus operandi is pretty simple:

1. We ascertain that they are accredited/qualified investors.

2. Isabelle then sends an information package out to them.

At the most, we usually do one email follow up and maybe once a year or something, nudge them by email and that's it. It's very unusual for me to get on an airplane to meet an investor. When the assets were really small, I did that a few times but I haven't done that in quite awhile. If I'm in a city for something else and there are potential investors that want to meet up that's fine.

And the phone rarely rings with potential investor calls and we probably have had less than one potential investor a month showing up at our offices.

Q: Are you considering increasing your bid on eBay this year to have lunch with Warren Buffett on eBay?

A: Well, I've tried and failed for three years now. The plan is to go back on eBay next year and give it another shot. Let's see what happens. Wish me well.

Q: Can you say a little bit more about that SEC investigation that went on?

A: We were contacted by the SEC, in July '04. I believe they were reacting to an article that Forbes had recently done listing some of our historical performance numbers, and the numbers sounded too good to be true. They contacted me and subpoenaed a wide range of documents from us. They wanted to look under the covers, so I invited them into our shop to dig into anything they wanted to. Four members of SEC's staff spent three days with me at Pabrai Funds offices. A few weeks later, they closed the investigation with no action and advised us of the same in writing. Other than subtly implying that we ought to password protect our website, they found nothing wrong and closed the investigation.

Q: Given your untraditional background in securities analysis and running your own company, etc. How do you think that makes you a better investor compared to the typical profile of the folks running mutual funds or hedge funds?

A: It is a huge advantage for an experienced entrepreneur or a CEO to delve into security analysis – if they have the passion for it. Buffett has a quote about it: "You can talk to a fish for a thousand years on what it is to walk on land but one day walking on land is more revealing than a thousand years talking about it. And one day running a business has the same sort of value."

It is surprising to me how many money managers have never ever met a payroll or run a business. They don't get all the messiness that exists in the real world. They look at the world through spreadsheets, build nice models several years out in nice increments, earnings going up every quarter, and when the business hits a pothole or airpocket, they get rattled. The reality is that there are virtually no businesses on the planet that function in that manner. Even a business like Microsoft, which has done so well over all the years, has had all sorts of gyrations over the years.

There is a reason most entrepreneurs don't do so well as stock pickers – even though they have all the skills for it. When they investment in the stock market, they forget all the rules that they apply when they run their businesses. But if an entrepreneur took the framework that they used to run their business and applied the same framework when they selected investments with the same rigor, they would do better than most securities analysts.

Most security analysts would do much better if they spent five years running a business and then came back. It's an advantage. I do not have a CFA or an MBA or any business degrees. I have not gone down that path but I have spent a lot of time running businesses and understanding the Buffett/Munger/Graham framework. That framework, coupled with my empirical and visceral experience with running businesses, has been very useful.

Q: Last year you spent a fair amount of time tracing your personal investment growth - from your original discovery of Warren Buffett and onward from there. My question for you tonight is whether Mohnish Pabrai is still growing in his investment skills and if so what have you learnt in the last year and how might it impact the future for Pabrai Funds?

A: One thing about investing that I like is that all knowledge is cumulative. It's not like you get to apply this knowledge every day, but it does build up over time. Over time there is a rich history of mistakes made and lessons learned. There is also more reading done. I'm reading all the time, but clearly I know more about the way the world works today than I had a year back.

I've probably got a better framework today than I had a year or two ago. Hopefully that will continue to be the case. What makes it a great discipline is that the knowledge builds and one can always learn and get better. Investing is perhaps one of the broadest of disciplines.

Q: Can you recommend some books that you've read that you've found helpful for investing?

A: The classic is Roger Lowenstein's book, *The Making of an American Capitalist*. It came out 12 years ago, but to me that's the best Buffett biography. More recently, *Poor Charlie's Almanack* which got released at this year's Berkshire meeting is fantastic. I rate that as the best book I've ever read. If you're looking for one book, Poor Charlie's Almanack is loaded with a lot of wisdom. If you spend some time on that book, it's pretty much all the wisdom Munger picked up in 82 years of living, so there's a lot of it digested and condensed in that book.

Q: Are there any advisory board members here tonight?

A: Would the advisory board members stand up. We don't have the PIF2 advisory board members here – they're all in Chicago. The three PIF4 advisory board members all reside in California. Two of them are here, Randy Gusikoski and Navneet Chugh. The third member Sam Maslak lives in your neck of the woods in Woodside, California so maybe you can contact him there. Randy and Navneet, would you please stand up.

Q: Thank you for having us again. I have a question about the Exide notes investment. Did you consider your Exide notes that you have as part of the 10 positions that you have? Is that considered a workout position?

A: The bonds investments are just like the stock investments – they are just a proxy for equity. I approached the Exide investment like an equity investor. It's just that in that particular circumstance there was just enough of a return by holding notes to make it attractive - and that gave me more significantly more protection than being an equity

holder. The analysis is the same that I would make if I was shareholder, and it is part of the 10 positions. And yes, it is a special situation/workout type investment.

Q: Having the benefit of 20/20 hindsight on Exide, what do you think you've learned. How do you characterize that and how does it effect future investments? Would you do something differently?

A: Generally speaking, one learns mostly from things that don't work. Success does not teach you a whole lot. I spent a lot of time thinking about what happened with Exide. While the numbers were compelling, the one thing that I ought to have paid more attention to in a situation like Exide was the nature and quality of management. We have Bob Lutz who was the CEO of Exide at the time. He's a flamboyant car designer. Now he's at GM. He has a website and a blog. Very talented car designer, but he had absolutely no skills in running a battery maker. I didn't appreciate when I was looking at Exide how much value bad management could destroy.

They destroyed 100% of the equity value and then they destroyed 93% of the bond holder value by the time we sold and probably more than that now. We've had a total of four investments in bonds and senior notes since the funds started six years ago. I don't think we've ever had more than one in the portfolio at any one time. Two of these bets didn't work - Exide and Budget. Budget was heavily affected by 9/11, so that's not a very crystal clear example. Both Budget and Exide were ones we lost money and with both of them the quality of management at the top was problematic.

With the other two, one is a present portfolio holding so we will discuss that at a future meeting, but the other one was Level 3 and was heavily based on the nature of management and that worked exceedingly well because I understood the nature of management extremely well – in addition to the balance sheet realities.

Q: Do you have any succession plan for your replacement?

A: We just set up an advisory board. Before the advisory board was set up, the way that the funds were set up was if I died or got mentally disabled then the limited partners in the fund would elect a general partner who would oversee the liquidation of the fund. What we changed that to now because now that's an unwieldy process – since we have hundreds of partners. We changed that to setting up an advisory board for the funds with three individuals. If I die or become mentally disabled, they would appoint an individual as general partner and then that individual over a three month period would liquidate the fund. The checks and wires would go out and we'd ask PwC to ratify the numbers and report the same to all investors.

Q: My question is a follow-up to a previous question. When will you stop taking new money? Is there an option of closing an existing partnership like before and opening a new one? The second follow-up question is will that really matter in terms of the performance of PIF4?

A: The way the SEC rules work is that each of these funds has a limited number of slots - other than the offshore fund. PIF4 is limited to 500 total investors. If we hit that 500 limit, the funds cannot take any more investors. I cannot start another fund and take more investors. They aggregate the total number of qualified investors no matter have many funds you have and cap it at 500.

We have a hard limit of 500 total investors who are qualified. We have a hard limit of 100 accredited investors. We have a hard limit of 100 IRAs and we can have an unlimited number of offshore investors. The total pool of investors I'm allowed to have is 700 U.S. based investors and an unlimited number of off-shore investors. There are no plans to start any new funds.

As discussed earlier, PIF4 went through a 15-20 fold increase in assets over the last two years – it did need to add assets to get critical mass. Such a huge delta does impact performance as I illustrated. I don't expect huge increases in PIF4 assets in the future, and I do expect long-term performance of all three funds to be pretty similar. No idea which one will do the best.

Q: This time last year you said that you were focused heavily on special situations – workouts, bankruptcies and the like. Is that still the case?

A: Since 1999 until now we've been operating in what I consider significantly overvalued markets. This has led to significant head winds for us. I cannot make investments in typical S&P 500 companies – they are mostly overvalued.

The modus operandi for the funds has almost been to focus almost entirely on special situations. I am looking for businesses that are misunderstood or have gone through a one time event that has collapsed the price - like the bad acquisition Sunrise did or Embraer after 9/11. Stamps.com is an example of a misunderstood business. It really didn't go through a bad event but it went through a change. Its management got religion to be a cash generator. Unless you drill downed and look under the covers you really wouldn't have seen what was going on in some of these businesses. Distress and/or misunderstood businesses are what I'm primarily interested in. In the last five years, that hasn't changed. That's the way I approach it.

Q: To get back to management, how do you evaluate management? Do you go talk to management? Do you find any value in that at all?

A: I virtually never try to meet management. This is a rule that comes straight from Ben Graham. The one skill CEOs have in common across the board is that they are awesome sales guys. Generally speaking, that's how they got the job they have. They are also optimists by nature. You can't be a pessimist and be a great leader. So you'd be interacting with highly persuasive sales guys with an optimistic view of the world. If you come into their sphere of influence you're likely to be emotionally swayed or be affected by the charisma, etc. That would create a negative distortion which will not help you – it would hurt.

Therefore Ben Graham recommended that one shouldn't meet management and make decisions based on that. What he recommended was looking at long histories of the way managements have performed. When I'm looking at a business and it's the same management team that has been running for five or ten years, I'll start with a ten year old annual report. I'll work myself forward until today.

I'll look at what they said in 1995 and compare it to what happened a few years later. Did he under-promise and over-deliver? Or did he over-promise and under-deliver? With the benefit of hindsight, we can get a pretty clear picture. We can overlay the understanding of the business with our understanding of the nature of the individual and try to extrapolate going forward.

Q: What industries are you interested in investing in?

A: There are some general rules. I'm not interested in investing in rapidly changing industries which means, generally speaking biotech, tech, or anything that is moving real fast is not of interest. Google is not of interest.

I'm looking for businesses in steady state industries. I need to ask myself honestly if a particular business or industry is within my circle on competence. Is it something that I can get my arms around if I spent sometime reading about it? Most businesses that are publicly traded are outside my circle of competence. I would say 5%-10%, at the most, might fall within it and I limit myself to those.

Q: You exited Sunrise when it hit 90% of intrinsic value. After that you mentioned that its up another 25% and you probably should have stayed. Can you elaborate?

A: I didn't say I should have stayed. I said that Sunrise was likely to continue to do well and, in hindsight, selling might not look so bright. My estimate of its intrinsic value was probably too conservative and it is likely headed higher. But conservative or not, I have to base decisions on my estimation of intrinsic value. Also, most stocks in public markets at most times trade at a premium to what I believe is there private market

value. You get a premium valuation because of liquidity. I don't think it is prudent to count on this premium and hang-on.

Q: With Stamps.com you recalculated the intrinsic value several times, right?

A: Yes.

Q: Why didn't you recalculate with Sunrise?

A: I did recalculate with Sunrise too. With Sunrise, I was very comfortable that mid-50's was a fair value for the business. They've continued to run the business exceptionally well and now the street is very interested and fully tuned in. Sunrise, at present prices, is probably trading over its intrinsic value. You're never going to get precise numbers on intrinsic value. I always focus on what I call "conservative intrinsic value." You could probably do a calculation on Sunrise today and come up with a calculation which says that it's below intrinsic value. You could also do a calculation which is conservative which might suggest that it is above intrinsic value.

Sunrise is likely valued at between 80% and 120% of intrinsic value today based on who does the calculations. I don't want to be aggressive on the way I look at it. Another value business had appeared on the horizon and I needed cash and I looked at the portfolio and so I made the swap. I would not have sold Sunrise at that price to go to cash.

I would have probably waited for surety that it was over 100% of intrinsic value before I sold and went to cash, but when I had another opportunity and it looked very good then I said yes. Let's go ahead and make that switch. In fact just for curiosity, I tracked the two since the switch. I have done better with the new one, but that's for just a few months of data – it doesn't mean much.

Q: You may get a chance to buy Sunrise again because the tragedy of the bus accident with Katrina victim seniors on board. I believe that bus was operated by Sunrise.

Any comment on long-term interest rates and the outlook for the global economy? Long-term interest that are so low and it seems like we live in a world that's getting smaller and smaller everyday. Everything we do is impacted so much by the whole global situation. Can you comment?

A: I have nothing intelligent that I could say to you about that. I have no idea about the direction of interest rates or how well the global economy will do in the near future. I do a bottom-up analysis. In a business like Stamps.com or a business like Sunrise or a business like Embraer, macro factors will affect it. They'll have some impact, but they will be dwarfed by the micro factors. The effectiveness of Stamps.com's marketing plan

to convert Pitney Bowes customers has a much bigger impact than interest rates moving a 100 or 200 basis points.

For most businesses, the micro overshadows the macro. It's not that the macro has no impact. Macro matters – for example 9/11 hammered Embraer's business revenues for a few years. But, macro gets to be very difficult to handicap and very difficult to forecast - at least for me.

So I just stay out of trying to make guesses on things that I don't have a high degree of conviction on. Investing is a game of probabilities. There is no business on the planet that we could say with surety would be here tomorrow. We could have a big asteroid come in or Yellowstone could erupt.

There is no such thing as a blue chip, rock solid sure bet. It's all a range of probabilities. One needs to handicap, with a high degree of probability, the expected outcome. And, if that outcome gives you enough of a return, then it may be a bet worth making. That's the way I approach it.

Q: Do you limit yourself to the stocks within your circle of confidence or if you come across a discounted stock then you develop the expertise in that new industry?

A: Yes, generally speaking I'll stay within what I know other than if something peaks my interest. I didn't know the battery business that well, but I said let's get under the covers and try to figure it out. I felt that I might able to get a decent handle on the business with some reading and digging.

In general, I'm not willing to just randomly go after things that are very cheap without understanding the business well. There has to be something that triggers my interest which is beyond just the price. It has to be something else that I understand about the business. Exide was a company that was around when I was growing up in India - we had a gas station right across the street and the Exide brand was pretty prominent. I probably saw the brand daily since I was two years old.

Q: What impact if any do natural disasters have on your funds?

A: Depending on the kind of natural disaster it can be a massive impact. There is a range. You don't want all the businesses in your portfolio on the California coast. You don't want all the businesses in any one state. In fact, many of our businesses have significant operations outside the United States. I try to look at geographic diversification as an important facet of the portfolio.

With many natural disasters, the businesses can recover and come back. Others may have a hard time. I'm willing to wait until they recover and come back – if the facts suggest that. We have no urgency to sell.

Q: Going back to the question of when you sell. Often when you've sold companies at 90% or at about 90% intrinsic value they've continued to rise. Could it be - I can't believe I'm asking you this question - that your assessment of intrinsic value is too conservative and maybe too low?

A: That's a good question. It's a very fair statement that at Pabrai Funds the definition of intrinsic value is perhaps too conservative. Intrinsic value is something that it's not precise – it is always an estimate or a range.

Frontline is a business that we sold at $14 and change. It's at $42 and change right now, but it spun off another business. It gave a bunch of cash back. If I include all that back, it's at $80 or $90 dollars today, and it's less than two or three years since we sold. We missed out on a six bagger after we sold. Tesoro is one we sold at $17 or $18 and it's in the mid-60's today.

With Tesoro, it's a Fortune 500 company that saw its stock vacillate between $1.33 and $60+ all in less than 3 years. It is quite stunning to see a Fortune 500 business offer the opportunity to have a forty bagger in three years.

In those specific two examples I have no qualms about selling. Those are very cyclical businesses and there's no way I could have run any calculations which would have gotten me comfortable when their intrinsic value was $80 or $60. It is true that Pabrai Funds is probably a klutz when it comes to selling. Just the way life is. The amazing part is that inspite of being so incompetent at selling, the results are quite acceptable.

My take is that it's not my money, it's your money. Because it's your money, I always want to be conservative. I don't want to be playing at the edge, so to speak. All decisions we want to be, what I call, no brainer decisions. If it gets close to the edge, I'm very willing to let it go and it if rises subsequently – such is life.

I would not sell an Embraer or a Sunrise unless it went over 100% of intrinsic value or I had a compelling need for the cash. If the business is a special situation play and mediocre then I am more rigorous about getting rid of it at 90%.

Q: Since last year, the SEC has forced you to make your holdings public. Has that made your life more difficult?

A: The investor is referring to the fact that there's an SEC rule that if any institution has over $100 million invested in U.S. stocks, they have to file what they call a quarterly 13-F form with the SEC. That 13-F is a public document. Anyone can pull that up on the SEC or EDGAR website. As of the end of last year, December 31, 2004, we hit that threshold.

Regardless of my perspective, we are required to file the 13-F every quarter. What the law doesn't require us to do is disclose all the analytics behind those positions. The way that things have played out is that there hasn't been much impact as a result of the 13-F filings.

I have not seen a significant rise in the prices of securities we hold because of the disclosure - which is a bummer - an ego deflator. I follow Buffett's perspective. He has said that specific investment ideas are rare and valuable and they're like intellectual property and subject to being lifted. Therefore he only discloses them to the extent required by law. That's pretty much what we follow.

We also went to full GAAP audits. Our annual audit reports now have a listing of all positions over 5%. Most partners don't even get to page three of the audit report, so I don't get too many calls on that either. Both of these have been going on for eight or nine months and has had virtually no impact on what I do. The policy of not discussing anything related to specific positions mentioned in the audit report or the 13-F seems to work well.

Q: Mohnish, I have a question to you in regards to being more proactive as a fund manager. Some of the fund managers like Daniel Loeb send some very interesting letters to management. In some cases we have a big enough stake in a business that management is likely to be at least somewhat responsive and open to dialog. I haven't seen you do much in terms of interacting with them. As you get larger, do you think that is something you would move toward?

A: Buffett has a quote that goes some thing like, "If they need my help we're both in trouble." We have no interest in being active investors and getting involved with management. I have no plans to ever enter any equity position with the intent of being active.

Certainly, I vote the proxies very carefully. I look at choices presented and try to vote them to the best of my ability, but I'm very reluctant to pick up the phone and call CEOs and throw our weight around. Unless there's a very egregious situation or something where we've given it enough time and such, we might get down that path. In the last six odd years, we haven't gone down that path at all. It could happen in the future, but it would be very unusual for Pabrai Funds to be an activist.

Q: For new investors – is there a minimum investment?

A: For U.S. investors the minimum investment is one million, and for non-U.S. investors outside the U.S. it's a $100,000.

Q: Did you buy Exide again below 10 when it dropped in 2003?

A: At one point, Exide went to .02 cents. We were looking at a 93% (paper) loss of invested capital at that time. There was a proposal that the secured creditors had made that was very unfavorable to Exide senior unsecured note holders, and there was very little chance – no chance - that proposal would get accepted in bankruptcy, but the price of the unsecured notes totally collapsed at that point.

The economics of buying then would have been that if that proposal had been accepted we would break even or make a little bit of money but if it got tossed out, we would make a lot of money. Those are wonderful odds to bet upon. But Exide was so ugly for me over that holding period that I couldn't bring myself to add more to it. Clearly, it was a mistake, I should have added more at that point.

Q: In the case of Embraer, when it dipped back down to 10 in 2003, did you pick up more of it then?

A: Yes, we did.

Q: So it ran up back down below your initial buy point and you bought more?

A: Embraer was a very fluid situation because there were times where intrinsic value based on expected cash flows was north of $45 or $50 a share, so we were willing to buy at $22-25/share. And then they'd get big cancellations, then they'd re-jiggle their schedules and reduce production. Naturally its intrinsic value was now lower.

That is why we ended up with an average buy price of about $18 or so. Margin of safety helped us make some money on Embraer and, more importantly, made sure we did not have a loss.

Q: Last year I asked you at this meeting if you had any interest in investing in India and China and you weren't too thrilled. I'm here to report to you that we have put some corporate pension money in an India mutual fund that doubled last year. Given that 40% of the world lives in India and China and given that the U.S. GDP is growing at 3-4% a year while India is growing at 6-7% and China at 8-10%, I'm wondering if Pabrai Investment Funds has learned anything new in the last one year?

A: The India-China answer is the same as last year. The two are very different so I'll take them one by one. China is almost an automatic pass mainly because I am clueless about Chinese GAAP. Also, corporate governance, ethos of management, etc. changes dramatically once you leave the shores of North America. I don't read Chinese, and most of the businesses there that are ones whose names I've likely never heard before. I probably have never have been a consumer or even have any familiarity with their

products and services. Sticking to circle of competence is fundamental. China is way out of circle of competence, so it's an easy pass.

India is a little bit different because I was born and raised there, and I visit frequently. With the mostly British legal framework, you can look at Indian GAAP and adjust for the delta between Indian GAAP and U.S. GAAP.

In my opinion investing in India is difficult without being there and without being singularly focused on it. You have a significant number of public companies but large numbers of them are family controlled. You're a minority shareholder and corporate governance and management ethos leads much to be desired. Many of these businesses are run for the benefit of the family and not the minority shareholders.

There are some great pro-shareholder businesses like Reliance or the Tata Group, but most of the Indian businesses that are publicly traded are in it for the benefit of the promoters. To invest in those businesses I would have to focus solely on them, relocate and purely focus on a small sector within that space.

Clearly the demographic trends are hugely in favor of India and China. Both economies have very high GDP growth rates, and I have no reason to believe that'll slow down anytime soon. Nonetheless, it's not ideal to start looking at markets when they are up 70% in the last one year. Many Indian businesses have high growth ahead of them – I agree with that, but they also aren't trading at single digit multiples of free cash flow either. With many of these businesses if the growth does not materialize, there is no margin of safety.

The second thing is that we need just three or four ideas a year. I'm very comfortable with the ability to find them in the United States or Canada and generate decent returns.

In fact, to that point, there's a mutual fund, I think the name is Mair Powers Fund in Minnesota and they have a mandate where most of the investments have to be in Minnesota based businesses. One would think that's a huge disadvantage, but if you look at Mair Powers track record they are probably in the top one or two percent of mutual funds. They got there by just investing in businesses based in Minnesota.

They are within two hundred miles of most of the businesses they invest in. They understand those businesses exceedingly well, and they also understand Minnesota related nuances really well. Sticking to one's circle of competence is a huge advantage. It is counter-intuitive, but having a laser focus on a tiny circle of competence is a huge advantage. One does not need to look at thousands of businesses to find three of four good opportunities a year. The US offers us plenty of opportunity to do well – especially if we fixate on distressed or misunderstood businesses like we have.

I probably have very little understanding of 99% of the public companies in India, so it's a very easy pass. Ask me again next year – who knows, I might have learned something by then.

Q: I understand that your 13-F Form is available on the SEC website for anyone to view. Is the audited report by Pricewaterhouse only available to current investors?

A: It goes out to all the current investors, and if a prospective investor requests it, we make it available to them as well.

Q: I've noticed that most of your holdings are small cap names. Looks like you are focused on small businesses. Why then do you own Berkshire Hathaway?

A: I've historically shied away from the largest businesses. I wrote in my book about Pabrai's Law of Large Numbers. Clearly there is more inefficiency among the smallest businesses. The largest businesses generally are widely followed, more analysts and so on. It's less likely that you'll get wide mis-pricing unless you have discontinuous events like 9/11 and such.

In general, I don't have interest in the very largest of the businesses mainly because there is significant efficiency at those levels. I don't talk about the present portfolio, but I'm going to talk a little about Berkshire Hathaway. Berkshire Hathaway is not a typical portfolio position - it doesn't trade at present at half off. It is what I call a placeholder which means it's a proxy for cash. It sits in the portfolio while we're waiting for a 50+% discounted business to buy. It will be unloaded at a profit if something else shows up. There are very few businesses that I would give placeholder status. I'm very comfortable giving the messiah's business placeholder status at present prices.

Q: What are your thoughts on AIG?

A: I have never analyzed the AIG. Mainly because its price never really collapsed. I assume AIG was fairly or overvalued before the scandal. It only took a 30% or so hit at the bottom. If it had gone to $10/share, I'd have been all over it. And plus, its size was a deterrent and we already have a lot of insurance related exposure in our portfolio.

Q: This is a continuation question. Given that you are the only person handling these funds, could it be a limitation in expansion and going in and getting a team of people to help you out and then diversifying more into other funds, your opinion please?

A: There are a couple of comments that I have. One is that distressed value investing is contrarian in nature. Let's say you get a team of very smart investment professionals in a room and they look at investments as a group and they had a modus operandi which says that they will invest only when they get consensus. What would end up

happening is you'd get consensus to buy Cisco in '99 and you would have a hard time getting consensus to buy Level 3's distressed debt in 2002, for example.

In general, it's hard to get intelligent people to agree on stuff that is hated and unloved and in meaningful quantities. As you add more team members to an investment team, you will move closer and closer to the buying the flavor of the day and the odds of beating the market go down dramatically. In investing, the more people you add, the worse off you are. The best investing teams are small.

The second thing is to take a look at Mr. Buffett. He manages over $100 Billion in assets, runs a public company with 180,000 employees and plays bridge for 10-15 hours a week. He has no one helping him make investment decisions. There are no investment analysts helping him. So clearly, a single human doesn't run out of capacity at even $100 billion in assets.

The human brain is clearly capable of quite a wide range. I have more than enough time to do what I'm trying to do because I'm only trying to make about, on average, one or maybe two investments a quarter. If I added people to the process, the results would suffer. Team size being small is very critical for trying to beat the markets. You can see that in Berkshire Hathaway. You can see that in most mutual funds and hedge that do well. An ideal team size is one because then you don't have this whole consensus issue. Investing is not a team sport.

Q: Is the main concern for not looking at private companies their liquidity?

A: The funds legal documents do not allow investments in private businesses. That is by design. We feel we have a large enough arena with looking at public companies. Also, we cannot invest in private businesses because we don't have a universal way to value them. We report net asset values every month and every other month depending on the fund. We need to have a means of arriving at a value and don't want to go into trying to put valuations on private businesses. Plus it is a huge advantage to invest in businesses where pricing is determined by a par-mutual type auction-driven mechanism.

Q: Mohnish, if we invested with you in a traditional IRA, would there be any problem in converting it to Roth IRA?

A: All IRA investments are through a custodian, so you would make that change through the custodian. You and the custodian would just inform us in writing and we'd change the legal name, etc. It's past 6:30 PM and I'm sure you're ready for cocktails. I'll take one last question.

Q: If the market got trashed to some great extent - I'd say an extraordinary amount. You said you'd still wouldn't use margin – why?

A: Pabrai Funds used to use leverage in the first couple of years then we decided to cease all use of leverage in 2002. In hindsight, I should never have used leverage in the first place. Especially with other people's money.

Buffett says it well - it doesn't make sense to marry for money in most cases but it absolutely makes no sense if you're already wealthy. There are six sigma events when you are levered which will force you to liquidate at times that are the absolute opposite of the time that you want to liquidate. I don't want to be in a situation, especially with other people's money where we are looking at force liquidations at the worst possible times.

Thank you very much for all the interest, support and questions. I do appreciate everyone coming out. Cocktails and Hors D'oeuvres await us outside.