

## Inside this issue:

Graham and Dodd Breakfast	p. 3
D.R. Horton, Inc.	p. 14
Macy's	p. 16
Netflix	p. 18
Industry Networking Night	p. 20
Value Investing in India	p. 22

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## Staying Power: Jean-Marie Eveillard

Jean-Marie Eveillard is a legend in the world of value investing. Widely recognized as the first truly global value investor, Jean-Marie achieved his status by adhering to the investment principles of Graham and Dodd, and expanded upon by Warren Buffett.

Jean-Marie began his career in 1962 with Societe Generale and became portfolio manager of what is now the First Eagle Global Fund in 1979. Prior to his brief retirement in 2004, Jean-Marie led the First Eagle Global Fund to a 15.8% average annual return - compared to 13.7% for the S&P 500 (according to Morningstar).

Jean-Marie Eveillard's strict investment discipline and outstanding investment returns earned him a Morningstar Lifetime Achievement Award in 2003.

On March 26, 2007 First Eagle Funds and its investment advisor, Arnhold and S. Bleichroeder Advisors, officially announced that Jean-Marie would resume portfolio management responsibilities for the First Eagle Global, Overseas, Gold, Overseas Variable and U.S. Value Funds.

**Q: It seems that every value investor has their own story about how they stumbled upon value investing. Can**



Jean-Marie Eveillard, Portfolio Manager - First Eagle Funds.

**you tell us your story?**

JME: I had been working since the early 1960's with a French bank doing securities analysis in Paris. The French bank sent me to New York presumably for a year or

## Welcome Back to Graham and Doddsville

As we enter our second year, we are pleased to provide you with the third edition of *Graham and Doddsville*, Columbia Business School's student-led investment newsletter, co-sponsored by the Heilbrunn Center for Graham & Dodd Investing and the Columbia Investment Management Association.

This edition features an interview with legendary global

value investor Jean-Marie Eveillard of First Eagle Funds. Mr. Eveillard was gracious enough to sit down with us and share the wisdom he has gained during a distinguished career that has spanned over three decades.

We also hope to give you a taste of some of the extraordinary events sponsored by Columbia Business School, the Columbia Investment Management Association,

and The Heilbrunn Center. Inside you will find coverage of the 17th Annual Graham and Dodd Breakfast featuring David Einhorn of Greenlight Capital; lessons from the Industry Networking Night featuring William von Mueffling ('95) of Cantillon Capital Management and David Greenspan ('00) of Blue Ridge Capital; and you will travel to India with Professor Bruce Greenwald and mem-

(Continued on page 2)



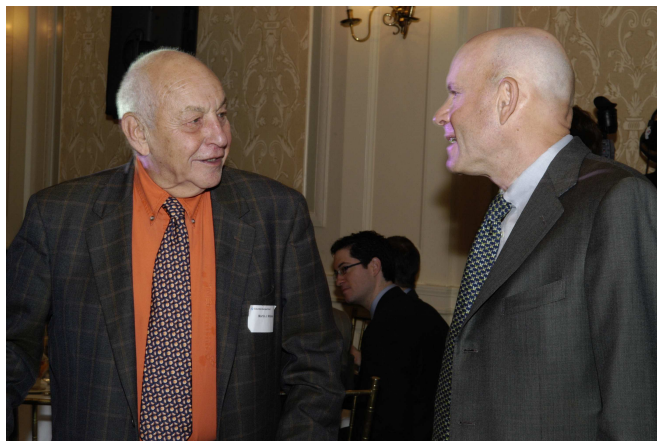
## Welcome to *Graham And Doddsville* (continued from page 1)

(Continued from page 1)  
bers of The Heilbrunn Center to discuss value investing, globalization, corporate social responsibility, and competitive strategy.

As always, we also feature investment ideas from the students of Columbia Business School.

Please feel free to contact us if you have comments or ideas about the newsletter, as we continue to refine this publication for future editions. Enjoy!

-G&Dsville



Legendary investors Martin Whitman and Edwin Schloss at the 17th Annual Graham & Dodd Breakfast on October 19, 2007. The annual breakfast is organized by The Heilbrunn Center for Graham and Dodd Investing.

**“To me, value investing is a big tent that accommodates many different people.”**

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## Jean-Marie Eveillard (continued from page 1)

two. I got to New York City for the first time in January of 1968. I didn't know many people, but I knew a few people in the French community, and I got to meet two French students attending Columbia Business School whose interests were not investing – their interest was marketing. During that summer, we bicycled together on weekends in Central Park. They knew that I was in the field of investments, and they had heard of Ben Graham. Investments were not their interest, but they mentioned Ben Graham to me. So, I went to a bookstore and bought *The Intelligent Investor* and *Securities Analysis*. *The Intelligent Investor* in particular sort of struck me.

There is a story in France about a famous French poet named Paul Claudel who had not believed in God. One day, he was standing by a pillar at a Cathedral near Paris and he said: “I was illuminated by faith.” In a sense, I was illuminated not by faith, but all of a sudden, it seemed to me that Ben Graham simply made sense. The idea of margin of safety, the idea of intrinsic value, the idea of Mr. Market, the very humble idea that the future is uncertain - it made sense to me. I stayed in New York for another few years, but I could not convince Paris headquarters because their whole approach was completely different. Their approach, in a sense, was more of a trading

approach – trading the big stocks. Neither in New York, nor when I went back to Paris for a few years, could I convince anybody to look at value investing. Still today to my knowledge, the French banks and institutions do not have value investing. Societe Generale sold our operation to Arnhold and S. Bleichroeder at the end of 1999, and I've kept in touch with some of the people there. I have tried to convince them over the past seven years that they should make some room somewhere in a little corner for value investing, but they are not into it.

Today in Paris there are a few people practicing value

(Continued on page 4)

## Fooling Some of the People All of the Time

*Graham and Dodd Breakfast  
with David Einhorn*

On the morning of October 19<sup>th</sup>, close to 400 investors gathered at The University Club in Manhattan for the 17<sup>th</sup> Annual Graham & Dodd Breakfast. This year's keynote speaker was David Einhorn, President of Greenlight Capital. Under the title "Fooling Some of the People All of the Time," Mr. Einhorn addressed the current state of the capital markets and shared his thoughts on ways to remedy the current situation in the credit markets.

Mr. Einhorn, introduced by Professor Bruce Greenwald as an investor with a creative mind, a powerful intelligence, and a sound instinct for value, is a graduate of Cornell University. He began his career in the Investment Banking Group of Donaldson, Lufkin & Jenrette. After 2 years with DLJ, Mr. Einhorn left to take a job as an analyst with a hedge fund. In January 1996 he co-founded Greenlight Capital. Starting with less than \$1 million in capital, Mr. Einhorn built Greenlight into one of the most successful hedge funds in the industry. Greenlight, which has grown to over \$4 billion, boasts returns which are reported to be 27% annualized.

In speaking about the credit markets, Mr. Einhorn declared "the crisis came because we have a lot of bad



practices and a lot of bad ideas." The result is that lenders were "induced to take imprudent risks and make imprudent loans, which of course led to losses." One practice admonished by Mr. Einhorn is the current system of delegating the assessment of credit risk to credit rating agencies that are paid by bond issuers rather than bond buyers.

While the media might lead one to believe that sub-prime loans are at the root of the current capital market disarray, Mr. Einhorn asserts that that sub-prime loans have become a convenient excuse for a much larger problem. The real issue is that lenders of all sorts lent too much money and did not demand enough interest to compensate their risk. "There has been a colossal undercharging for credit across the board," Einhorn stated. Loans were issued based on the borrower's ability to refinance rather than the borrowers ability to repay the loan.

This includes not only the sub-prime market but also all areas of residential real estate, commercial real estate and the corporate lending markets and has applied equally to borrowers whether they are an average American trying to purchase a house or a private equity firm pursuing an LBO.

Why have borrowers enjoyed such low rates? According to Mr. Einhorn, the answer lies in how this risk of structured financial products are assessed. Rating agencies perform their analysis free from the restrictions of "Reg FD". Without access to the same information as the credit agencies, investors are not able to decide whether they agree or disagree with the rating. "Without enough information in the market other than the credit rating, it is hard for buyers and sellers to decide what to do once the credit rating comes into doubt." Einhorn believes that one solution to this problem is to make all

(Continued on page 4)

**"The crisis  
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CBS alumni reconnect at the  
Graham & Dodd Breakfast

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## 17th Annual Graham and Dodd Breakfast

(Continued from page 3)



Mario Gabelli ('67) and Walter Schloss catch up at the Graham and Dodd Breakfast

information shared with rating agencies available to the entire market.

Einhorn suggested that "the rating agencies

have lost their ability to impose discipline on the balance sheets of the broker dealers, the financial guarantee companies, enablers of structured finance that bring so much business to the rating agencies. This creates

an enormous systemic risk as these entities are able to maintain access to cheap credit while over extending themselves beyond prudence."

In describing his own investment philosophy, Mr. Einhorn said that the idea is to preserve capital on an investment-by-investment basis. His goal is to put together a portfolio of individual ideas that are set up to preserve capital if he is wrong, and will achieve a good return if he is something other than wrong.

David Einhorn concluded his remarks by reading an excerpt from his forthcoming book due on bookshelves next spring. Among the guests at the breakfast were three generations of value investors including Walter and Edwin Schloss, Marty Whitman, Mario Gabelli, Jean Marie Eveillard, and Tom Russo. The breakfast, which is organized by The Heilbrunn Center for Graham and Dodd Investing, was simulcast to London and webcast to an audience around the world.

-G&Dsville

## Jean-Marie Eveillard (continued from page 2)

(Continued from page 2)

investing. Twenty years ago, there was nobody to my knowledge, but I think today there are a few independent shops that tend to do value investing. And, indeed, there are two young Italian men three or four years ago who went to the same business school I went to in Paris. They looked up my name in the alumni book and called me and came to see me because they had just started a small value shop in Paris. I became a minority shareholder in their advisory firm.

So in any case, I came across *The Intelligent Investor* in 1968 and, then, had to wait a little more than 10 years until late 1978 when Paris headquarters was getting tired of hearing me talk

about value investing. They said: "Hey – we have a small fund in New York - \$15 million – why don't you go back to NY and run it?" Because it was small and because I was across the ocean, they basically let me run it the way I wanted. Within a few months of when I came back to New York in late 1978, I also came across the annual reports of Berkshire Hathaway. To me, value investing is a big tent that accommodates many different people. At one end of the tent there is Ben Graham, and at the other end of the tent there is Warren Buffett, who worked with Graham and then went out on his own and made adjustments to the teachings of Ben Graham. Still today, Buffett says *The Intelligent Investor* is the

best book that has ever been written about investing.

Over the past almost 30 years, we (First Eagle) have sort of floated between Ben Graham and Buffett. We began with the Graham approach which is somewhat static and less potentially rewarding than the Buffett approach, but less time consuming. So as we staffed up, we moved more to the Buffett approach, although not without trepidation because the Buffett approach – yes, you can get the numbers right, but there is also a major qualitative side to the Buffett approach. We, or at least I, surely do not have the extraordinary skills of Buffett, so one has to be very careful when one

(Continued on page 5)

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## Jean-Marie Eveillard (continued from page 4)

(Continued from page 4)

moves to the Buffett approach. Today, we have Bruce Greenwald as director of research, and there are nine in-house analysts. I think Bruce will take that number up to something like twelve within the next few months.

So this is how I came across Ben Graham and then 10 years later, just in time, the Buffett approach.

**Q:** You have been managing the First Eagle Global fund since 1979, and you spoke about how your philosophy has shifted over time. How have you seen the philosophy of Value Investing in general evolve over that time?

**JME:** I think today, to some extent because of the extreme popularity of Warren Buffett, there is more competition. If you think of the previous generation of true value investors – individuals like Walter Schloss and the like – they were truly very close to the Graham approach. And I think today when you look at the various value shops in the U.S. – keeping in mind what the late Bill Ruane tried to figure out six or seven years ago, and it is probably true today – there was really no more than 5% of professionally managed money in the U.S. that was invested on a value basis, broadly speaking. And there was much less than that outside the U.S.

So there are not a great number of value shops, although I must confess that there are quite a few value shops on the hedge fund side. Usually they are long only. They have the ability to borrow, the ability to short, but there are very few value investors that get involved in shorting because

**“There are very few value investors that get involved in shorting because if you are a value investor, you are a long term investor. If you are a long term investor, you don’t have to worry about market psychology.”**

if you are a value investor, you are a long term investor. If you are a long term investor, you don’t have to worry about market psychology. As Ben Graham said: “Short term – the stock market is a voting machine; long term – it is a weighing machine.” But it is very hard to get involved in shorting without taking market psychology into account. Of course, by definition,

there are two characteristics to borrowing. Number one: borrowing works both ways. So you are compromising the idea of margin of safety if you borrow. Number two: borrowing reduces your staying power. As I said, if you are a value investor, you are a long term investor, so you want to have staying power.

I’m not familiar with many of the value shops on the long only hedge fund side, but if you look at the mutual fund world, you don’t have that many value shops. You have Marty Whitman’s Third Avenue, you have Mason Hawkins at Southeast, you have Oakmark in Chicago, you have Tweedy Browne, and a few others, but you don’t have that many.

**Q:** You were probably one of the first recognized global value investors. How has global investing, in general, changed over the past 30 years?

**JME:** It has changed in the sense that it has also become more competitive because there are more American value investors who invest on a global basis, and because there is a little bit more competition from the locals, there are more people outside the U.S. looking for value investment ideas. Let me give you an example: In the 80’s and up until the early 90’s, there were many companies in

(Continued on page 6)



Professor Bruce Greenwald and Dean Glenn Hubbard

Columbia Business School is a leading resource for investment management professionals and the only Ivy League business school in New York City. The School, where value investing originated, is consistently ranked among the top programs for finance in the world.

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## Jean-Marie Eveillard (continued from page 5)



Jean-Marie Eveillard, Xavier De Romana ('02), Walter Schloss

***“Every chief financial officer in this country, and even some outside the U.S., seems to be trying to show his or her highest possible reported earnings without going to jail.”***

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(Continued from page 5)

Europe that had very conservative accounting. The locals did not pay attention to how conservative the accounting could be. This is no longer true.

**Q: What are the characteristics that draw you to an investment and how do you go about finding new ideas?**

**JME:** Well, in terms of hunting grounds, in general, we don't do screens because we like to check the accounting carefully and make our own adjustments. To take an extreme example, take a look at an American forest products company. If they still own timberland, as is the case of Weyerhaeuser, which they acquired about a century ago, they continue to carry it on the balance sheet for about \$1 an acre. Today, it is more like \$1,000 an acre or more in the south and \$2,000 an acre in the Pacific Northwest. So a screen would not help you in any way in that respect. The way we go about it is

that if we decide to look into a particular investment idea we have to do most of the work in-house, hence the extreme importance of the in house research department. This is because sell-side research is directed towards the 95% or so of professional investors who are *not* value investors, so their time horizon is usually more along the lines of six to twelve months as opposed to five or more years for us.

The work, of course, starts with public information – running numbers. Sometimes, we make adjustments to the reported numbers, which is particularly important today because every chief financial officer in this country, and even some outside the U.S., seems to be trying to show the highest possible reported earnings without going to jail. In order to do so, they have to make sure that they observe the letter of the regulation, but they don't hesitate to betray the spirit of the regulations. So, we run the numbers coming from public information, and it's not a matter of having fifteen pages of numbers. I like the idea that the important numbers have more or less to fit on a single page or two pages at the most.

Then, there is the qualitative side, which is of course judgmental and has a lot to do with trying to figure out the three, four or five major characteristics of a business.

For instance in the early 1970's, Buffett figured out that the major characteristics of the newspaper business had to do with the fact that many newspapers had a quasi-monopoly. Buffett determined that what was important was not the fact that already in the 1970's circulation was not growing much, if at all, but that the local department store automatically advertised in the local newspaper. On top of that, it was not a capital intensive business. It was a service business with higher margins, not that they could charge any price, but they were the advertising instrument of choice for local businesses. Wall Street was entirely focused on the fact that they were not growth companies, presumably because circulation was not going up.

This fits in with Buffett's idea that value investors are not hostile to growth. Buffett says that value and growth are joined at the hip – value investors just want profitable growth and they don't want to pay outrageous prices for future growth because, as Graham said, the future is uncertain. And also, what is probably more important from Buffett's point of view is to identify the extremely small number of businesses where, after doing a lot of homework and exercising judgment, you come to the conclusion that the odds are good that the business has a

(Continued on page 7)

## Jean-Marie Eveillard (continued from page 6)

(Continued from page 6)

'moat', the business has a competitive advantage, and that business will be as profitable five or ten years down the road as it is today. This is opposed to simply extrapolating 20% or 25% annual growth observed over the past three years. There is a very limited number of businesses that can continue that type of growth. In any case, Buffett never insisted on 20% - 25% growth. I think he even said something to the effect that a profitable business that is not growing is *not* a business that has no value. A business can have value even if it is not growing. In that sense, value investors tend to think like private equity investors – we are looking for stable and profitable businesses – sometimes in what appears to be mundane areas.

The analysts here keep track of what we own but in our case, most of the work is done before we start buying a stock. Afterwards, it is just a matter of updating and we don't spend any time trying to figure out the next quarter. So our nine analysts keep track of the securities we own, they investigate the ideas that the portfolio manager may have which, at least in my case, usually comes from reading newspapers or flipping through some sell-side research and saying "hmmm, maybe we should look at this." Of course, for a value investor the devil is in the

details, so sometimes the analyst investigates an idea for a few days or for a few weeks and comes back to me and says "Sorry, but this is not a very good idea and here are the reasons why." This is fine with me. Third, we always make sure the analysts have enough time left to initiate and develop their own investment ideas. They come to me first, but it is very rare for me to tell them that I think they are barking up the wrong tree, wasting their time for such and such reasons. It very seldom happens.

So the analysts go out, run the numbers according to public information, and make the adjustments to the numbers as necessary. For instance, for quite a while, we had to make the adjustments for the issuance of stock options because there were many companies that until they were forced to do it, just didn't do it.

The analysts try to figure the 3 – 5 major characteristics of the business. I don't ask them to write about this, but it comes in the conversation that we have after we look at the numbers. Then there is the back and forth between me and the analyst.

Many years ago, when our younger daughter was six or seven years old, somebody at school must have asked her, "What does your father do?" She was embar-

rassed because she didn't know. And so that evening, when I came home, she asked "What do you do at the office?" I thought, rather than trying to explain what money management is to a six year old, I said, "I spend half of my time reading and half of my time talking with my colleagues." My daughter said: "Reading? Talking? That's not work!" But in fact, that is what I do! I spend a considerable amount of time talking with the analysts, looking with them at the various angles, trying to make sure that they have properly estimated the strengths and the weaknesses of the business – then they go back and investigate further.

We invest, if in the end, we agree with them from an analytical point of view. In other words, we think we understand the business, we think we like the business, and we think investors are mis-pricing the business. For value investors, the edge is seldom in unusual information which the rest of the market doesn't have. There is a fine line between unusual information being obtained by regular means or by 'not so regular' means. It is more in the interpretation of the information. It is more figuring out the major characteristics of a business. Buffett didn't know more than Wall Street knew about the newspaper business. He just decided that looking at

(Continued on page 8)

***"For value investors, the edge is seldom in unusual information which the rest of the market doesn't have. There is a fine line between unusual information being obtained by regular means or by 'not so regular' means. It is more in the interpretation of the information."***

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## Jean-Marie Eveillard (continued from page 7)



(Continued from page 7)

the advertising power of the newspaper was more important than the flat circulation numbers.

**Q:** You said that occasionally you will tell an analyst they are barking up the wrong tree. Are there any recurring traps that investors with less experience might fall into?

**JME:** It might be the impression I might have had because maybe I looked at the businesses six or eight years before, and I was under the impression that management was intellectually dishonest. In terms of management, of course there is the Buffett quip that when rowing a boat - what matters less is how strong your arms are, what matters more is whether the boat is leaking. This is, of course, a metaphor for the fact that Wall Street tends to pay a great deal of attention to how good the management is, but Buffett has also said that he wants to buy into businesses that even an idiot could run. It is the *quality*, or lack thereof, of a particular business.

I could think, again because I came across the stock before, this is a business where the accounting is dubious, or I could be under the impression that there is a major weakness to the business that may not be apparent immediately.

Only after the analysts have already done a lot of work will they go and meet management, because management figures out very early in the conversation whether we already know a lot about their business, so they are less likely to lie. I am exaggerating here, but sometimes there are instances where either they tell you nothing, or they tell you lies, or they tell you things that they shouldn't tell you in the first place. We have to be very careful, not because management deliberately tries to give us inside information, but sometimes, particularly if we own 10% - 15% of a business, we are the second largest holder after a family that controls the business and we've held the stock for 7 or 10 years, so management truly looks at us as long term partners.

**Q:** You have often been quoted as saying you have a five-year time horizon vs. Wall Street's six-to-twelve month time horizon - When do you think about selling a stock? Especially given that your performance is measured against other mutual funds, how do you have the staying power to remain disciplined?

**JME:** That is a key question - to answer the second question first - if you are a value investor - you are a long-term investor. Warren Buffett did not become very rich trading securities. If

you are a long-term investor, you accept in advance that you are making no effort whatsoever to keep up with your benchmark or your peers on a short term basis. So you know in advance that every now and then you will lag. We lagged sometimes in the 1980's, in the early 1990's we lagged as well, but then in the late 1990's we lagged terribly for several years. We were still producing absolute returns, but relative to our benchmark and to our peers we were lagging terribly because I had declined to participate in technology, media and telecom, together with many other value investors.

In less than 3 years, between the fall of 1997 and the spring of 2000, our Global Fund, which I had run since early 1979 and had a long term record, lost seven out of ten shareholders. One has to live with that because a mutual fund is open to subscriptions and redemptions every day. You don't get to choose your investors. You take whoever is sending the check. You try in your sales effort to explain very clearly what you are trying to do, so that you don't get the wrong type of investors. But there are many investors who will either not understand what we're trying to do or will understand what we're trying to do, but if we lag for a year or two, they will forget about it.

(Continued on page 9)

**"Sometimes, there are non-value investors who tell me, well, I would love to do what you do, but if I did it and start lagging, either my boss or my shareholders will fire me. Of course, the answer is you have the wrong boss or wrong shareholders or both!"**

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## Jean-Marie Eveillard (continued from page 8)

(Continued from page 8)

There is impatience among investors. Ideally, if you run money professionally on a long-term basis, you would want shareholders in your fund to be long-term investors, but that's not always what happens.

Incidentally, not only does value investing make sense, at least to me, but it works. In that respect, you are probably familiar with the piece written by Buffett – “The Superinvestors of Graham and Doddsville” – and then 20 years later, the piece written by Louis Lowenstein (“Searching for Rationality in a Perfect Storm”). Buffett himself considered another nine value investors. So then the question arises - why are there so few value investors if it makes sense, if the approach makes sense and it works? I think the answer is truly psychological, and that is what I was referring to when I said that if you are a value investor, you have to accept in advance that you will lag. And if you lag, you suffer. Yes, you say to yourself, I'm a long-term investor so my day will come, but if it goes on too long, it is not only the doubt, but there is a genuine suffering associated with lagging, and human nature shrinks from pain. Sometimes, there are non-value investors who tell me, well I would love to do what you do, but, if I did it and start lagging, either my boss or my shareholders will fire

me. Of course, the answer is you have the wrong boss or wrong shareholders or both!

**Q: You must have experienced that, especially early in your career when you were with Societe Generale?**

**JME:** That is why very early, late 1997, after only a few months of net redemptions, they made the decision of selling our investment advisory firm. They were extremely impatient. One thing is that if I look back, we ran a total of \$6 billion in the fall of 1997. Even though we continued to make money for shareholders, funds were down to \$2.5 billion in the spring of 2000. Today we manage close to \$35 billion. So what I am saying here is that it seems to me that it goes to show that if you do what you think is right for the shareholders, even if they don't seem to agree themselves, if you think you do what is right for the shareholders, in the end, it benefits your business from a long-term point of view because \$35 billion is not only a lot more than \$2.5 billion, it is also a lot more than \$6 billion. It goes back to when Peter Lynch was running the Fidelity Magellan fund. Lynch had a superior long-term track record, but he discovered to his dismay that the great majority of shareholders of the Magellan Fund during his manage-

ment had done much worse than Peter Lynch's record because they usually bought into the fund after Peter Lynch had really hit the ball and then they would leave if for six or nine months if he was doing less well or if the market went down during that period. I hesitate whenever I meet with financial planners or brokers, who are our real constituency, because they are the ones who decide to choose which mutual fund to invest in for their own clients. I am reluctant to try to tell them how to run their businesses, but it seems to me that they are much too worried about asset allocation, they should be trying to find three, four or five good value managers and just stay with them. Maybe they are worried that if they

(Continued on page 10)



Professor Bruce Greenwald

Bruce C. N. Greenwald holds the Robert Heilbrunn Professorship of Finance and Asset Management at Columbia Business School and is the academic Director of the Heilbrunn Center for Graham & Dodd Investing. Described by the New York Times as “a guru to Wall Street's gurus,” Greenwald is an authority on value investing with additional expertise in productivity and the economics of information.



Jean-Marie Eveillard answering questions after delivering the keynote address at the 15th Graham & Dodd Breakfast on October 18, 2005

## Jean-Marie Eveillard (continued from page 9)



David Einhorn with his parents at the Graham & Dodd Breakfast

(Continued from page 9)

pick three, four or five value managers and stick with them, after two or three years the clients will say "What am I paying you for?"

**Q:** I recently read that Tweedy Browne opened their Global Value Fund, Third Avenue International is opening their fund, Longleaf is opening their Partners Fund, and you just opened your Global and Overseas funds. Does this mean that investment opportunities are beginning to appear on the horizon?

**JME:** That is right - I saw the press release from Third Avenue and I also saw the press release from Longleaf. Longleaf is saying "We see opportunities today." Third Avenue and we are saying much more that the market is very turbulent. To paraphrase Ben Graham, Mr. Market seems to be moving from fear to greed and back. Both Third Avenue and we are saying that maybe there will be opportunities if the turbulence continues, but neither one of us is saying we see an opportunity right today. I believe Mason Hawkins is saying that there are currently opportunities and for all I know, he may be right.

**Q:** Your answer leads me to believe that you would currently be looking at some of the most turbulent areas of the market right now? Is that true and where might that be?

**JME:** Yes, but if you look at the U.S. equity market, we are in the midst of what appears to be a major and worldwide credit crisis. In August, the crisis was identified as a sub-prime housing American problem. Today, four months later, it appears to be a worldwide credit crisis, and yet the American stock market is 5% off its high at the end of the fifth year of a Bull market. Except for the Tokyo stock market, which I think is about 20% off its high, markets in the U.S. and Europe and most emerging markets are very close to their high. Combined with the fact that we are in the midst of a major financial crisis, it seems to indicate that investors, and for all I know they may be right, believe that we'll get out of the crisis reasonably soon. Otherwise, markets would be much lower than they are today. So that is why, speaking very generally, we don't find a tremendous amount of investment opportunities right now.

You know value investors are bottom-up investors, but I do pay some attention to the top-down. First, it cannot be completely ignored. Second, the intrinsic values we establish for the businesses we are invested in or that we consider investing in do not assume eternal prosperity. They assume that the world muddles through, which is usually what the world does. They do not assume a year

or two or three of very difficult economic and financial circumstances, because if that were the case, those intrinsic values would be at least temporarily too high, and accordingly, the risks associated with our equity portfolio would be bigger than I think they are. So, to the extent that we consider the top-down we look from a negative standpoint. What could screw up, from the top-down, the investments we make with a bottom-up approach?

In another respect, we've been in a twenty-five year credit boom, since the early 1980's, interrupted painfully but briefly in 1990. I say painfully because at the end of 1990 you can point to Rupert Murdoch's News Corp. almost going bankrupt until the banks, and we - although I made the mistake of buying the bonds instead of buying the stock - and a few others understood that what they had was a liquidity problem, but not an insolvency problem. Even on a conservative basis, the sum of the parts of the assets was quite a bit in excess of the debt. They simply had a temporary cash flow problem. Also in 1990 is when Sam Zell's real estate empire almost collapsed. So, we have been in a twenty-five year credit boom with one interruption, which is a truly long credit boom.

We seem to be facing a

(Continued on page 11)

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## Jean-Marie Eveillard (continued from page 10)

(Continued from page 10)

worldwide credit crisis. The central banks are pedaling as fast as they can to mitigate the damage. This is crisis number six or seven. You had October 1987, you had 1990, you had the late 1994 Mexican crisis, you had the 1997 Asian crisis, in 1998 the Russian crisis and the Long Term Capital Management collapse. You had the bursting of the technology/media/telecom bubble and now the sub-prime housing crisis. The odds are pretty good that crisis number six or seven in twenty years will be gone in a few months, but maybe it will take longer or maybe the financial system is truly fraying at the edges.

I think it is Peter Bernstein who said sometimes what matters is not how low the odds are that something truly negative happens - and the odds are pretty low that the system blows up - sometimes what matters is what the consequences would be if it happened. For example, if I tell you if you do this, the odds are one-in-ten that you will lose \$50, no big deal. If I tell you the odds are one-in-one hundred, even better odds in the sense that the risk of losing is minute, that you die, then the consequences are so drastic that even the odds as low as one-in-one hundred are just not good enough.

I think there is a mindset among many professional

investors that if I go down the drain, well it is o.k. as long as everyone else is going down the drain with me. I think that with the hedge fund business, at least so far, the regulators have been careful enough to basically prevent the middle class from getting involved with hedge funds. But in the mutual fund business, we have almost one-million shareholders in our funds and while we have some institutional accounts and some very wealthy individuals, the great majority of the one-million are middle class people. If I screw up, I can make daily lives difficult. Financial planners have told stories about individuals who did not have a great nest egg, but thought they had enough of a nest egg to retire. They invested the money with conventional money managers who proceeded to lose 30% to 40% between the spring of 2000 and the spring of 2003. These people had to go back to work, or sell the boat.

I remember the day after I retired, which was January 1, 2005, I got up late, took a stroll in Central Park and I felt lighter than air. The responsibility was off my shoulders. That is why I wasn't particularly eager to come back, but I had been treated very well here at Arnhold and S. Bleichroeder, and also there was a side to it where particularly the old fund, which I have run since 1979, was in a

sense my baby. I didn't want to just leave it. In view of the size of assets under management, it was odd in a way that there was only one portfolio manager. I mean myself for twenty-six years and Charles De Vault for two years. Of course if you have a single portfolio manager and he leaves or is run over by a bus, what is left is a big void. Although it is true that value investors, at least in our case, it doesn't matter who has the biggest battalions. What I mean is if I had forty-five analysts, we wouldn't be doing any better than nine or ten, but I think it is the kind of approach where we want as many people on the in-house research staff and as few people as possible on the portfolio management side.

**Q:** You spoke about risk being the consequence, not necessarily the odds. How does this thinking come into your investment process?

**JME:** Risk to us goes back to not paying attention to how one does in the short term. If you go back to Berkshire Hathaway's annual report page that has the forty-plus year record of Buffett, on a cumulative basis the record is extraordinarily better than the S&P 500, but you can spot four or five years, I think there is one year where he is 1,500 basis points behind the S&P 500. So he too accepts the fact that every now and

(Continued on page 12)



**“You know value investors are bottom-up investors, but I do pay some attention to the top-down. First, it cannot be completely ignored. Second, the intrinsic values we establish for the businesses we are invested in or that we consider investing in do not assume eternal prosperity.”**

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## Jean-Marie Eveillard (continued from page 9)



Jean-Marie Eveillard and David Winters at a past Graham & Dodd Breakfast

(Continued from page 11)

then you will underperform.

Risk to us is absolutely not volatility. We always have this discussion with financial consultants - it is not volatility. Marty Whitman is unusual in a sense that there are not many value investors who were very good practitioners and also could write from a theoretical point of view. Marty, in one of his books, makes a key distinction between what he calls *temporary unrealized capital loss*, which is you buy a stock at \$35 and, after a year or two or three, it is at \$25 or \$30. If you think you have done your original homework before you bought the stock in a proper manner, if you kept reasonably close to the situation as the business evolves over time, and if you believe that nothing major has changed for the worse since you started buying the stock, that is what Marty calls temporary unrealized capital loss, which is nothing to worry about. If anything, it is

probably an opportunity to buy more of the stock. The key distinction is what Marty calls *permanent impairment of capital*, which are fancy words for "Damn it, I made a mistake." Not a mistake because I bought a stock at \$35 and now it is at \$27. I made a mistake because either my original analysis of the business was wrong or because after I started buying the stock, I failed to observe that the business model was changing for the worse. In this case you have to acknowledge your mistake, sell at a loss, and move on.

If you think it is a temporary unrealized capital loss, if you bought a stock at \$35 and two or three years later it is at \$27, it becomes painful and the great majority of money managers get very upset. But you have to ask yourself, "Did I miss something?" If the answer is, "I don't think so," then you have to accept that fact. For example, if you buy a stock for \$25 and four years later it is still at \$25 and in the fifth year it goes to \$50, I don't think in terms of I wasted my time for four years or it was what some investors call stale money for four years, I say hey, I doubled my money in five years and that is 15% annualized a year and that is fine.

Going back to what I was saying, not that value investors are masochists, but that accepting in advance that every now and then you will

suffer because you will lag. It goes back to what Buffett was saying when he said something to the effect that investing does not require high intelligence, but it requires some temperament.

**Q: On the topic of temperament - Buffett has said that he is "wired" a certain way. Do you think temperament is something you are born with or a trait that can be learned?**

JME: One way to view it is in the U.S. and also now in Europe, some people go too easily to the psychiatrist, because if they do so, it shows that there is an expectation that they should be happy every day. Of course, it is true at the other extreme. You have people who tend to believe too easily that life is a valley of tears and that one can only be happy in the eternal. The truth is in between, one has to accept the fact that one is not happy every day. One is not entitled to be happy every day and I think that as an investor it is the same idea that we don't need to win every day. We just need to win over time. Maybe the people who say, well, I cannot afford to be a value investor because my boss or shareholders will fire me, maybe they are right. But I think there is also the idea that I just don't want to suffer. I remember there was a movie about baseball called "A League of

(Continued on page 13)

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## Jean-Marie Eveillard (continued from page 10)

(Continued from page 12)

Their Own” where at some point a woman says to Tom Hanks, who plays the coach, “Baseball is too hard.” Tom Hanks replies something to the effect of “Of course it’s hard. If it was not hard then everybody would be doing it.” It is the idea that everything in life that is worthwhile comes hard.

**Q:** You recently hired Columbia Professor Bruce Greenwald as the Director of Research. He is one reason that many of us choose to pursue an MBA at Columbia. How do you think he will enhance the team you have in place at First Eagle?

**JME:** Bruce is sixty-one years old, and I first met him several years ago. His entire professional career has been in the academic world, and he was willing to go into the real world, so to speak, as opposed to the academic world. He was intrigued by the idea of being director of research and, in that respect, I think he will do at least two things. Number one, although of lesser importance, he will help us beef up the research department because he knows a lot of people who graduated from Columbia Business School and were enrolled in the Value Investing Program. I never thought I was understaffed until I recently met with David Barse who is the CEO of Third Avenue. He

said there were at least 20 analysts there. The truth is they do distressed investing and you need specialized people for that. Marty has also decided to become more of an activist, which we have done very rarely, takes a lot of time and energy.

Number two, and most importantly, in the value tent, Bruce is definitely on the Buffett side although he is very tolerant. Some people on the Graham side are intolerant of the Buffett side and vice-versa. You know, Buffett has called the pure Graham style “Cigar Butt” investing, which is not very flattering, although I remember Walter Schloss chuckling that he himself thought he got more than one good puff every now and then. However, Bruce has also introduced some refinements of his own to the Buffett side and that will be very helpful to the analysts here. Although the in-house staff here does not need to be energized, you know that Bruce is an energizing personality. So, we are looking forward to his joining the team. To me, he is the ideal director of research.

**Q:** What advice would you offer an MBA student aspiring to enter the field of investment management?

**JME:** Join a value shop. Keep in mind there are value shops in the mutual fund field and the hedge

fund field, most of which are long only. Also, keep in mind that in the words of Paul Isaac, hedge funds are a compensation scheme and that indeed a reasonably good value mutual fund is, in the end, from the point of view of the shareholder of the funds, a very cheap hedge fund, because all value investors, whether they are with hedge funds or with mutual funds, shoot for absolute returns. If you achieve absolute returns and compound at a reasonable rate over the years the difference between you and a long only hedge fund is that you are charging 1.25% overall expense ratio as opposed to two-and-twenty. You should also approach professors who are also practitioners to get their opinions on which firms would be good for you to join.

*Thank you, Mr. Eveillard.*

**“Join a value shop. Keep in mind ... that indeed a reasonably good value mutual fund is, in the end, from the point of view of the shareholder of the funds, a very cheap hedge fund, because all value investors, whether they are with hedge funds or with mutual funds, shoot for absolute returns.”**

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## D.R. Horton, Inc. (SHORT)

Joshua Chekofsky  
JChekofsky08@gsb.columbia.edu

November 2007



D.R. Horton, Inc. (DHI)  
Price: \$15.43  
(Jan. 25, 2008)

Capital Structure - Total Company	
Price per Share	11.86
FD Shares	317.8
Market Cap	3,718.8
Net Debt	4,856.0
Minority Interest	85.1
Enterprise Value	8,659.9
% Insider Ownership	12.6%
% Short Interest	12.1%
% Dividend Yield	5.1%
Total Debt / Total Capital	46.1%
Total Debt / EBIT (before Imprmnts)	4.0x
EBIT (before Imprmnts) / Int. Exp.	25.6x



**Investment Thesis**

I advocate a short position in the common stock of D.R. Horton, Inc. ("D.R. Horton" or the Company), as I believe the stock has an intrinsic value today of \$7.25 (representing a margin of safety of approximately 40%, against today's price of \$11.86), based upon a Price / Adjusted Book Value analysis; yet, there is risk of 15% upside (\$13.75). A six-month timeframe, across which the Company will report its next three fiscal quarters of performance, should be ample for the Company's homebuilding fundamentals to deteriorate further and for management to make additional impairment announcements. The Company is poorly positioned in the current homebuilding environment. It has significant exposure to the weakest geographic housing markets, and owns some of the youngest land supply in the industry, which is at greatest risk of loss. Sales orders have fallen dramatically, while cancellations are at abysmal levels. As management pursues aggressive sales to generate free cash flow to pay down its significant debt load, operating margins will deteriorate further. With adjustable-rate mortgages continuing to re-set, the Company's core first-time buyers will be considerably affected. D.R. Horton will be required to take extensive further impairments on its inventory (homes, land and options). Housing market conditions will continue to be challenging and the timing of a recovery is unclear. The industry is currently mired in a deep cyclical trough, which will likely persist for the foreseeable future. There will be continued margin pressure from increased price reductions and sales incentives, continued high levels of new and existing homes available for sale, weak demand for new home as potential buyers continue to see home prices adjust downward, increased sales cancellations, continued weak housing affordability, and a decline in the availability of mortgages due to further credit tightening. The formerly hottest housing markets are now reeling, a growing number of foreclosed homes will be returning to the market, a sizable level of mortgage loans will continue to default, and it will now take an elongated timeframe for the average home buyer to receive a mortgage. The primary valuation was based upon a Price / Book Value methodology, in which book value was adjusted for anticipated substantial further asset impairments. A 0.75x multiple (given investors' weak confidence and the turmoil in the industry) was allocated.

### Supporting Points / Catalysts

- Any further negative economic and industry performance releases will lead to a decrease in the Company's stock price.
- The Company recently reported that cancellations increased to 48% in the 9/30/07 quarter, which is dramatically higher than the 30% to 40% in prior quarters. The Company's backlog no longer provides accurate visibility on future revenues. Cancellations should continue to remain at heightened levels.
- D.R. Horton has significant exposure to the weakest geographic housing markets including California, Arizona, Nevada and Florida. Moreover, the Company maintains a very young land supply, relative to other home builders. This land which was purchased in 2005 and 2006 in formerly hot markets is at significant risk of impairment.
- D.R. Horton has a heavy debt load. Any further deterioration in performance could lead to debt downgrades, and extensive impairments will reduce the borrowing base. This leads to broken financial covenants and lower liquidity.
- D.R. Horton's target customer base has been greatly affected by tightening in the mortgage market, as the Company's focus is on first-time buyers and first time move-up buyers (with most homes priced below \$250,000).

### Business Description

D.R. Horton is the largest homebuilding company in the country based on homes closed during the 12 months ended 6/30/07. The Company constructs and sells homes through its operating divisions in 27 states and 83 metropolitan markets. Homebuilding operations include the construction and sale of single-family homes with sales prices generally ranging from \$90,000 to \$900,000, with an average closing price of \$261,600 during the nine months ended 6/30/07. Approximately 80% of home sales revenues were generated from the sale of single-family detached homes in the 9 months ended 6/30/07, with the remainder from the sale of attached homes. DHI Mortgage, a wholly-owned subsidiary, provides mortgage financing services to purchasers of homes it builds and sells.

### Historical and Projected Performance

The Company's performance has deteriorated over the last several quarters. Sales and operating margins for the homebuilding operations have dropped precipitously, and results for the financial services busi-

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## D.R. Horton, Inc. (Continued from previous page)

ness have followed in concert. The Company has aggressively moved towards selling its inventory, to work down the glut of supply, which has lowered its average selling price and operating margins. The fall-out from the exuberant rise in homebuilding activities will take time to work its way through the system. Until the demand/supply imbalance is corrected and selling prices stabilize, performance will continue to be depressed. Further compounding the problem, the Company will very likely have to recognize significant additional impairments on its inventory (homes, land and options), as management realizes that losses will be worse than expected. It is assumed that industry fundamentals will remain weak across Q4 2007 and FY 2008, and that the situation won't stabilize until 2009. Revenue and margins are projected to improve in 2009, towards the levels reached in the earlier part of this decade.

### Valuation

Given the weak recent EBIT growth, poor pre-tax ROTC, and heavy debt load, the EV/EBIT valuations produce low intrinsic values. The historical EV/EBIT analysis produces a value of \$5.45 to \$9.30. The Projected EV/EBIT analysis produces a value of \$6.20 to \$8.60. A more robust approach for this inventory-intensive business is a Price / Adjusted Book Value analysis, which produces a target price of \$7.25. Impairments on homes is driven by the perception that 20% of the 6/30/07 homes inventory book value is at risk, as D.R. Horton has aggressively moved towards price slashing, which may create a price-cutting war. The Company's core first-time buyers are seriously affected by the recent credit crisis. The estimate for the decline in homes inventory is estimated to be negative 20%. The level of impairments on the land (held for development, under development, and in development) is assumed to be triple this dollar amount, as land prices change at three times the price of homes, given that the Company prices land on a residual basis, after development and construction costs. Options on land/lots are assumed to be worthless, as these contracts were entered into at the peak of the real estate boom. The impairments are tax-effected at a discount to the 37.5% tax rate, given the risk and elongated timeframe to reap the deferred tax asset benefits. With the current turmoil in the housing sector and the lack of investor confidence, it is assumed that the market will allocate a 0.75x multiple. An upside risk scenario is also calculated.

**Risks to Thesis:** The prices of homebuilder stocks have fallen substantially already this year, and any positive national economic activity news, housing industry news, or peer earnings releases could spur an upward bounce in stock prices. The level of housing starts (i.e., new construction activity) has already decreased significantly from levels in previous years as homebuilders have shifted focus towards working through the excess supply of inventory on the market. Although the Company has high leverage, the majority of the debt does not mature for a few years, and D.R. Horton has been generating strong cash flows from operations recently, albeit through very aggressive pricing and weak gross margins. A significant decline in long-term interest rates (and correspondingly in mortgage rates) would increase housing affordability, as well as lead to inventory burn and a return to price appreciation.

All Amounts in Millions of Dollars Except Per Share Data

Historical EV/EBIT Multiple Analysis			Price to Adjusted Book Value Multiple Analysis				
	Low	High		6/30/2007 Book Value	Pre-Tax Writedown %	Pre-tax Addnl. Impairment	Post-tax Addnl. Impairment
LTM EBIT (Excluding Impairments)	1,224.2	1,224.2	Unadjusted Book Value	5,677.7			5,677.7
EBIT Multiple	5.5x	6.5x	Construction in Progress and Finished Homes	4,207.5	-20%	(841.5)	(610.1)
Enterprise Value	6,733.1	7,957.3	Residential Land/Lots (Devlpd and Under Dvlpmnt)	5,869.5	-40%	(2,347.8)	(1,702.2)
Less Net Debt	(4,909.4)	(4,909.4)	Land Held for Development	359.4	-40%	(143.8)	(104.2)
Less Minority Interest	(85.1)	(85.1)	Earned Money Deposits (Options on Land/Lots)	133.7	-100%	(133.7)	(96.9)
Equity Value	1,738.6	2,962.8	Goodwill	153.3	-67%	(102.7)	(102.7)
FD Shares	317.8	317.8	Adjusted Book Value				3,061.6
Intrinsic Value per Share	5.47	9.32					
Current Share Price	11.86	11.86					
Margin of Safety on Short Position	53.9%	21.4%					
Projected EV/EBIT Multiple Analysis			TARGET				
	Low	High		Low (a)	High (b)		
FY 2009 EBIT (Excluding Impairments)	910.2	910.2	Adjusted Book Value	3,061.6	4,369.6		
EBIT Multiple	7.0x	8.0x	Price to Book Value Multiple	0.75x	1.00x		
Enterprise Value	6,371.1	7,281.3	Equity Value	2,296.2	4,369.6		
Less Net Debt	(6,154.0)	(6,154.0)	FD Shares	317.8	317.8		
Less Minority Interest	(85.1)	(85.1)	Intrinsic Value per Share	7.23	13.75		
Plus Cash Build	2,195.1	2,195.1	Current Share Price	11.86	11.86		
Equity Value	2,327.1	3,237.2	Margin of Safety on Short Position	39.1%	-15.9%		
FD Shares	317.8	317.8					
Intrinsic Value per Share	7.32	10.19					
Discounted to 2007 at 12% (1.5 Yrs)	6.18	8.60					
Current Share Price	11.86	11.86					
Margin of Safety on Short Position	47.9%	27.5%					

#### Notes:

(a) Assumes that 100% of the expected additional impairments are recognized, and a 0.75x P/B multiple is utilized.

(b) Assumes that 50% of the expected additional impairments are recognized, and a 1.00x P/B multiple is utilized.

**“Sales orders have fallen dramatically, while cancellations are at abysmal levels.”**

**“A more robust approach for this inventory-intensive business is a Price / Adjusted Book Value analysis, which produces a target price of \$7.25.”**

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## Macy's, Inc. (NYSE: M)

Long

Del Anderson, CFA  
DAnderson08@gsb.columbia.edu

Current Price (1/25/2007): **\$22.47**  
Intrinsic Valuation Range: **\$37.00 (\$34.00 - \$45.00)**  
Margin of Safety: **+60% (base case)**

**Thesis Summary:** Macy's is a long because of:

Horizon mismatch: Macy's shares have been punished due to slow sales growth at rebranded May stores; however, the near-term focus of many analyst models fails to capture a "sweet spot" in which sales growth normalizes at these stores throughout 2008 and beyond, improving returns and turnover.

**Impact:** *True demand in new markets is presently undervalued*

Downside Protection: Recent investments in revenue optimization systems and "service culture" will improve margins in the event of a full-blown downturn, while Macy's ownership of most of its stores provides a tangible floor of \$14 for the stock price. Additionally, middle-market retailers (including Macy's) have outperformed both lower- and higher-end peers significantly during each of the past three Fed easing cycles.

**Impact:** *Sensitivity to downturn low relative to peers*

Stock buyback: Macy's repurchased 22% of shares outstanding in 2007 out of strong free cash flow, and has made a commitment to maintain its investment grade rating while repurchasing ~5% of shares during the coming year. In retrospect, Macy's could have purchased some shares at lower rates, but it still represents a long-term positive for equity holders given that shares were purchased well-below my intrinsic valuation.

**Impact:** *EPS to be amplified 5%+ as share count contracts*

**Bottom line:** *Macy's may decline modestly with retail peers in the near term, but this represents a buying opportunity. Over two-year horizon, Macy's will be a strong outperformer from current levels.*

### Background:

In late 2005, Federated Department Stores (now Macy's) acquired a key competitor, the May Company, doubling its store count in largely untapped markets and adding 15 new states to its territory, making it a truly national brand. Subsequently, the firm has realized administrative synergies in excess of initial plan but sales growth at rebranded stores has lagged.

### Market Misperception:

Macy's shares declined throughout 2007 on recession fears and concerns about poor performance at acquired stores. In one salient example, former Marshall Field's shoppers in Chicago began boycotting rebranded Macy's stores; however, I believe it won't be long before these protesters trade their picket signs for Macy's cards. At present, sales at "new Macy's" stores are lagging because shoppers are not used to Macy's promotional style (no coupons), sales associates are unaccustomed to Macy's brands and regional merchants have not fully adapted Macy's product lines to local consumer tastes. All of these issues are temporary. On the operational front (gross margin, SG&A expense, systems integration), Macy's has delivered as promised by the merger. Thus, I believe that the first evidence of a sales revival at the new stores will be a strong positive catalyst for the company.

### Total Enterprise Value Calculation

Share Price (01/25/08)	\$22.47
x Shares Out.	433.0
<b>= Market Capitalization (\$MM)</b>	<b>\$9,729</b>
+ Net Debt	10,456
<b>= Total Enterprise Value (TEV)</b>	<b>20,185</b>
<b>EV/EBITDA</b>	<b>5.6x</b>
<b>52-Week High</b>	<b>\$46.51</b>
<b>52-Week Low</b>	<b>\$21.31</b>

### Forecast & Consensus

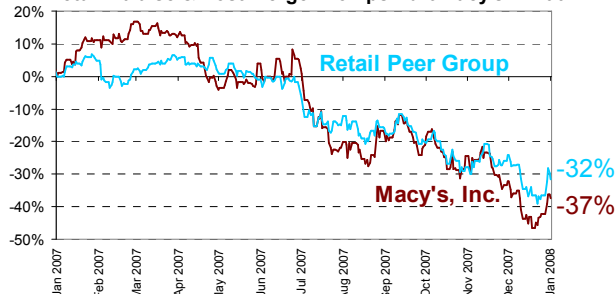
	EPS	P/E	Consensus
Current*	\$2.18	10.3x	\$2.19
FY' 2009	\$2.41	9.3x	\$2.37
FY' 2010	\$2.72	8.3x	\$2.62
FY' 2011	\$3.03	7.4x	\$2.90

\*Current (FY' 2008) ends on 1/31/2008

### Valuation Methodologies

Free Cash Flow to Equity (base case)	\$37.00
Private Market / Reproduction Value	>>\$35.00
Comparable Multiples (14x Fwd P/E)	\$34.00
Liquidation Value	\$15.00
Upside FCFE:	\$45.00 <b>+100.3%</b>
Downside FCFE:	\$18.00 <b>-19.9%</b>
<b>Upside / Downside Risk Ratio</b>	<b>5.0x</b>

### Retail Malaise & Post-Merger Comps Hurt Macy's in 2007





## Macy's, Inc. (Continued from previous page)

To test the impact of the current sales drag, I modeled sales by region and store type based on growth projections using pre-merger sales data. Assuming a conservative -10% sales drag at the rebranded stores, Macy's revenues will be impaired by \$1.1 billion during 2007. However, this bodes well for the future, since it means that current sales numbers are temporarily suppressed. As customers adapt to Macy's strategy, the sales drag will narrow and total sales will increase rapidly in 2008 and beyond. The table below forecasts sales for Macy's major divisions, with an estimate of the gap between new and legacy stores. The sales growth estimates for legacy divisions are conservative and well-below Macy's historic organic growth rate of 4.3% over the past seven years.

Sources of Macy's Sales Growth (Legacy v. May stores)	CY		Growth (%)	2007 (E)		Growth (%)	2008 (E)		Growth (%)	2009 (E)		Growth (%)	2010 (E)	
	2006 (A)													
Bloomingdales	2,317		6.0%	2,456		3.0%	2,530		4.0%	2,631		3.5%	2,723	
Macy's East	7,193		2.5%	7,373		2.0%	7,520		2.0%	7,671		2.5%	7,862	
Macy's West	6,002		3.0%	6,182		2.0%	6,306		2.0%	6,432		2.5%	6,593	
Macy's South & Florida	5,564		-5.0%	5,286		-1.5%	5,207		2.0%	5,311		2.5%	5,443	
Macy's Central & Midwest	5,444		-2.0%	5,335		0.0%	5,335		2.0%	5,442		1.0%	5,496	
Macy's.com	450		50.0%	675		25.0%	844		20.0%	1,013		15.0%	1,164	
Less: Lag from legacy May Stores*	11,601		-11.4%	(1,105)		-5.6%	(416)		-4.4%	(217)		-3.7%	(147)	
<b>Total Revenue Projection</b>	<b>26,970</b>		<b>-1.5%</b>	<b>26,564</b>		<b>3.4%</b>	<b>27,471</b>		<b>3.4%</b>	<b>28,392</b>		<b>2.9%</b>	<b>29,135</b>	

\* Sales growth lag relative to growth rates at legacy stores.

### Scuttlebutt Research Support:

Interviews with buyers at Macy's and Bloomingdales, visits to rebranded stores and some entertaining hours online reading blog posts and online consumer chatter about Macy's brand yielded several key insights:

- 1) According to buyers, sales at rebranded stores are lagging legacy stores by ~10% overall and up to 20% in some regions, although sales of exclusive brands (inc. Martha Stewart) were strong companywide. Over the holidays, the gap between legacy and rebranded stores declined.
- 2) Rebranded stores have the potential to deliver results on-par with legacy Macy's stores. Longtime May employees believe that their customers are no different from Macy's target customers, so localization strategy should yield results.
- 3) Consumers' online sentiments are getting better. One enlightened poster even noted that "My rage at the Marshall Field's takeover diminished when I visited Macy's.... To my surprise, they retained many MF touches. I've seen nothing but improvement in the store."

### Industry Analysis:

Retail stocks are out-of-fashion at the moment, creating a buying opportunity for the shares of several companies (Macy's, Nordstrom, JCP); however Macy's is particularly well-suited to outperform given that its stores are less-concentrated in the bubblest housing markets and that under 15% of sales come from home essentials. As a purveyor of reasonably-priced quality brands, Macy's stands to benefit in a downturn relative to higher-end peers (i.e., pinched Saks/Nordstrom shoppers would feel comfortable being seen at Macy's).

As of 1/25/2007				Volume			Valuation					Leverage			Operating & DuPont Metrics					
Company Name		Enterprise	Total	Sales	Price/Earnings		EV /	Price /	FCF	Dividend	Debt/	Interest	S&P	Gross	Oper.	Sales		Asset	Equity	
		Value	Sales	Growth	Current	Forward	EBITDA	Book	Yield	Yield	Assets	Coverage	Rating	Margin	Margin	ROE	Margin	Turnover	Leverage	
Macy's Inc. (M)		21,973	26,878	(1.8)	12.0	10.8	5.6	1.2	4.5	1.9	36.2	4.7x	BBB	40.2	8.3	10.2	=	3.3	1.0	3.1
Peer Summary Analysis				%	x	x	x	x	%	%	%	x		%	%	%	x	x	x	
Median		13,248	17,336	6.7	16.3	14.3	7.9	2.5	-3.4	0.9	25.0	6.6x	-	32.2	7.37	20.5	4.2	1.6	2.7	
Target Corp. (TGT)		57,380	63,207	11.4	15.7	14.2	9.0	2.8	-0.1	0.9	32.7	4.2x	A+	30.2	8.5	19.0	=	2.2	1.6	2.7
Sears Holdings Corp. (SHLD)		20,322	51,777	(2.0)	19.8	23.2	6.0	1.3	6.9	0.0	13.6	8.9x	BB	26.3	4.1	10.9	=	0.9	1.7	2.8
Kohl's Corp. (KSS)		15,560	16,417	10.9	12.6	11.6	6.8	2.6	-3.2	0.0	20.0	10.9x	BBB+	34.2	11.6	20.4	=	3.7	1.6	1.9
TJX Cos. (TJX)		14,371	18,256	7.5	17.0	14.9	9.6	6.5	5.0	1.1	12.4	25.5x	A	24.1	6.2	26.6	=	7.1	2.8	3.2
J.C. Penney Co. Inc. (JCP)		12,124	20,134	3.6	9.7	9.9	5.5	2.2	-3.5	2.3	27.3	4.2x	BBB-	37.1	9.5	33.1	=	4.7	1.5	3.1
Nordstrom Inc. (JWN)		10,842	8,945	8.7	13.5	12.3	7.3	6.8	-4.6	1.3	38.1	15.9x	A-	37.6	10.7	45.0	=	2.3	1.8	4.2
Saks Inc. (SKS)		3,169	3,238	15.5	40.9	30.2	14.4	2.3	-27.8	0.0	24.6	1.5x	B+	36.2	2.2	2.8	=	5.8	1.2	2.2
Dillard's Inc. (DDS)		2,940	7,441	(1.8)	28.1	54.2	5.6	0.6	-7.1	0.8	25.5	1.1x	BB	29.5	0.6	6.6	=	8.2	1.2	2.4

Source: FactSet Daily Prices, Capital IQ, Reuters Global Fundamentals, First Call Estimates

History also suggests that the freefall of retail stocks may be nearing its nadir. During the past two consumer downturns (1990, 2001), general retail stocks fell ~40% from peak-to-trough and they reached bottom within a month of the official start of the recession. Macy's shares hit a cyclical low three months before the 2001 recession after falling 50% during the preceding year. Such statistics are meaningless from a fundamental perspective, but they do suggest that the majority of the losses associated with a recession may be reflected in Macy's share price already.

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Netflix (NFLX)  
Price: 21.75  
(Jan. 25, 2008)

*“Simply put  
there is no rea-  
son for Netflix to  
exist.”*

## Short Netflix (NFLX) at 21.75 — Price target \$16

Avram Drori  
ADrori09@gsb.columbia.edu

November 2007

Price:	\$21.75
52 week high:	\$30.00
52 week low:	\$15.62
LTM P/E:	23.0
LTM EV/EBITDA:	10.1x

'08E P/E:	25.0
'08E EV/EBITDA:	10.2x
Market Cap:	\$1.43Bn
Enterprise Value:	\$1.03Bn
%held by insiders:	1.1%
Short as a % of float:	24.2%

### Investment Thesis:

Simply put there is no reason for Netflix to exist. The business model is fundamentally anachronistic and the company is destined to become a marginal player within the medium term. Cable, satellite and telcos have achieved penetration rates of advanced video on demand services in ~75% of their cumulative territory, implying ~65% of American Households can watch video on demand (VOD). VOD has incremental costs of essentially nil and the immediate gratification provided by the model is superior to Netflix's 1 day turnaround. Additionally, the company has been late to recognize this and continues to spend money to attract new customers. The economics of new customer growth are extremely unattractive and as customer usage of the service declines, there will be a self-selection process whereby only the heaviest users of the service (and therefore the most costly to the company) will maintain their service. Due to stagnating growth and shrinking margins, I have assigned a price target of \$16, representing ~30% downside from current levels. However, because of the high short position (~24% of float) and the relatively volatile nature of the stock (beta=2.2) there is a meaningful risk of short term trading losses due to potential short squeezing and the stock could trade up to \$25 (15%), but given the poor fundamentals, I expect any uptick in the stock to be a temporary trading move, not a fundamental revaluation with the ultimate downward catalyst coming when they announce Q4 numbers and the damaging impact of their new marketing strategy and unattractive incremental sub economics flows through to their financials.

### Financial Snapshot:

	2004	2005	2006	2007E	2008E
Revenue	500.6	682.2	996.6	1178.1	1194.7
Growth YoY		36%	46%	18%	1%
COGS	330.0	464.6	626.0	777.1	818.4
Operating Expenses	152.0	206.4	306.2	347.1	348.7
Operating Income	18.6	11.2	64.4	54.6	27.6
Net Income	20.6	45.6	49.0	43.8	27.4
Growth YoY		121%	7%	-11%	-37%
<b>EBITDA</b>	<b>43.0</b>	<b>35.6</b>	<b>93.1</b>	<b>87.0</b>	<b>69.6</b>
Growth YoY		-17%	162%	-7%	-20%
<b>EPS</b>	<b>0.32</b>	<b>0.73</b>	<b>0.70</b>	<b>0.63</b>	<b>0.40</b>
		128%	-4%	-10%	-37%

### Company Overview:

Netflix provides online subscription services for DVD's. Customers log on to their website and select movies or TV shows they would like to watch and the company ships out the DVD's to the customers via US Postal Service. There are no late fees and the company has several pricing plans and fee structures but their most popular allows for unlimited rental per month, with up to 3 DVD's at a given time for \$16.99/mo. No pricing plan charges late fees.

### Investment Thesis:

\*The company has already experienced their strongest growth phase. The initial

ramp is rolling off and revenue should peak in '08. Management is seeking to initiate a second stage of growth where they will attempt to distribute videos online. The company will not be successful in this endeavor because they have no competitive advantage (and importantly, unlike MSO's and telcos, they don't own the pipes into consumers homes and ISP's can prioritize their traffic over NFLX downloads). Additionally, the company lacks sufficient scale with content producers to negotiate favorable on-line distribution terms.

\*The subscriber economics are becoming increasingly unattractive. Because the company continues to spend aggressively on both attracting new customers (SAC continues to rise and

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## Netflix (Continued from previous page)

	2006	2007E	2008E	
Churn	4.2%	4.7%	4.8%	even if management gets it under control, the levels are unsustainable) and continued churn
Avg. Lifetime	24.2	21.2	20.8	make per sub economics dilutive to the overall company. Management could throttle back on
ARPU	\$ 16.30	\$ 14.40	\$ 14.40	SAC and milk the company for cash flow and possibly generate
Lifetime Rev	\$ 394.46	\$ 305.28	\$ 299.52	meaningful cash flows, but they have given no indication of their willingness to do this.
COGS	\$ (248.00)	\$ (212.00)	\$ (233.00)	
Fulfillment	\$ (37.00)	\$ (29.00)	\$ (31.00)	
R&D	\$ (18.00)	\$ (16.00)	\$ (15.00)	
SAC	\$ (43.00)	\$ (54.00)	\$ (39.00)	*The eventual emergence of a new DVD technology will increase the costs associated with meeting customer needs. For the
G&A	\$ (12.00)	\$ (12.00)	\$ (11.00)	
Lifetime EBIT/ sub	\$ 36.46	\$ (17.72)	\$ (29.48)	

medium term (until a winner in the HD-DVD/Blu-Ray format conflict emerges) the company will have to purchase both formats, as well as traditional DVD formats. This will squeeze margins and I estimate an incremental 300 bps of margin compression from this dynamic.

### Valuation:

\*A \$15 price target is based on a (generous) 8x multiple off '08 EBITDA-an analysis of variation around multiples demonstrates the potential conservatism of this estimate

\*Based on the fundamentals of the company and deteriorating subscriber economics the long term prospects of the company are poor. From a trading perspective the stock is volatile and the position could see upward pressure, but long-term downward catalysts should come when damaging impact of the company's marketing efforts flow through in Q4 numbers. Additionally, continued price wars with Blockbuster and Wal-Mart will provide an inevitable downward catalyst (these price announcements have occurred every few months for the past two years).

\* My \$15 price target is based off an '08 P/E of 18 (weighted 40%), an '08 EBITDA multiple of 8x (weighted 40%) and potential for near term trading up to \$25 (weighted 20%) to achieve the \$16 level.

***"Based on the fundamentals of the company and deteriorating subscriber economics the long term prospects of the company are poor."***

### PE Multiple Valuation

Variance to Base:

	-10%	-5%	0	5%	10%
14	\$ 7.94	\$ 8.38	\$ 8.82	\$ 9.26	\$ 9.70
16	\$ 9.07	\$ 9.58	\$ 10.08	\$ 10.58	\$ 11.09
18	\$ 10.21	\$ 10.77	\$ 11.34	\$ 11.91	\$ 12.47
20	\$ 11.34	\$ 11.97	\$ 12.60	\$ 13.23	\$ 13.86
22	\$ 12.47	\$ 13.17	\$ 13.86	\$ 14.55	\$ 15.25
24	\$ 13.61	\$ 14.36	\$ 15.12	\$ 15.88	\$ 16.63

### EBITDA Multiple valuation

Variance to Base:

	-10%	-5%	0	5%	10%
6.0	\$ 13.24	\$ 13.64	\$ 14.03	\$ 14.43	\$ 14.83
7.0	\$ 14.43	\$ 14.89	\$ 15.36	\$ 15.82	\$ 16.28
8.0	\$ 15.62	\$ 16.15	\$ 16.68	\$ 17.21	\$ 17.74
9.0	\$ 16.81	\$ 17.41	\$ 18.01	\$ 18.60	\$ 19.20
10.0	\$ 18.01	\$ 18.67	\$ 19.33	\$ 19.99	\$ 20.65
11.0	\$ 19.20	\$ 19.93	\$ 20.65	\$ 21.38	\$ 22.11

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## “Innovations in Investing” — Industry Networking Night and Panel

**“There is no ‘hedge fund’ industry that exists separately from the ‘money management’ industry.”**  
—William von Mueffling

*Industry Networking Series with Professor Bruce Greenwald, William von Mueffling ('95), and David Greenspan ('00)*

On October 30<sup>th</sup>, over two hundred students, alumni, and faculty filled every spare square inch of the large hall at the Columbia University Club of New York on West 43<sup>rd</sup> Street for a night of learning and networking.

Professor Bruce Greenwald opened the panel discussion by contrasting the evening's enthusiastic crowd with a somewhat different audience. “No one sat in the front row,” he observed, “at my executive seminar at Harvard Business School.” Indeed, it was standing

Greenwald, who is the Robert Heilbrunn Professor of Finance and Asset Management at Columbia Business School and Director of the Heilbrunn Center for Graham and Dodd Investing.

Mr. von Mueffling kicked off the discussion with a Letterman-style list of observations on major changes in the investment industry.

He began with a question: Which asset class do you think has grown the most in the last three years? People shouted out answers, which ranged from index, international, and various hedge fund strategies. The answer was a strategy he termed “low octane alpha”—quantitative investing strategies that deliver roughly a few hundred basis points of excess return over a market benchmark.

Next, on a related note, von Mueffling pointed out that clients are more sophisticated than in the recent past. “The customer base knows the difference between alpha and beta, which is an important change.” Third, Mr. von Mueffling advised that the distinction between hedge funds and traditional buy-side firms may no longer be valid. “There is no ‘hedge fund’ industry that exists separately from the ‘money management’ industry—they are one in the same.”

Mr. von Mueffling's next

observation is that “the big are getting bigger.” As an example, he observed that hedge fund firm Citadel currently has 86 investment professionals on the ground in Asia. The next five of von Mueffling's observations included:

- Given the explosive growth of alternative asset classes, investment managers must employ more sophisticated risk management processes.
- Pensions and endowments are now among the largest investors in hedge funds.
- Some alternative investment strategies are already obsolete, such as convertible arbitrage, statistical arbitrage, and macro.
- Long/short equity is large and growing but offers a lot of market correlation, whereas some firms (including Cantillon) offer their clients “pure alpha.”
- John Paulson's success in shorting the sub-prime mortgage market demonstrates that securitization (and other forms of financial innovation) creates opportunities for alpha.
- Investors' return expectations are out of touch with the reality of today's market. Underscoring this point, Mr. von Mueffling observed that equities have returned an average of just 3.5% per year since 1998 (excluding dividends).



David Einhorn and Whitney Tilson

room only to hear a panel discussion on innovations in investing, featuring former students William von Mueffling ('95), founder, President and CIO of Cantillon Capital and David Greenspan ('00), Managing Director at Blue Ridge Capital. The panel was moderated by Professor Bruce

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(Continued on page 21)



## “Innovations in Investing” (continued from page 18)

(Continued from page 20)

Mr. Von Mueffling closed his remarks with some advice for MBAs aspiring to a career in investment management. “Don’t ask about compensation—prove yourself first.” Asking about compensation, he quipped, “is an immediate disqualifier.”

Next, David Greenspan shared his thoughts on the three common “ingredients” in his most successful investment ideas:

1. Identifying Instances of “Investor Hard Wiring”
2. Exploring Nontraditional Areas
3. Elongating the Search Process

Mr. Greenspan summarized the first ingredient by pointing out that, “When investors stop thinking, it creates opportunities to make money.” For example, in 2004, Greenspan and his colleagues noticed that Fiat was one of the least recommended stocks in Europe. In general, the automotive sector had fallen out of favor, and investors complained that Fiat’s balance sheet was in disarray. In 2005, the company hired a new CEO who embarked on a series of positive restructuring efforts. However, at the time, investors failed to appreciate these developments, which created an opportunity for Greenspan. In summary, Greenspan noted, “The longer the period of good

or bad fundamentals, the more likely you are to discover an instance of hard wiring.”

Second, Greenspan discussed the virtues of exploring investment opportunities in nontraditional areas, such as in developing countries or asset-backed securities. Regardless of the terrain or subject area, Greenspan advised the audience to “think about unique elements that you can bring to the table.” He also observed that nontraditional areas often involve complexity, which can create opportunities for investors.

Finally, Greenspan suggested that he has benefited by lengthening his search process for uncovering new investment ideas. “I am constantly filtering the world, looking for signposts of investor hard wiring or complexity—and therefore potentially misunderstood—situations.” Ultimately, Greenspan’s goal is to find opportunities with a lack of economically motivated buyers and sellers.

Professor Bruce Greenwald wrapped up the panel discussion with a series of comments on ways investors can generate alpha in today’s market. His comments were united by a common theme: know (exactly) what you are buying. In particular, Professor Greenwald outlined three types of knowledge that are



particularly important for realizing investment opportunities.

First, intangible assets. “Profit levels around the world are higher than ever,

but are they sustainable?” Professor Greenwald suggested that one cannot answer this important question without first understanding the intangible assets, such as organizational capital, that are associated with service-based industries. According to Greenwald, the world is not yet sophisticated in judging the worth of intangible assets, which creates opportunities for investors.

Second, franchise value. “Opportunities are local in nature. Recognize that, and fetch information that is unavailable to most investors.”

Third, growth. “Investors frequently misjudge the value of growth—it is simply done wrong.”

—G&Dville

Jean-Marie Eveillard and Professor Bruce Greenwald

**“Opportunities are local in nature. Recognize that, and fetch information that is unavailable to most investors.”**  
—Prof. Bruce Greenwald

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## The Heilbrunn Center Goes to India

Professor Bruce Greenwald spent two weeks in January traveling across India to discuss Value Investing, Globalization, Corporate Social Responsibility, and Competitive Strategy with a number of Indian business audiences. Professor Greenwald began his tour of India speaking at the Corporate Governance and Social Responsibility Conference organized by The Chazen Institute of International Business at Columbia Business School.

The discussions focusing on value investing began in earnest before a room of over 170 individual and institutional investors in Mumbai. The seminar was organized by local investors Chetan Parikh of Jeetay Investments, Sanjay Bakshi of Tactica Capital Management and Dhananjay Lodha. Greenwald conveyed Columbia's modern view on Graham and Dodd Investing – speaking to the audience about valuing growth in terms of return potential and not paying for growth in businesses where franchises do not exist. He pointed to commodities such as steel or cement as examples of such businesses. We hope that the late January decline of the Indian stock markets is uncorrelated to Professor Greenwald's January 8<sup>th</sup> remarks about not overpaying for non-franchises and that exercising valuation discipline is as important in India as in any other global market.

During his next stop, Professor Greenwald taught Value Investing at the Indian Institute of Management- Ahmedabad to approximately 40 students and



gave a talk on Globalization to approximately 50 professionals at the Ahmedabad Management Association. Greenwald then traveled to New Delhi, where he was a panelist at an investing forum sponsored by Reliance Mutual Funds, a large mutual fund company in India. There, he discussed the importance of local/regional economies of scale in building defensible business models and encouraged Indian companies to pursue regional strategies that can leverage the economics of large fixed cost infrastructures. Throughout the trip, Professor Greenwald met with several Indian companies, including pharmaceutical companies, retail companies textile manufacturers, financial services institutions, private investors, real estate development firms and noted that he was impressed by the quality of management within the companies and enjoyed their discussions about strategy.

-G&Dsville



*If you have questions or ideas about other international activities, please contact the Heilbrunn Center at:*  
[valueinvesting@columbia.edu](mailto:valueinvesting@columbia.edu).

The Heilbrunn Center for Graham & Dodd Investing is a premier knowledge center for the practice and theory of investing. Building on Columbia Business School's renowned history in value investing and finance, the center furthers new developments in investing and imparts the original principles of *Security Analysis* authors Benjamin Graham and David Dodd.



## Get Involved:

To hire a Columbia MBA for an internship or full-time position, contact Bruce Lloyd, assistant director, outreach services, in the [Office of MBA Career Services](#) at (212) 854-8687 or [valueinvesting@columbia.edu](mailto:valueinvesting@columbia.edu). Available positions also may be posted directly on the Columbia Web site at [www.gsb.columbia.edu/jobpost](http://www.gsb.columbia.edu/jobpost).

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