

December 9, 2010

A Dream about Warren Buffett and Railroads

I was dreaming. [Warren Buffett](#) and I were having dinner in Omaha, Nebraska, home of [Berkshire Hathaway Inc. \(NYSE: BRK\)](#).

[Warren Buffett](#) might be surprised to know that I have dreamed about him. This is no surprise, however, to me. I am fascinated by finance, money, and how to work most efficiently, and with the least possible risk, to accumulate wealth, and [Warren Buffett's](#) name is synonymous with making money efficiently.

There was a time, especially when I was in college at [Swarthmore](#), that my highest priorities consisted of having an intense Saturday night date. I would have dreams with romantic content, but now my dreams are based on investments and money, not women.

One common theme in my dreams is this: I am having dinner with [Warren Buffett](#) at [Gorat's](#), his favorite restaurant in Omaha. I am enthralled watching his brilliant mind at work, enjoying every moment of his wisdom and his humor, admiring his ability to cut to the essence of the matter, making simple what the bombastic and insecure strive to make complicated.

There is the yuppie or young urban professional, a stereotype, a conveniently drawn picture, of someone, probably in their early thirties to forties, whose career is on the rise, and whose spending is on the rise as well, often with a trajectory steeper than the rise in his (or her) paycheck. The yuppie, or senior urban professional, on the other hand, is interested in investing and savings, and is less excited about spending money than a yuppie. I have always had yuppie values. In any case, I am now a yuppie.

Some things about being a yuppie are not so good: when you walk up to the second floor at the [St. John Health Club](#) in Tulsa, OK to do some elliptical work or some training with light weights, it is unlikely that the women working out will be distracted by your physique. It is unlikely that you will be mistaken for one of the men on the cover

Business Summary: [Kansas City Southern Industries](#)



[Kansas City Southern Industries \(NYSE: KSU\)](#) hauls unit trains (trains transporting a single commodity from one source to one destination) of coal for eight electric generating plants in the central United States. The coal originates from the Powder River Basin in Wyoming. [Burlington Northern](#) brings the coal to Kansas City, where it is interchanged with [Kansas City Southern](#), which takes it to utilities in Arkansas and Louisiana. [Kansas City Southern](#) reaches into Mexico and is strategically situated there, having sole rail access to the booming port of Lázaro Cárdenas, as well as a strategic position at Laredo, Texas, the second largest inland border crossing in the United States.

of *Men's Health* who, open shirted, shows off abdominal muscles that are so well defined that they seem to be a product of science fiction. I do swim vigorously three mornings every week on a team that meets at the uncivilized time of 5:30 A.M., but such magazine-worthy muscles I will leave to the twenty-something underwear models.

No, this is the period of life when any experienced money manager, who has come to understand his strengths and his weaknesses, is excited to dream about money and about people like [Warren Buffett](#), people who excel at making money year in and year out, investment professionals who use common sense and a sharp understanding of what they know and what they do not know, who are in touch with their areas of competence, and mindful of areas that present too much risk.

[Mr. Buffett](#) and I are discussing the investment outlook for American railroads. I have just told him about our positions in [Union Pacific Corporation \(NYSE: UNP\)](#) and [Kansas City](#)

Southern Industries (NYSE: KSU). Buffett knows **Union Pacific** well. **Union Pacific** and **Berkshire's Burlington Northern** are the two largest domestic railroads, with 2009 operating revenues of approximately fourteen billion dollars each. He knows **Kansas City Southern**, but perhaps not as well as the other two. At least that is what I want to believe, because I am eager to tell him about **Kansas City Southern**, and to get the jump on him at least once.

The waiter comes along and suggests a shrimp cocktail as an appetizer. I decline, knowing that the T-bone steak as the entrée will be more than enough for me. Buffett applauds my decision, telling me that ordering at a restaurant, making selections from the menu, or filtering suggestions from the waiter or waitress is not much different—he has a remarkable ability to make concepts simple—from choosing where to put your money to work.

He uses a baseball metaphor to make his point: you can stand at the plate and wait for the pitch you like (not a perfect analogy as you could also pass up some throws that were strikes and then be called out). A hitter in baseball or an investor does not have to take the first swing, or use money on the first idea. You can take your time until you see something you like. In both cases, there is no reason to rush yourself, or to be rushed.

The steaks and the hash browns arrive. Buffett takes a bite of his T-bone and says he has two questions for me.

“One, what is your investment thesis for railroads and why do you think they can provide a superior return, better than the Standard & Poor 500? And two, what is so special about **Kansas City Southern**?”

“Before I answer your questions,” I say, “I do have, Warren, a frustration with you and **Berkshire** that I want to air, to get off my chest.”

“What is that?” he asks.

I tell him that my clients and I had had a position in **Burlington Northern Santa Fe Co. (NYSE: BNI)** before he, operating through **Berkshire Hathaway**, had offered one hundred dollars a share for the railroad on November 3, 2009.

“We had been glad to make an excellent return on our position, which we had purchased in March of 2009 for an average weighted cost of \$88.54 per share, but we were frustrated that we had lost an opportunity to enjoy excellent returns over many years. We had believed, and our belief is as strong as ever, that railroads would offer excellent

investment returns for many years, so we had mixed feelings when you made your offer for the railroad.

“Fortunately,” I added, “there were other railroads, all with good competitive positions.”

Buffett leaned back, playing psychologist, asked the waiter for another **Cherry Coke**, and said, “Fred, I hope you can get over your frustration and move on, so lay out your global thesis.”



A Burlington Northern Santa Fe train hauls intermodal containers past downtown Tulsa. (Photo courtesy Katie Michaels-Johnson).

“First,” I replied, “is the dynamic of global trade and the opportunity it provides for railroads. Consider the shipment of tangible goods, such as cars and refrigerators, from one country to another, usually by ship, and the hauling from ports to cities on the east coast and on the mainland in the United States. The cargo at the ports is hauled by railroads.”

To understand the dynamic growth in this business, consider the following two examples:

In 2003, \$122.051 billion worth of imported and exported merchandise moved through the port of Los Angeles. By 2008, this figure had nearly doubled, to \$243.91 billion.

In 2000, China's trade with the United States totaled \$116.3 billion. By 2009 this figure had more than tripled, to \$366.3 billion.

"Second," I continued, "is the state of American highways, particularly the Interstate Highway System. When authorized by the Federal Aid Highway Act of 1956, legislation passed during the Eisenhower administration, the Interstate system was a revolutionary idea, designed not only to handle private and commercial interstate traffic, but also to strengthen our domestic defense systems."

In the first decade, at least, after its completion, the system handled traffic well. That was decades ago, when owning an automobile was exciting, almost a novelty, and the interstate highways were in good shape, not breathing heavily under the relentless load that they must carry today, and certainly not as congested as they are today.

In 1960, four years after the passage of the Federal-Aid Highway Act, Americans owned seventy-four million automobiles. By 2003 Americans owned 231 million cars, almost three times as many as in 1960. In 1960, passenger vehicles, motorcycles, trucks, and buses accounted for a total of 718,763,000,000 (718 billion) miles driven on the Interstate Highway System. In 2008, vehicles traveled 2,973,509,000,000 (2.97 trillion miles), more than four times as many miles as traveled in 1960. No wonder the average American driver spends thirty-six hours a year stuck in traffic.

More people own more cars and drive more miles than they did in the fifties and sixties, but today's roads are often old and fatigued, so much so that they are frequently crumbling or contain potholes deep enough to make Midas Muffler, and other companies that work on automobile underbellies, rich.

It would require many billions of dollars to restore the roads to working order, let alone expand them for the inevitable increase in traffic. Trucks

depend on the compromised interstate highway system, putting them at a severe disadvantage to railroads, which use good tracks, well-maintained through the company's generous cash flow.

Buffett nodded in agreement.

I continued, "We are a twenty-first century nation, with all the intense demands made by fast growing commerce and transportation needs, but we are living with a twentieth century road infrastructure, and paying a heavy price in lost productivity every day. Fortunately, we have railroads that can make up the slack."

Buffett seconded my thoughts: "As I said when Berkshire bought BNSF, our country's future prosperity depends on its having an efficient and well-maintained rail system."¹

Another reason for excitement about the railroads is the factor of barriers to entry. Investors prize companies and industries that can keep new competition from encroaching on their businesses. Railroads enjoy virtually insurmountable barriers to entry as far as the construction of a major new railroad is concerned.

It seemed to me, I pointed out, that it would be impossibly capital and time consuming to launch a major railroad. I thought I was on the correct track (I could not resist) but I wanted to confirm my thinking. So when our portfolio managers and I were talking with Bill Galligan and Ginger Adamiak of Kansas City Southern on November 15, 2010, I put this question to them of how significant barriers to entry were to the contemplated construction of a major railroad.

"It's getting land," Galligan said.

To create a whole new railroad would be just about impossible; to get any kind of continuous right to land for any kind of distance that would make sense to get in. And if you add the rail on top of that, you can calculate a million dollars or more per mile

¹ "Buffett's firm to buy Burlington Northern." David Ellis, CNNMoney.com. November 3, 2009.

to build in. It's not a cheap venture.

To maintain, I don't know our per mile number, but usual maintenance on a railroad is fairly expensive. It goes about nine to ten per cent of revenue per year. The overall capital budget for a railroad is between fifteen to seventeen per cent of revenue, with the rest being road capital for expansion of business, stuff like that.

But, to get back to the concept of barriers to entry, **Ginger Adamiak** noted:

We built a rail line, we actually just finished it last year, in Texas, ninety miles, from Victoria to Rosenberg, and that was biggest rail project for anyone in the last twenty years. Ninety miles was unheard of. There are huge barriers to entry. It's like building a nuclear atomic plant—no one wants a railroad in their back yard.

To replace the track probably costs a million dollars a mile, so you can see how the Victoria to

Rosenberg piece adds up.

“Just think,” I said, turning to Buffett as he began on his second helping of hash browns. “A ninety mile project was a big deal, a major capital expenditure. Now you get a picture of how costly it would be to buy the land, lay the track for any new major railroad.”

“I agree with your macro railroad thesis,” **Buffett** said, “but what about **Kansas City Southern**? I know that it is a railroad with exciting prospects, but one that was too small for **Berkshire** to buy at the time we were considering buying a railroad. However, with **Burlington Northern** delivering coal to Kansas City at the Kansas City interchange, it is not out of the question that we might be interested in acquiring **Kansas City Southern**.” (A reminder: I was dreaming and of course, if he were interested in **Kansas City Southern**, **Buffett** would never, for legal and strategic reasons, reveal any takeover target that **Berkshire** had in mind.)

“Let's consider Mexico,” I said. “**Kansas City Southern** dominates the Mexican market and unless Mexico descends into chaos—if we are realistic we have to admit that as of now this is a possibility—Mexico will be a gold mine for **Kansas City Southern**. In Mexico, more than fifty per cent of the railroad's shippers have no choice but to use this railroad for their needs.”

As far as efficiency with capital expenditures goes, **Meredith Bohot Cothran's** father, a civil and structural engineer for **Chicago Bridge and Iron Co. (NYSE: CBI)** reports the following:

Kansas City Southern is doing some interesting and significant things regarding Houston to Mexico improvements. **Kansas City Southern** aims to take at least a day off of the Houston to Mexico trip. They are building a large truck to rail facility Southwest of Houston along Highway 59. It is first class railway work all the way to the border. I see it when I am traveling to Matagorda Bay.

It is the real deal. I have been observing their work for some time with an engineer's eye. **Kansas City Southern** has the most level, well engineered and constructed railways and revamped rail bridges that I've ever seen. Their work screams efficiency to anyone that seriously looks at it, including the truck to rail facility. It will be huge savings on crew costs and equipment utilization for knocking off a full day of transit time.

Charles R. Bobot, Civil/Structural Engineering, Lummus Technology, Inc., Beaumont, Texas, a division of Chicago Bridge & Iron Co. (NYSE: CBI).



*The American side of the Juarez-Lincoln International Bridge. The bridge crosses from Nuevo Laredo in Mexico, over the Rio Grande River (seen on the right) to the United States Customs station in Laredo, Texas (the red brick buildings on the left). It is one of four vehicular international bridges in Laredo, carrying only buses and non-commercial traffic. You can see this traffic entering America from Mexico.
<http://www.ci.laredo.tx.us/>*

“Now, let me focus on the opportunity in Laredo, Texas” I continued. “Imagine that we are truck drivers hauling a load of refrigerators and washing machines, ready to enter Texas through the border crossing at Laredo, Texas.”

Trade is booming between Mexico and the United States. But the booming trade has caused congestive road failure at crossing points between the two countries, especially at Nuevo Laredo, Mexico and at Laredo, Texas.

Truckers haul their cargo of refrigerators and washing machines from Mexico City, destined for sale in the United States, up through dusty Mexican towns with names like Huehuetoca and San Luis Potosi and Saltillo. The trucks are now waiting in Nuevo Laredo in the state of Nuevo Leon in Mexico, waiting along with more than three thousand other trucks to cross the border into Laredo, Texas.

Laredo, Texas is no place where the Chamber of Commerce advertises its oceans or its cool mountain temperatures, its five star hotels, or its nouvelle vegan cuisine. No, Laredo is a place where cowboys, with dust on their boots and their Levis, gather in the local bar to watch a hockey game or a football game. But Laredo is the home of three professional sports teams, a famous

birding festival, numerous ballet and symphony events, and Miss Texas 2010. There are, of course, the usual American landmarks and signs of civilization: Wal-Mart, McDonald's, Family Dollar.

Nor is Nuevo Laredo, Laredo's Mexican sister city, a place where you would want to spend too much time. There are bargains, especially if you were looking for pottery and other arts and crafts. When Meredith Cothran and her family visited Nuevo Laredo, they were advised by their friends that lived in Laredo, Texas not to take their own car because of horror stories about Americans who had driven to Nuevo Laredo, Mexico in their own vehicles only to have these vehicles stolen. In most cases, these vehicles were never found, and in some cases the policia (the Mexican police) tried to charge the owners to get information about the stolen vehicles. Meredith's friends advised her and her family to rent a vehicle to drive across the border from Laredo to Nuevo Laredo and to obtain a one-day insurance policy on the rental vehicle, should the vehicle be stolen.

But while not beautiful like Aspen, Colorado, or Mazatlan, Mexico, Laredo, Texas is a critical border crossing between Mexico and the United States. Laredo is the second largest land gateway behind Detroit, MI, handling \$115,759 million worth of imports and exports in 2008 alone.

Four vehicular bridges and one rail bridge span the Rio Grande between Laredo and Nuevo Laredo, with one eight lane bridge dedicated solely to commercial trucking traffic. **Kansas City Southern** provides exclusive rail access to the United States and Mexico through Laredo on its Texas Mexican Railway International Bridge, owned and maintained by Texas Mexican Railway (a subsidiary of **Kansas City Southern Railway**) and **Kansas City Southern de Mexico** (**Kansas City Southern's** Mexican operation).

Also, under a fifty year renewable concession with the Mexican government, Kansas City has the right to “control and operate the southern half of the rail bridge at Laredo, Texas which spans the Rio Grande River between the United States and Mexico,” **Ginger Adamiak**, investor relations for **Kansas City Southern**, told us during a November 22, 2010 phone call. In 2005, the Surface Transportation Board approved **Kansas City Southern's** purchase of a controlling interest in Texas Mexican Railway, which owned the northern half of the bridge, thus giving **Kansas City Southern** sole control of the only rail border crossing in Laredo.

“Did you know,” I asked **Buffett**, “that more than two million trucks pass through Nuevo Laredo and Laredo every year? It is an astounding number and this number, I believe, is a powerful competitive advantage for **Kansas City Southern.**”

Last year, **1,382,319 trucks** entered the United States at the Laredo, Texas border crossing, hauling **1,382,455 truck containers** (loaded and empty). During the same year, **2,716 trains** entered the U.S. at this crossing, hauling **271,095 rail containers** (loaded and empty). This works out to just barely over one container per truck (**1.0000983 containers/truck**) and **99.8 containers per train**. Trains, which can carry much more cargo, can cross the border more efficiently than trucks.

Note that the above numbers are just for trucks and trains *entering* the United States from Mexico. About fourteen per cent (by dollar value) fewer goods are exported through Laredo than imported. Assuming, then, about fourteen per cent fewer trucks and trains are needed to move

these goods, our portfolio manager **Katie Michaels-Johnson** calculates that a total of roughly **2,571,113 trucks** and **5,051 trains** passed through Laredo in 2009.

But to return to the numbers reported by the Bureau of Transportation Statistics for trucks and trains crossing into the United States from Mexico, we find that an average of **115,193.25 trucks** crossed into the U.S. at Laredo *each month*, or an average of **3,787.18 trucks per day**. An average of **226.33 trains** crossed into the U.S. at Laredo *each month*, or an average of **7.44 trains per day**.

Buffett sighed, and said. “I’ve got the idea, **Fred**. No more numbers, please.”

“Yes, but just one more set of numbers to complete the picture.”



A line of semi-trucks stretches into Mexico as the trucks wait to cross the World Trade International Bridge into Laredo, Texas. This image was taken from the live web camera feed of the bridge at 10:13 a.m. Central time on Tuesday, November 30, 2010.

These **3,787 trucks** have one bridge with four lanes to use for crossing into the country. Those **seven trains** have just one bridge, but clearly the congestion for truck traffic is much greater than for rail. The average wait time for a commercial vehicle at the World Trade bridge between the hours of eight a.m. and six p.m. was thirty-nine minutes in 2007, up from 17.2 minutes in 2003. These wait times can vary greatly, however, and the *Laredo Morning Times* reported that “commercial traffic often experience a two-to-

three hour wait when crossing the World Trade Bridge.”²

“Just consider this story,” I continued. “I have a friend who works in an investment management firm in Kansas City. His sister is married to a truck driver who regularly drives from Mexico City to Laredo and then on to San Antonio. Every time the brother-in-law passes through Laredo it is an experience of supreme tension and boredom. He often has to wait one to two hours at the crossing, behind one to three miles of painfully slow-moving trucks waiting to clear customs.

“Sometimes, as his truck idles, consuming expensive oil, my friend’s brother-in-law sees the **Kansas City Southern** train pass through the border, almost effortlessly, and he groans in envy.”

Buffett took another sip of his **Cherry Coke** and noted: “**Fred**, before I become enthused about any investment I stop myself occasionally and force myself to come up with some tough questions. I see that you are up on your figures when it comes to analyzing how difficult it is for a truck to move back and forth from Mexico and the United States through Nuevo Laredo and Laredo, but you imply that railroads have a much easier time getting through customs and the border than trucks do. What, in fact, are the facts?”

“Yes, **Warren**,” I replied, “I am aware of your disciplined approach and of course I admire it and I hope I have emulated it successfully. We, too, were interested in how difficult it was for a train to pass through customs at Laredo. We wanted to make sure that we did our due diligence.”

² “Bigger bridge: Feds call for 9 more lanes at World Trade,” Ashley Richards. *Laredo Morning Times*, May 10, 2007.

In our November 22 conversation with **Bill Galligan** and **Ginger Adamiak** we asked this question, and this was the answer:

The cargo on the train clears customs when it is loaded onto the train of origination. When the train gets to the border, it is x-rayed for security purposes. The train will then proceed across the bridge and stop halfway. The first crew exits the train and then the second crew gets on the train to continue the trip. The process takes approximately two hours. It’s a very simple process and is a huge selling point with customers through the border at Laredo.

I looked around the bustling and unpretentious dining room. **Buffett** likes **Gorat’s**: the restaurant



Gorat's Steak House, Omaha, Nebraska.
(<http://www.flickr.com/photos/darrensnow/2929437146/>).

offers a simple steak and potato cuisine. Everything about the restaurant is unpretentious, as is **Buffett**. I had been there once while visiting a company in Omaha and I found the experience pleasant, in refreshing contrast to some of the pretentious restaurants where I could not pronounce the names of the dishes and felt tongue-tied when

ordering and somewhat intimidated, as if I were in an introductory course to fine dining, especially when the waiter details, in a flowery style, each dish and the fancy sauce that would accompany it.

Here at **Gorat’s** there was no problem, as the menu is simple, the food is good, and everyone was friendly. Of course some visitors to **Gorat’s** have pronounced the experience mundane, not exciting:

I was in Omaha for the **Berkshire Hathaway** annual meeting and, yes, I had to check out all of **Warren Buffett's** favorite places. I hoped that **Gorat’s** would be

awesome, but my expectations were set pretty low given that (a) this was Omaha, not quite the Mecca of fine cooking; (b) I've had some damn good steaks in my time; and (c) Buffett isn't quite known to be a foodie (the man has eaten the same burger, Cherry Coke, and chocolate diet for the past 80 years) and he has simple tastes. (User Stephen C. of New York, NY on Yelp.com. <http://www.yelp.com/biz/gorats-steak-house-inc-omaha>).

(I guess Stephen C. was disappointed, but even the most rabid fans of Omaha would concede that it does not match New York City for cuisine. In Omaha, you visit Berkshire Hathaway. You go for great steaks, not nouvelle cuisine.)

Mr. Buffett stopped. He had been enjoying his T-bone steak with a double order of hash browns, his favorite meal at Gorat's.

“Another unique advantage,” I continued, “for Kansas City Southern: Lázaro Cárdenas. The Mexican government is developing the port at Lázaro Cárdenas to serve Mexican markets as the alternative to the congested U.S. west coast ports of Long Beach and Los Angeles, with Lázaro Cárdenas serving Asian traffic bound for Mexico as well as the eastern, southern, and Midwestern United States. Kansas City Southern holds the sole rail concession for this port.”

From the Kansas City Southern 10-K filed with the Securities and Exchange Commission for the fiscal year ended December 31, 2009, I learned, I noted to Buffett, of the following regarding the railroad's business at Lázaro Cárdenas:

KCSM provides exclusive rail access to the Port of Lázaro Cárdenas on the Pacific Ocean. The Mexican government is developing the port at Lázaro Cárdenas principally to serve Mexican markets and as an alternative to the congested U.S. west coast ports of Long Beach and Los Angeles. KCSM is the

sole provider of rail service to this port, which provides an alternate route for Asian traffic bound for the eastern, southern and Midwestern United States. Traffic at Lázaro Cárdenas is both domestic and import traffic, consisting of intermodal containers, minerals, iron, steel slabs, wire rods, and fertilizers.

“Warren,” I said, “my portfolio managers and I wanted more details on Lázaro Cárdenas, so we asked Galligan and Adamiak to expand on the concept of the importance of the port at Lázaro Cárdenas to the railroad.”

Galligan noted:

First of all, you know we got involved in Mexico in 1997, and if you had asked me about Lázaro Cárdenas in 1998 I would have had no idea what you're talking about. We had no idea of the importance other than the concession we had for the track, but who cares?

But in 2001, I think it was, the LA/Long Beach longshoreman went on strike. So Wal-Mart commissions the big steamship line, Merck, to do a study of big ports in North America on the Pacific to find out which was the best, and they determined that this one at Lázaro Cárdenas had the greatest potential. It's a natural deep water port, doesn't silt, fifty-five to sixty foot depth, ample room to expand. And it's closer from Lázaro to Houston or from Lázaro to Atlanta than it is from LA.

Plus, for every container that comes off ship and goes on train, it's seven hundred dollars cheaper to do it at Lázaro than at LA/Long Beach—for every container! This is because the

workers are non-union and there are no environmental taxes and taxes like those that California puts on to try to keep economy alive.

Also, another advantage is that loading is on dock, not across town like it is in LA. You have to drive the container twenty miles to get it onto the train in LA. Our train goes right onto the dock, so you don't have to drive it more than a few feet.

This port's never going to replace

LA/Long Beach; that's an established major port. But it's going to be a major option for ocean vessels serving both the population around Mexico City and, in 2011, I think you'll see more go from Lázaro to Texas via railroad, all in our market. So it's going to grow to the size of LA/Long Beach over a fifteen-year period and we're the only railroad that gets in there, so it's a potential gold mine for us.

Free Cash Flow and **Union Pacific**



On October 21, 2010, **Union Pacific** reported earnings for the quarter ending September 30, 2010, noting that earnings for this period increased by fifty-four per cent over the comparable 2009 quarter.

The company says it is producing lots of free cash flow. Now, what is free cash flow? As is true of many terms that publicly traded companies use, free cash flow can be misleading. It is important to be intelligently skeptical about the use of the term.

Free cash flow is the cash after capital expenditures have been deducted, capital expenditures needed to maintain and improve the infrastructure of the company. In the case of **Union Pacific**, free cash flow is the cash spent on the rails, on warehouses, on switching stations.

But is free cash flow truly free cash flow? What if the company is not spending enough cash to maintain and improve its infrastructure and its competitive position? If that is the case, then the amount of free cash flow is exaggerated.

If the company has claimed free cash flow historically and there is no evidence that the company has compromised on what it had to spend to be competitive, then the free cash flow figure is accurate. But the free cash flow number that any company reports is always a subjective number, as it reflects what the company's leaders think they must spend to run an efficient operation.

If, in the case of **Union Pacific**, its customers, the shippers who use its conventional railcars and its intermodal units are satisfied with the railroad's service, if the trains run on time, if there are no delays due to mechanical problems—in contrast to the publicly traded airlines such as United Airlines and American Airlines which suffer frequent, yet excruciatingly unpredictable delays often because the aircraft is either old and/or has not been properly maintained and serviced—then it is probably okay to believe that free cash flow is an accurate figure.

Footnotes

1) I began my professional investment management career as a trust investment professional at the **Fourth National Bank of Tulsa**, in Tulsa Oklahoma in 1978. I became interested in railroads when I was at the bank. My interest was in the **Kansas City Southern**, which enjoyed the shortest, most direct route to the Gulf Coast.

The shortest direct route from Kansas City to the Gulf made it a valuable franchise, but there was some icing on the cake, some sizzle to the steak: the route serviced utilities in Arkansas Missouri and Alabama utilities in unknown places such as DeQueen, Arkansas and Deridder, Louisiana, all of which used coal. I learned that these coal shipments would accelerate or at least the payments would accelerate because the utilities had signed multi-year take or pay contracts that obligated them to pay for the coal, whether or not they decided to take it or use it. Taking a substantial position, almost two per cent of the railroad's outstanding shares, and then selling these shares six years later for a seven hundred per cent return, was my first major investment victory.

2) **Buffett** looks for great companies at a reasonable price. I have never seen his definition of what a great company is. I would guess it is a company that enjoys great barriers to entry (get definition) and whose numbers, such as return on equity, margins, reflect those barriers.

These are wonderful qualities. But you want these qualities at a reasonable price. **Buffett** does not define reasonable price explicitly, but he defines it implicitly by saying that every investment---if it is based on sound reasoning---must leave room, must anticipate, a margin for error, for mistake, or for the unpredictable.

This thinking would probably exclude many pharmaceuticals and high technology companies, especially young ones, whose income statements show losses, companies which depend on the discovery of a new drug or creation of software to become profitable, let alone the consideration of relationships.

3) *Ports in which **Union Pacific Corp.** (NYSE: UNP) operates:*

Washington
Seattle, WA (Port of Seattle)

Oregon
Portland, OR (Port of Portland, Inc.)

California
Oakland, CA (Port of Oakland)
San Francisco, CA (Port of San Francisco)
Los Angeles, CA (Port of Los Angeles)
Long Beach, CA (Metropolitan Stevedoring)

As of the close of business on **December 7, 2010**, clients and employees of our firm owned **36,200 shares** of **Kansas City Southern Industries** with a market value of **\$1,773,076.00** and **31,340 shares** of **Union Pacific Corporation** with a market value of **\$2,950,034.20**.

We may liquidate, decrease, or increase our position in **Kansas City Southern Industries** or **Union Pacific Corporation** at any time, without notice before or after we do so.

Fredric E. Russell, lists his academic and professional background as follows: **B.A.**, Swarthmore College, Swarthmore, PA; **M.B.A.**, and **M.A.**, Washington University, St. Louis, MO. He also holds the **CPA certificate** and has taught accounting and finance at three universities. He believes his love for writing and his usually correct grammar come from spending four years learning the English language at **Deerfield Academy** in Deerfield, MA, and from reading everything well-written he can find.

Katie Michaels-Johnson graduated in 2008 with a Bachelor of Arts degree in English and German from the **University of Tulsa**, where she studied as a National Merit Scholar. **Pu Wang** joined the firm in May 2010. He holds a master's degree in finance from the **University of Tulsa**, where he studied on a full tuition scholarship. He is from Shanghai, China. Both **Pu** and **Katie** contributed significantly to the creation of this letter.