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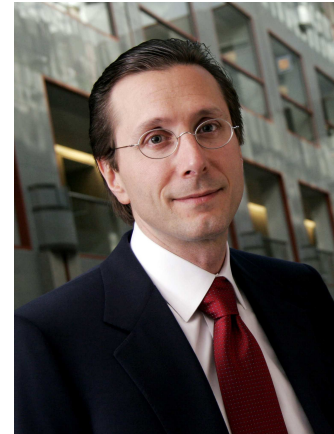
“If Not Now, When?” — Bruce Berkowitz

Despite never having attended Columbia Business School, Bruce R. Berkowitz has become one of the most highly regarded value investors of his generation. He is the Founder and Managing Member of Fairholme Capital Management where he has trounced the market averages and developed a loyal following. Prior to founding Fairholme, Mr. Berkowitz worked at Lehman Brothers until 1993 and at Smith Barney from 1993 to 1997, where he was a Managing Director. He graduated from the University of Massachusetts at Amherst with a Bachelor of Arts in Economics, cum laude.

G&D: You’ve said that you manage the portfolio as if shareholders have 100% of their money in your fund, which is unique in a world in

which professional investors increasingly aim for specific style boxes. How did you develop and refine the approach to investing you employ at Fairholme Capital?

BB: Well, there are many elements. If you are going to manage other people’s money and do it well, you have to put yourself on the same level, the same playing field as your investors. The only way to do that is by being one of your own investors. In order to make as few mistakes as possible, I assume that investors have entrusted me with all of their money, and then I try to understand the implications of that. Essentially, it means we can’t lose. The only way to fully understand that is for me to put as much of my



Bruce Berkowitz, Portfolio Manager - Fairholme Capital.

own money as I possibly can in the fund. So, we are trying to create level playing fields. I am constantly trying to put myself in the shoes of our shareholders and our investors. So, “don’t lose” is always going to be rule num-

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Welcome Back to Graham and Doddsville

The Heilbrunn Center for Graham and Dodd Investing and the Columbia Investment Management Association is proud to present the fifth edition of the *Graham and Doddsville* newsletter. With the tumult in the financial markets and economy at large, we at G&D have found ourselves more excited than ever to report on the theory and practice of Value Investing – which we believe to be more relevant than ever.

Despite our best efforts to follow the value investor’s creed and remain strictly rational – we confess to have gotten somewhat carried away. In the spirit of excess, this edition of G&D is 50% bigger than past issues. And while we certainly agree that quality is far more important than quantity, we think you will find the extra time spent reading to be well worth the effort.

In our feature interview with Bruce Berkowitz of Fairholme capital, you will not only learn how he thinks about “killing” companies but also which musical instrument he plays in his spare time (hint: it’s not a clarinet). Michael Mauboussin discusses how understanding investor behavior and expectations is a key component to any well designed investment strategy. And Profes-

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

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sor Bruce Greenwald walks us through his analysis of financial services firms, his thoughts on the new edition of *Security Analysis* as well as the three characteristics it takes to be a great investor.

We hope you enjoy reading this as much as we enjoyed putting it together – and be sure to keep an eye out for the next issue of *Graham and Doddsville* coming out this spring.

—*Graham & Doddsville*



Bruce Greenwald, Seth Klarman, and Jim Grant speaking at the Graham & Dodd Breakfast on October 8, 2008. The annual breakfast is organized by the Heilbrunn Center for Graham and Dodd Investing.

**“So, ‘don’t lose’
is always going
to be rule
number one.”**

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Bruce Berkowitz (continued from page 1)

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ber one because no one wants go back and start again. And again, that is easy to say and easy to think about, but until you put yourself in the situation where if you did lose, you would have to start all over again, then you can’t fully comprehend it.

G&D: At the Graham & Dodd Symposium this fall, you talked about working as a bookie growing up. Of course, a lot of other great value investors have had early experiences that involved gambling. For instance, Warren Buffett handicapped horses as a kid. How do you think those skills relate to value investing and how did “making a

book” shape your evolution as an investor?

BB: The business of making odds goes back a long way and is the concept of trying to figure out what you give and what you get. That’s pretty much the same as the business of investing. You are constantly trying to understand the cash you are going to have to pay and what you’re going to have to give up. Then you try to figure out—over the life of the investment, from the day that you make it to the day the investment ends—how much you are going to make. So you have to come up with some kind of odds. Also, if you are smart and you know what you are doing, then you build in a

huge margin of safety so that the odds are in your favor.

The other element of growing up in a book-making environment—a Las Vegas-type of environment—is that you do develop an intuitive understanding of what I call a perverse psychology. So at a very young age, I received my first education in behavioral finance before the term was coined.

G&D: It is interesting because, in a sense, gambling implies risk-seeking behavior, while many value investors describe themselves as being very risk-averse.

BB: It depends. If you are

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Second Annual Pershing Square Challenge

December 4, 2008—Bill Ackman, founder of hedge fund Pershing Square Capital Management, visited Columbia Business School to kick-off the Pershing Square Challenge, a stock pitch competition for CIMA members. The visit was both insightful and entertaining, as Mr. Ackman interjected a bit of humor along with his thoughts and guidance.

The Pershing Square Challenge, which will commence in March, is sponsored by Pershing Square Capital Management in conjunction with CIMA. The contest is structured as a team event in which one second-year student will partner with two first-year students to pitch an investment idea to Mr. Ackman and a panel of judges. The winner of the event will be presented with a \$25,000 award, which will then be gifted back to Columbia Business School at the discretion of the winning team. During the presentation, Mr. Ackman said he created the competition to encourage and teach the next generation of value investors as well as to engrain the virtues of charitable giving. Despite being a Harvard Business School graduate, he enjoys working with Columbia and holds its Applied Value Investing program in high regard.

Ackman's advice for students centered around the idea that, "high-quality person meaningfully increases

your chances of success." Ackman reflected on advice he received while in business school from CBS alum Warren Buffet who suggested that if you want to be like Michael Jordan, genetics play a big role. But if you want to be a successful person, whatever you need, you can have. Ackman suggested many of the attributes that lead to success are relatively simple, such as returning phone calls promptly, treating others appropriately, being diligent, and having good character.

Confidence and humility are the two psychological traits Ackman pointed to as essential to a successful investing career. In his mind, with respect to investing, confidence is "believing you are right and sticking with it when everyone else thinks you are wrong." Ackman commented that investors need the confidence to "pull the trigger," because every investment has a flaw. The key is to make sure the price adjusts for the probability of the flaw. On the other hand, the humility to admit when you are wrong is equally, if not more, important.

Ackman also offered some advice drawn on experiences and lessons he has learned during his career. For example, he referred to his first hedge fund, Gotham Partners, when suggesting that investors are wise to stick to what they know. Ackman learned this lesson

when Gotham Partners began investing in new strategies and asset classes, which he humorously claimed had a "low return on invested brain damage." He also remarked that it is very important to stay disciplined as an investor and to never reduce your standards of value just because the world is not offering many interesting opportunities. Finally, in a nod to the value investing curriculum at Columbia Business School, Ackman noted that despite the recent market turmoil, the principles of value investing will continue to endure and they continue to underlie the investment strategy of Pershing Square Capital Management.

Given the state of the financial markets, Ackman also offered some timely thoughts on how we got into this difficult environment. Contrary to what has been written in the popular press, Ackman does not believe the majority of our problems can be blamed on a lack of regulation. Rather, he pointed out that many of the high profile failures have occurred at some of the most heavily regulated institutions in the US, namely AIG, Fannie Mae and Freddie Mac, and Lehman Brothers. By comparison, Ackman pointed to the lightly-regulated hedge fund industry, which he believes outperformed virtually every other asset class in 2008.

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"Mr. Ackman said he created the competition to encourage and teach the next generation of value investors as well as to engrain the virtues of charitable giving."



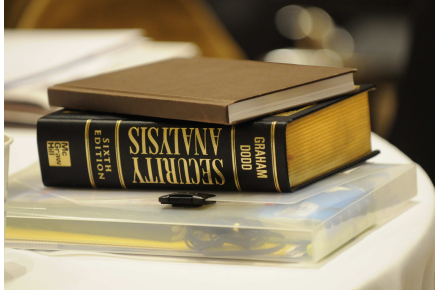
Bill Ackman spoke on campus in December to promote the Pershing Square Challenge.

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Pershing Square Launch (continued from page 3)

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Columbia Business School is celebrating the 75th anniversary of Graham's *Security Analysis*.

When asked what he thought should be done to help shore up the economy, Ackman had some thoughtful advice for the incoming administration. First, he suggested a tax holiday may encourage the repatriation of a portion of the massive amount of corporate cash sitting idle overseas; cash

Ackman encouraged the SEC to publicly promise to “never again change the rules of the game.”

that could be invested at home. Next, Ackman believes that a stimulus package is important, particularly if it is focused on infrastruc-

ture, such as energy and transportation-related investments. Ackman also proposed a restructuring of Fannie Mae and Freddie Mac, which would include recapitalizing and merging the two institutions. Finally, referring to short-selling regulations, Ackman encouraged the SEC to publicly promise to “never again change the rules of the game.”

—Graham & Doddsville

Interview with Bruce Berkowitz (continued from page 2)

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the house it is risk-taking. If you are the gambler, it is risk-seeking. I always enjoyed being the house. I was never a gambler.

G&D: I know that *Security Analysis* had a big impact on your approach. How significant was it for you to be asked to write an introduction to Part IV of the 6th edition of that influential text?

BB: It was a huge honor. I was really quite stunned that I was asked to do it. To be asked to write an introduction to an important section of Graham & Dodd's work was quite an honor, and I don't know what more I can say. Fundamental analysis, margin of safety, behavioral finance—the building blocks are just

all there.

G&D: In your introduction to Part IV, you wrote about the importance of evaluating companies' free cash flow. If free cash flow is the primary metric, then management is critical because you have to trust that they are going to do something good with that cash flow. How do you evaluate managements?

BB: The management factor is important, but the ability of a company to intrinsically generate cash is probably more important. It is always nice to own a company that your idiot relative could run. Great managers have failed at lousy businesses, so really the nature of the business and its ability to generate reasonable amounts of free

cash flow—even in stressful environments—in relationship to the price that you paid is the most important factor. Bad management or a bad person can really screw up a good company so the management factor has become more and more a part of how to kill a business. Once you ascertain the free cash flow of a company, one of the ways that you can try to kill a business is through poor capital allocation.

More and more I think it is going to be important to study the paper trail of existing management. You have to understand how a manager behaves and how that manager has behaved in past situations. In general, you have to understand the history of that person's be-

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havior to get an idea of what the future is going to look like. While very smart people and good managers don't all of a sudden get bad, it is possible. I think the Madoff affair shows that. I am stunned by the people who seem to have fallen into some kind of trap, which I just never would have expected. It also shows that one bad thirty-second decision could possibly destroy a lifetime's worth of work.

The management factor is extremely important when a manager can kill the business. We don't try to, or we've never made very good money trying to predict the future. It is impossible for me to do that. My crystal ball has never worked well and our performance last year showed that. Therefore, we tend to react in response to the environment. We feel it is important to try to understand how managers have reacted in the past and not focus as much on the unknown of the future. It is important to understand a company's strategy and a manager's strategy, the philosophy going forward, and where the company will be five or ten years from now. But it is more important to understand past actions.

G&D: You mentioned on a public shareholder conference call last fall that you hadn't actually spoken with Eddie Lampert before making your investment in

Sears. Is it fair to say that you were able to assess Eddie Lampert's background from what he had done in previous stressful situations?

BB: Yes, we examined his career – how he behaved, his performance, and what kind of person he is. Is his hero in fact Warren Buffett?

“It is always nice to own a company that your idiot relative could run. Great managers have failed at lousy businesses.”

Does he take to heart the tenets of Buffett, Benjamin Graham, Phil Fisher, and Charlie Munger? That helps us think about how he is going to behave in the future. The man is not as smart and he's not the messiah that he was made out to be at one point, but he's definitely a very sharp guy. And he's nowhere near as bad as he is being portrayed right now. All of a sudden, people think that he is over the hill—in the same way, people once thought that Buffett was over the hill.

G&D: In your earlier comments, you referenced this idea of “killing the company”—figuring out what it

would take to destroy or impair a company's ability to generate cash flow. How do you go about killing a company you are considering investing in? I guess each case might be different, but maybe you could walk us through an example with the HMOs and how you thought about killing those businesses.

BB: To kill the HMOs, you just have to answer the following question: Who would do what they're doing if they weren't doing it?" The big issue with HMOs is a radical restructuring of the healthcare system and whether or not someone else can do what they are doing, or whether they can be forced to do it at much lower prices. By studying the industry and the participants, you can come to the conclusion that the only thing the government can do is cut a check. And every time they've tried to run a healthcare system by cutting checks, such as with Medicare, the costs just escalate. The HMOs have become gatekeepers and they do it for reasonable prices. There is no other organization or other industry that we believe is a competitive threat, and there are no other people that have the scale or skills by which to carry forth the future healthcare system, whether it is universal health or corporate health-care policies. So when we are trying to kill an HMO, the first question that we



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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Interview with Bruce Berkowitz (continued from page 5)



Berkowitz and Glen Greenberg ('73) share a laugh at the Security Analysis Symposium.

“We tend to start off looking at industry sectors and businesses that are under stress. And by stress, I mean that their stock prices and their market values have fallen off a cliff.”

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address is the obvious issue of how they can be pushed aside, and our answer is that we can't find any way to kill them from a competitive or regulatory threat.

Once you get to that, then you can say that these companies have had really poor capital allocation policies in the past. They have spent billions of dollars buying their stock back at two times or three times current prices. The only conclusion that we can come to there is that it wouldn't be a mistake for them to do that today. Most likely they are all buying their stock back. So if the HMOs—United Health, WellPoint, and others—are not going to manage the healthcare system, then who is? And I can't find an answer to that. I can't find an alternative.

G&D: Is killing the company a mindset that you employ when you analyze a business, or is it a separate process you take on after you have analyzed a business or when you are talking to experts? You've de-

scribed it before as a role-playing exercise.

BB: I think killing a business is the research process. We tend to start off looking at industry sectors and businesses that are under stress. And by stress, I mean that their stock prices and their market values have fallen off a cliff. Then we try to understand the current free cash flows of those businesses and try to understand how much free cash flow can be maintained. Or if it can't, what level can be maintained assuming that they will be able to maintain the business at some level. Also, how are those free cash flows going to get to the owner? After all, they are owner earnings as Benjamin Graham would say. Are we going to see dividends or buybacks or is the money going to be funneled back into the business for growth? Or is it going to be, as Peter Lynch used to call it, “de-worsification”? Are the executives going to piss away the money? We had a company called WellCare in which—for reasons beyond my understanding—a past CEO decided not to report an overbilling.

Then it goes into a more macro environment. What happens if a small, dirty nuclear bomb goes off in the New York port? You go through crazy, man-made and natural catastrophes such as going into a deep recession. And then, after asking all the questions and testing your thesis that a

company will be able to maintain a set level of cash flow, you get to more and more questions about a company and an industry and an environment. You just keep going. The process is continuous.

G&D: When you think about how much a business can earn in a normal environment, how do you think about what a normal environment will look like? Has your view on that changed in recent months?

BB: We've gone further than that now. We no longer think about a normal environment, we think about an abnormal environment. We focus on a difficult and continuing environment where credit markets are still rigid. They're just not working. If the current difficulties keep going for another year or two years or more, I want to understand whether or not a company can survive. Just look at what is going on with the banks and the brokers. For years, we could not understand what they owned and what they owed. It was nearly impossible for the insurance companies or any financial institution that had a large or not-so-large derivatives book. Today it's not even clear to me who owns them. I can't tell you who owns Citigroup. My default answer would be that the government owns Citigroup. It is pretty obvious with the auto companies that some combination

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Interview with Bruce Berkowitz (continued from page 6)

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of bondholders and retirees have owned the big three auto companies for quite a long time, so the stock prices of GM and Ford never made sense to me. It just seemed to be a fallacy. And we are going that way now with our large banks.

The amazing thing is that people just don't seem to learn from history. Difficult times correct problems. Companies are tightening up, losing the fat, becoming more efficient, learning very tough lessons about leverage, and relearning about the sanctity of the balance sheet. They are learning that you should not play Russian roulette even if the gun may have a thousand chambers and only one bullet because if you hit that bullet, you are dead. Much of the probability and statistics work—for instance, Monte Carlo simulations—are based upon thousands and thousands of spins of the wheel. But if you kill yourself that one time, you can't spin again. I don't know where that is addressed in the statistical courses. Now we know it. Now we have books about black swans and fat tails, and we understand that a bad thing can happen more often than you think.

In life as in investing, what kills you is what you don't know about and what you're not thinking about. Today investors are focused on most of the ways in which you can die, which is a great signal for the future.

It is when you're not thinking about it that you get hurt. It is when you pay that optimistic price. It has always paid to be very greedy when everybody else is quite fearful of the environment, because that fear factor is priced in. You tend to get a relatively decent margin of safety based on the price you are paying for a given level of free cash flow. That is where we are today. What better time is there? If not now, when? Was it a better time to invest three years ago? Six years ago? And the answer is no. What is happening today, as in most bear markets, is that people either don't have the cash or they don't have the stomach—hence the low valuations.

G&D: You've received a lot of kudos for avoiding financials in the last year or so. Is there anything that would make financials more attractive to you going forward? Do you envision them becoming an investment opportunity again at any point?

BB: I think that there are many financials out there where they haven't put themselves into a death spiral. Some are just in a tough position because of a lack of credit. Once the credit markets open up, they will be absolutely fine. To some extent, some of these trite sayings are actually quite true: whatever doesn't kill you only makes you stronger. They will come out of this bigger and better. They just currently

have to throttle back down because the credit markets will not allow them to do the kind of volumes that they are capable of doing. I am a director of AmeriCredit now so I can't spend time talking about the company, but if you take a look back and see—before I was a director—a deal where we had AmeriCredit securitize auto loans. We were able to get our shareholders a significantly over-capitalized 18% yield-to-maturity with a cash cushion and a significant corporate guarantee behind it. It was a great deal for our shareholders, and it also helped AmeriCredit securitize loans that were in their warehouse facility. Fairholme would love to do more of that. Today you can be at senior levels of a company's credit structure or in a position where you have significant collateral and still get an equity return.

G&D: So you believe that the dislocations at the top end of the financial system are creating some potentially attractive valuations at the lower end among smaller, more transparent financials. Do you think this is an attractive area for value investors to prospect?

BB: Yes. The news is focused on the top dozen financial institutions, but there are good companies out there. If you can actually read their reports to the SEC and they make sense to you, that's great.

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“They are learning that you should not play Russian roulette even if the gun may have a thousand chambers and only one bullet because if you hit that bullet, you are dead.”

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“What better time is there? If not now, when? Was it a better time to invest three years ago? Six years ago? And the answer is no. What is happening today as in most bear markets is that people either don’t have the cash or they don’t have the stomach—hence the low valuations.”

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When you read the report of AIG half a dozen years ago, the section on derivatives was one paragraph. How could you know? And today it is page upon page upon page and you still don’t know. How do you know the ultimate counterparty? So that is a form of killing a business. You end up saying, “I can’t figure this out. It’s too tough. Move on.”

G&D: We’ve seen the financial sector as a percent of the S&P rise from 5% in the early 1980s to above 20% a couple of years ago. Do you think that the financial economy has driven too much of the productive capacity of the country? Is this the beginning of a reversal of that trend? Can the productive sectors of the economy absorb the slack from the shrinking financial sector of the economy?

BB: Oh, I think you’ve got it right. Yeah, I think you pretty much have it exactly right. Wall Street was the biggest casino, and it just doesn’t make sense for so many people to be doing what they were doing. It had to end. What happens is that the worst possible results usually happen when you take a good idea to some kind of illogical extreme. It is a crazy idea that you can take a whole bunch of crap and chop it, dice it, mix it, shake it up and then paste it back together again and all of a sudden it gets a

AAA rating. It is the same idea with off-balance sheet financing. Even if you could do it, if you had an off-balance sheet company blow up, you’ve lost your reputation. Reputation is critical even if it’s not part of the Qs and Ks of a company.

G&D: What types of investments are you looking at right now that you find most interesting in the current environment?

BB: We are driving less and we need more healthcare as we get older, so we have made a significant move away from oil and gas to healthcare companies such as pharmaceuticals or

not going out there and acquiring a whole bunch of competitors at stupid prices. The company is learning that it doesn’t have to be fat to be happy, and there is tremendous cost-cutting going on. The company has the largest global distribution capabilities in the industry and realizes that everything doesn’t have to be created at the company, but that it has the distribution, the cash, and the know-how to be a great partner with any other pharmaceutical company—especially in phase three drugs.

It faces Lipitor going off patent in a couple of years, and everyone’s perception

is that it is going to kill them. What no one realizes yet is that Pfizer is the sixth or seventh largest generic drug manufacturer

Pfizer Inc. Stock Chart



the HMOs. Our largest position today is Pfizer which we think we have a better handle on than most. It has a AAA-rated balance sheet, a 7%-plus dividend yield, trading at seven to eight times free cash flow, and generating about \$17 billion in free cash, which works out to be \$2 to \$2.50 per share of free cash flow. The stock is trading below \$20 per share. Pfizer has a great new CEO that everyone hates because he’s

It most likely will continue to increase sales of generics that everyone is worried about. It is interesting that people will spend more time thinking about the kind of chocolate they eat than the kind of medicine they’re swallowing. People just blindly accept chemical compounds without realizing that generics are not exactly the real deal. They may be as effective, but then again they may not

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be as effective. The big pharmaceutical companies have historically just given that business away, but they're not giving it away anymore. There is nothing wrong with the profit margins of mature products, so you are going to see big pharma move more and more toward mature products and think about competing in that space.

So we like the company, we like the strategy, we like the paper trail of the chief executive, and we love the amount of free cash flow the company is generating. The only reason that it has such a high free cash flow yield is because the price of the stock has fallen off a cliff. Many of the companies that are very interesting right now are interesting because their price has declined in relationship to their earnings. Pfizer was a company that a decade ago people were willing to buy at 40 times or 50 times earnings, and today it is trading at seven to eight times earnings. This is a level that I can't find the last time that the company ever traded at. So again it goes back to the old days as a bookmaker or at the corner grocery shop I grew up in, watching the register and the money go in and out. I learned a lot about the perverse psychology of the human condition. It all adds up to what Munger calls these lollapalooza effects that exist today.

G&D: Here is a hypothetical for you: If you had to put all of your money in one stock right now, what would that stock be?

BB: It would be a holding company with a diversified group of business like Berkshire Hathaway or Leucadia, where you have smart, bright, and talented people who think that not losing is much more important than making a fortune. You know that they have a balanced portfolio of businesses where no one company can kill the portfolio. That doesn't mean that they have to have dozens. It is like the central limit theorem in math—you don't need that many to approach diversification. You do need to have a strong assessment of the management with a long, successful paper trail. A trail of not making a lot of bad decisions, especially if the idea is that you can only pick one company and have to live with it for a decade.

G&D: Earlier you touched on your strategy of marrying debt with equity. When did you begin employing this strategy in the portfolio?

BB: It germinated based on our role-playing activities regarding how we could lose money. The idea that we buy a company cheap doesn't mean that we'll live to see it do really well if companies are taken over, and taken over cheaply as has happened in the past.

So we started to look at the credit structures and the bonds of companies that had covenants that insisted upon paying them in full upon change of control. From there we started to look at all of the covenants and indentures such as cross defaults, rankings and repayments during defaults. There are a lot of bonds out there yielding 20% to 30% that had to be as good as the equity—maybe even better—given that you had to see something improve in that credit structure before you would start to see the equity of that company improve. If your bond is yielding 30%, the market thinks there is a real risk that you're not going to make it. However, if the bonds start to improve and the yields go down dramatically it would be an indication that the equity structure is stronger than most thought. So by marrying the two together, we thought that each part made the package stronger.

G&D: And you are planning on doing more of that in the future?

BB: We can. If the opportunity is there, it makes perfect sense to me—especially when you can get excess equity returns with fixed income instruments.

G&D: Regarding short-selling, in the past you have said that you have no problem with shorts. In fact, you've pointed out that

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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.

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shorts are sometimes beneficial because they may create opportunities for you to buy stocks cheaper. But you don't do any shorting yourself. Why not?

BB: Because I am not genetically engineered for shorting. If you are long and you are wrong, you go to zero. If you are short and you are wrong, you may face death. The mania of markets can last quite a long time, and when you take into account mark to market and the collateral needed, it doesn't appeal to me. It frankly does not appeal to me to bet against the company, and the managers, and the shareholders.

G&D: In a sense, shorting seems to fit quite well with your philosophy of trying to kill the company. If you find a company that you can kill, wouldn't it make a good short?

BB: Do you want to beat it up or kill it? That involves a certain amount of mud wrestling that I think life is too short for.

G&D: With regards to capitalization, some value investors prefer to target less efficient areas of the market—for example, in small and mid-cap stocks. What has enabled your out-performance in large-caps? Does it have something to do with the fact that they are large-caps, or do other factors explain your outper-

formance?

BB: I don't know if it has to do with the size. My past successes have usually been due to a kind of informational arbitrage or insight that existed—for example, if a company has done quite well, but the market does not expect it to continue to do so well or even expects it to do poorly. This reminds me of the story of Warren Buffett when he invested in American Express. He knew that the salad oil scandal was a one-time bump that had nothing to do with their basic credit card operation. So he asked, "Will people stop using the card?" Then he would go in his favorite restaurants and watch whether people would use their American express card, or their MasterCard, or Visa, and came to the conclusion that the scandal was not going to kill American Express,

Also, in the early 1990s I was a big investor in Wells Fargo when it was being shorted heavily and considered by many to be a bankrupt bank because of the huge reserves they were taking on in their real estate portfolio. But the bottom line was that the reserves were being forced by the government agencies because of all of the disasters that they were facing taking over banks. Their so-called bad assets for which they had to reserve billions and billions of dollars were also

generating a 5%-plus cash return on cash. I don't know how you can call that a bad asset. And our insight from trying to kill Wells Fargo was enough to make a very big investment in Wells Fargo.

G&D: If you were running 50 million dollars instead of the amount that you are running today, would you be doing anything differently?

BB: Obviously, the size would enable you to look at smaller companies, which would make a difference. But what I think a lot of people don't fully comprehend is that with these small companies also comes illiquidity. So say you find a nice portfolio of small and medium-sized companies, and then the world changes as it did in November of last year, and all of a sudden there are other great small and medium-sized companies to invest in. What do you do? Your companies are down and by the nature of small companies, they are very illiquid. So you've put yourself in a corner, and then you start to have redemptions, and then you have to sell that which is illiquid. So the moral of the story is that Fairholme is agnostic about size. There is good and bad to all levels of capital structure size, and we will go wherever it makes the most sense to go. At any given time that may be large-cap or small-cap. What we do is multi-cap

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Interview with Bruce Berkowitz (continued from page 10)

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value investing. Even if all these great small cap ideas existed, it could potentially be a suicidal strategy just to invest in those companies. The lesson of the past few months is that cheap has become cheaper. Never before have I sold so much of that which is cheap to buy that which is cheaper. You can do it in large caps, but it is difficult when the trading in a security trickles toward zero.

G&D: Shifting gears to your interaction with your analyst team: How does an analyst convince you that he or she really understands the business?

BB: It is based on this process of trying to kill the business. Once a person has an idea, we then start whacking at it. We invert the concept. Instead of trying to prove a person's idea, we try to kill it, and if we can't kill it then the person is onto something. Whether it is my own idea or someone else's idea, that is the process we go through. We will then talk to experts with 20 or 30 years of industry knowledge, and we will try to attack it from every way that we know how. After a period of time as we go through our checklist and we've been through all the ways that we can kill an institution, we decide that maybe we can make some money. Much of investing is about not losing just as much of

life is about not dying. It is avoiding those places where you can die. That's why I'm not a really big fan of parachuting.

G&D: The current environment showcases the frustrations inherent in running a public fund. What made you structure the fund as it currently exists rather than as a hedge fund or investment partnership? Would you make the same decision now? How does the structure of the fund impact the way you invest?

BB: We restructured the fund somewhat in the past year. We've redone our foundation documents such that we have a lot of flexibility. We have as much flexibility as you can have under the 1940 Investment Company Act, and I believe that the fund can do much of what a partnership can do. It is done in a more regulated fashion, which I think is good for my shareholders. And I don't have a problem that we charge a flat 1% fee. With the scale that we have now, we have the ability to pay, achieve, hire, and do whatever we need to do. I think that the fact that we are a mutual fund with a low fee structure also attracts a certain type of shareholder. We've tried very hard to attract the right shareholders that understand our philosophy, our strategy and the long term nature of our investments. Investing is not that much different than business. I have been ex-

tremely humbled and impressed by our shareholder base. Our shareholders have really stuck with us. If we had a gigantic partnership structure at one-and-twenty, I don't know if that would be the case. We have engineered Fairholme such that I would be happy if I were the client. As a client, I like the concept of a 1% flat fee. I like the transparency of the fund. I like the public reporting and auditing. I like the safety and the separate custodianship and independent appraisal. Mutual funds have a system of checks and balances that I feel very comfortable with.

G&D: Do you think that hedge fund fees—and manager compensation—are going to come down?

BB: I don't know. At the end of the day the fees should not matter. What should matter is the after-fee, after-tax return of the fund, and with an assessment of how that return was generated. If it was generated through a mediocre return leveraged up, then you have a problem. Very smart, talented people deserve to make a lot of money. Mediocre people shouldn't be making anywhere near the money that they are making. I don't know where this issue will go, but I know that I personally think that lower fees make a lot of sense. It takes away a lot of the perverse

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“Once a person has an idea, we then start whacking at it. We invert the concept. Instead of trying to prove a person's idea, we try to kill it, and if we can't kill it then the person is onto something.”

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Bruce Berkowitz (continued from page 11)

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psychology. A one-and-twenty structure allows someone to go for the gusto, knowing that you only need a couple of years of great success to achieve the same as a decade of hard work. That can cause some serious problems. But once again, the idea isn't bad—it has just been taken to an illogical extreme. I think that a lower fee structure without leverage—and



Business School

Bruce Berkowitz (Center) on a panel with Greenwald, Greenberg ('73), and Russo at the Security Analysis Symposium.

an investment process that is fairly simple—is probably a better way to go through life.

G&D: You are considered to be a contrarian investor. Other contrarian investors prefer to stay under the radar, but you have committed yourself to continued media interviews and public calls with your shareholders. How do you think about communicating with the public and with your shareholders?

BB: The balance is between not hurting the per-

formance of the fund due to taking up one's time doing interviews on one side and effectively communicating with our 200,000 shareholders on the other side. You can speak openly in a public forum in a way that you cannot openly speak one-on-one. For example, that which I say in a webcast becomes public. That which I say to an individual investor may not become public. If I want to tell our shareholders how I feel and where we're going, it is best for me to do that in a public format.

It is done to keep our shareholders informed in this environment. The big danger for a shareholder in our fund is that other shareholders sell at the worst possible time. I don't know how you can talk to 200,000 shareholders and give them your views and let them ask questions and give them answers. I try to accumulate the toughest questions I can find and even come up with some of my own, and then go through them on public conference calls. At the same time, I don't think I'm giving away the candy store talking to them. I could talk to you about Pfizer until I am blue in the face. But in this environment, there is not much you can do about it. It is not as if I have a strong desire to invest much more of the fund's money in these names due to concentration rules.

So given the rules of engagement and putting myself in the shoes of my shareholders, I have made the decision that it makes sense to do an interview or go on CNBC for 13 nanoseconds or do a one hour conference call. Would I do this when we get to a more normal time? The answer is no. It would not be an effective use of my time. I have saved up this time for when the environment is difficult. That is the time you have to communicate with your shareholders more than ever. I don't think there is a real need for intense, constant communication all the time. In normal environments, there is no need for frequent communication because strategies don't change.

G&D: On a recent conference call, you commented that—if it turns out that you made the wrong decision by going on offense in the fall and buying into the market—you don't deserve to be in business. That is a pretty strong statement.

BB: The point I made is that, if this isn't the time to more aggressively buy public equities in recent years, then I think that is correct. I have always suffered from what I call premature accumulation, because that is just part and parcel of not having a crystal ball and the fact that cheap can become cheaper. If you don't step up to the plate when you

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Bruce Berkowitz (continued from page 12)

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can find high quality companies at mid-to-high single digit multiples, then when are you going to do it? If performance suffers from mistakes, then I don't deserve to be in business. I'll be the first one to pull the plug.

G&D: By that logic, a lot of people who are considered great investors today should also not be in business.

BB: I don't judge. I'll talk about sins, but I won't talk about sinners. I must admit that I have enough of my own mistakes to focus on than to look at others so I can't comment. Let me put it in the words of Buffett. I know that I was swimming partially naked last year with a lot of other great people, but that is no excuse. We don't want to be naked. You can't control the mania of the markets. The trick is to not let the mania negatively influence you. The markets are made to be taken advantage of, not to be persuaded by. That is Ben Graham's Mr. Market. The market in the short term is a voting machine and in the long term it is a weighing machine. The voting is quite pessimistic right now and it should be something to take advantage of. If I have dramatically misjudged the free cash flows of companies or the safety of their balance sheets and businesses, then I shouldn't be in business. Over the long term, your perform-

ance record will tell you that. We have great shareholders and smart shareholders and I am not going to be the only one to come to that conclusion. It is harsh to judge yourself that way, but that is the way it should be. In the long term if you're not good at what you do, then you're not doing anyone a favor, including yourself.

G&D: A lot of great investors read voraciously and are very curious thinkers. If you weren't a professional money manager, what would you see yourself doing instead?

BB: It is interesting that you say that—voracious readers. I must admit that I have been reading less lately because I just don't want to get persuaded by mass sentiment right now. If you are talking about the great books and classics, I think that is correct.

And I don't know what I would be doing. You need some kind of diversion. I tried golf, and it didn't work. These days, believe it or not, it has been music. I am trying to play the guitar. Nothing makes me happier than when my youngest comes running out of her room asking me to turn down the volume on the amp.

G&D: What advice do you have for MBA students heading into a difficult job market but a very interest-

ing market for investing?

BB: I think this is the time. I can't think of a better time to be getting out of business school than in the next year. However, the world is so competitive; you have to do what you like. There is no way you can go out for eight to 10 hours a day, five to seven days a week otherwise. It is impossible. You'd just kill yourself. It is also important to find a decent, successful person to mentor you. If you work with the right people and do what you like to do, then you've got it made. The work has to be in the category of a hobby. You would want to do it even if you weren't getting paid for it. If you are lucky enough to find something, whatever it is, you should do it, because you will eventually achieve what you want to. The best plumber in the world probably ends up owning the largest plumbing company in the world after just being a good plumber for a while. Those are the only two points I have been able to figure out so far. Also, it is important whom you marry. The right person will be beyond-words helpful and the wrong person will destroy everything in your life.

G&D: Thank you, Mr. Berkowitz.

“Nothing makes me happier than when my youngest comes running out of her room asking me to turn down the volume on the amp.”

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Highlights from the Graham & Dodd Breakfast



Seth Klarman speaking at the Graham & Dodd Breakfast.

October 8, 2008—Inaugurated in 1988, the Graham & Dodd Breakfast exemplifies eight decades of Graham and Dodd tradition at Columbia Business School. Held in New York City every fall, the breakfast brings together alumni, students, scholars and practitioners for a forum on current insights and approaches to investing. This highly successful

and invigorating event attracts some of the most prominent figures in the investing community.

Jim Grant, the breakfast's first speaker, expounded on Benjamin Graham's historical returns and his human fallibility as an investor during the Great Depression. Grant claims that Graham occasionally "outsmarted himself" and "got caught up in the times in which he lived," enjoying the equivalent of today's "Greenwich lifestyle."

Graham entered 1929 with \$2 million of capital in long positions, hedged with \$2 million in short positions. Despite this apparent conservatism, his partnership also had \$4 million in levered long positions, which he considered to be worth more than their market price. However, by 1932,

Graham had lost 70 percent of his partnership's net asset value, as he suffered losses of 20 percent in 1929, 50 percent in 1930, and 16 percent in 1931.

Wearied by the market turmoil and his dismal record the prior decade, Graham wrote at the end of the 1940 edition of *Security Analysis* that institutional investors should buy bonds, which were yielding 2-3 percent, and avoid stocks despite their superior yield of 6-8 percent. The irony, according to Grant, is that Graham added this commentary after writing 750 pages on the virtues of fundamental common stock analysis. It seems that even the "father of modern security analysis" had difficult days at the office and second-guessed his approach at times. However, Graham remained "determined and undefeated," according to Grant, and he prospered after the Great Depression. Grant emphasized his admiration of Graham's analytical powers and good heart.

Seth Klarman followed Jim Grant with his own perspective of *Security Analysis* as a practitioner. The address was an inspirational appeal for the audience to maintain a disciplined and rigorous approach as value investors. Klarman spoke with impressive candor as he discussed his greatest fear as an investor of "buying too soon on the way down from often very

overvalued levels." He stated that "at some point, being too early feels indistinguishable from being wrong," which is a significant risk for "value-starved" investors. Despite this risk, Klarman shunned attempts at market timing and suggested that value investors should be buying stocks when they are cheap and offer a sufficient margin of safety, instead of waiting for them to fall further.

Klarman recalled "the wisdom of Graham and Dodd" and advised that *Security Analysis* is a "remarkable roadmap carried on the most successful investment journeys the past 70 years." Klarman also recounted that as Graham and Dodd were writing *Security Analysis* in 1934, they had to "combat a widespread conviction that financial debacle was to be the permanent order." Klarman later reminded the audience that "you can only control your process and your approach" and echoed Warren Buffett's advice that you should only hold investments that you would be comfortable with even if "the market could be closed for the next five years."

Following Seth Klarman's speech, Professor Bruce Greenwald spoke about his re-reading of *Security Analysis*, his deep admiration for Graham and Dodd's quality of thought. Prof. Greenwald explained to the audience that no one knew what a

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Graham & Dodd Breakfast (continued from page 14)

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discounted cash flow analysis was in 1934; it wasn't taught at Harvard Business School until 1949. Additionally, fundamental analysis was also not widely practiced at the time and was typically restricted to bonds.



Greenwald, Grant, and Klarman at the breakfast.

In hindsight, Greenwald was also impressed by Graham and Dodd's diligence and research process of looking at *all* available facts, from reports to the controller of the currency for banks to industry publications. Greenwald remarked, "If people did this today, there would be a lot more successes in this tradition," and perhaps many fewer investment mistakes and frauds.

Professor Greenwald then further espoused the virtues of Graham and Dodd's asset-based approach to valuation, suggesting that investors should start their analysis with the most reliable information—the balance

sheet. He also praised Graham and Dodd's prescience on the value of active security analysis, while keeping in mind that the performance of the average professional investor is, well, the market average. To conclude, Professor Greenwald

offered these encouraging words: "There are no bad days in the market; when it goes down, [there are] bargains; when it goes up, no bargains, but you're rich!"

Following the three speeches, Grant, Klarman and Greenwald sat together as a panel to answer questions in a Q&A format. Some highlights:

- In a reply to a question about gold as an inflation hedge, Jim Grant said, "Gold is the value investor's guilty pleasure. It yields nothing, earns nothing; no management to talk to, which is a good thing..." Nonetheless, he saw gold prices going higher as the U.S. "carpets

the world with dollars" through expansionary monetary and fiscal policy.

- Seth Klarman's comment that, until today's unprecedented buying opportunities due to market dislocations and forced sales from redemptions, he had not been extremely active in the U.S. equity markets since 1992. Over the past 15 years, Klarman had moved to less liquid, less public investments as he took advantage of opportunities in the real estate market following the S&L collapse. In previous environments, he noted that you had to compete against many smart people and corporate insiders; whereas today, you have sellers who have not carefully analyzed the positions. "What a great time to be a value investor," he said.

- Bruce Greenwald's encouraging view that unemployment was 14% in 1940 and that there are large institutional differences between now and the Great Depression, after which he offered the advice, "People should take a deep breath and put it in perspective."

This article was contributed by Eric Beardsley, MBA '09.

"Klarman also recounted that as Graham and Dodd were writing Security Analysis in 1934, they had to 'combat a widespread conviction that financial debacle was to be the permanent order.'"

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Marvel Entertainment, Inc. (SHORT)

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November 2008



Marvel Entertainment (MVL)
Price: \$26.67
(Feb. 6, 2009)

Capital Structure:

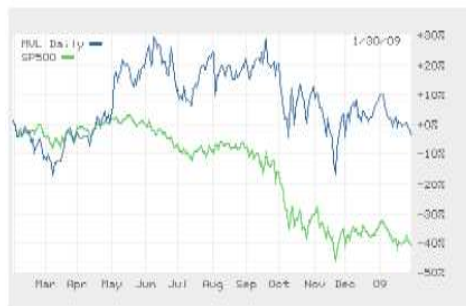
Share Price:	\$30.00
Share Outstanding:	78.4MM
Market Cap:	\$2.35Bn
Debt:	\$182MM
Cash:	\$125MM
Enterprise Value:	\$2.41Bn

Multiples:

EV/EBITDA:	7.7x
EV/EBITDA-Capex:	7.8x
P/E:	21.6x
P/Book:	7.1x

Return Profile:

Return on Equity:	66.3%
Return on Assets:	17.1%
Short Interest:	12.7%



Thesis:

I advocate a short on Marvel Entertainment (NYSE: MVL) at \$30 as I believe the stock is meaningfully overvalued and has substantial downside due to unconventional financing and accounting as well as slowing long term demand. I believe fair value is \$18, representing ~40% downside from current levels. The company's core business-production of films based on a stable of proprietary characters-has proven successful in the past, but now they are working with 2nd and 3rd tier characters who lack the installed audience base of earlier characters which will lead to declining box office revenues. Additionally, a declining economy will crimp discretionary spending and movie receipts will likely be negatively impacted by this in general. Declining box office receipts will lead to declining merchandise sales and related ancillary revenue. Finally, and perhaps most importantly, the company has employed a particularly unconventional financing and accounting format which means GAAP earnings are not at all reflective of true cash flow accruing to equity. This presents the potential for a serious negative catalyst if top line performance doesn't meet bullish expectations.

Background:

In 2006 Marvel moved from a licensing based model, whereby they were essentially an intellectual properties company, to a more traditional film production company. They are now producing a slate of movies which is a riskier model since they assume significant production costs but it also implies potentially larger payoffs. To finance this the company contributed ten characters (Ant Man, Black Panther, Captain America, Cloak & Dagger, Doctor Strange, Hawkeye, Iron Man, Nick Fury, Power Pack, Shang-Chi, The Avengers and The Incredible Hulk) to an LLC as collateral on an otherwise non-recourse \$525MM revolving credit facility. The company draws down on this revolver to finance film production and then as profits from the films come in, these flow to the LLC and remain there until there is a net cash balance of \$350MM, at which time funds can be dividended out to the company.

Investment Overview/Catalysts:

- Based on conversations with management and entertainment industry sources, Marvel needs to generate ~\$150MM in domestic box office revenues to break even on their films (as per illustrative model below). Excluding outlier franchises (e.g., Spiderman and X-Men) the company has generated an average domestic box office (DBO) of \$122MM across 15 films since 1998. This, combined with the fact that the films in the LLC are generally 2nd and 3rd tier properties, suggests this is probably a fair number to assume going forward. Even assuming a significantly more generous domestic box office take of \$175MM, the company still does not generate significant value.

- Due to the LLC structure, assuming \$175MM average DBO, the company cannot access cash at the LLC until 2011 at the earliest. If their movies perform more in-line with how they have performed in the past (the \$122MM average DBO of non-outlier films), they will never be able to access this cash and residual value to shareholders will be minimal.

- Another wrinkle of the LLC structure is that the company, when valued off EBIT or net income multiples, may seem reasonably priced, but because that cash is trapped, income statement multiples are inappropriate and a DCF (representing ultimate cash flow to equity) is probably the best way to value this company. Based on a DCF of CF's to equity, fair equity value for the company is ~\$18 (see sensitivity analysis below). Again, this is based on a possibly generous \$175MM average DBO; a lower DBO suggests no value for the LLC equity and a residual common equity value <\$10.

- Note this financing model which leaves cash trapped at an LLC creates a disconnect between net income and cash flow. Cash flow is essentially zero for the next few years while net income will be significantly higher as it will represent net income to the LLC. If the company never exceeds the minimum cash balance at the LLC this money will never be available to the equity.

- The second-tier nature of the LLC properties suggests that DBO will likely be weak relative to past blockbusters. While the company will continue to generate licensing revenue from previously licensed properties (Spiderman, X-Men etc) their self produced films will see softer built-in demand. Additionally, it is reasonable to assume that eventually people get "superhero fatigue." In addition to Marvel characters, there are several other superhero type characters (e.g., Batman, Superman, Transformers, Green Hornet, Conan, Hellboy) which will dilute the genre.

- Management has changed significantly over the past two years. This company has a turbulent background with a robust history of lawsuits and bankruptcy. The person generally credited for reviving

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Marvel Entertainment, Inc. (Continued from previous page)

the franchise, CEO Avi Arad, left the company in '06 in what seems to have been a pretty good deal for him (and a much less good deal for the company). He convinced the company it was necessary to self-produce movies to avoid the problems they had with Sony over Spiderman, but also convinced them to allow him to leave the company and become the producer for all their self-produced films. He is credited with creating the vision behind the company so it is somewhat unclear how well positioned current management is to run the operations.

Risk to thesis:

- Risks to my short thesis include box office performance significantly better than what I anticipate. Still, I believe the base case scenario of a \$175MM DBO average is, if anything, generous for the company considering the weak character roster they present.
- A related risk is my film financing model may not accurately reflect their costs since it is based on an "average" film. The company may be able to adjust costs to lower their break-even DBO.
- Also, the market may not care about the unconventional financing structure. I think this risk is significantly mitigated (if not entirely reversed) by the fact that the market generally may not be aware of the LLC structure. I believe investors will care that the "cash" generated by their company isn't really theirs, but I could be wrong. The company has a large retail ownership based (only ~62% of shares owned by institutions) which is due to Marvel Comics fans buying stock in a company they like. They may not be the most sophisticated investors and may not even know about the LLC structure.

Assumptions

Domestic Box Office	\$150.00	
Negative Cost	(\$140.00)	range of \$135m to \$165m
P&A Spend	(\$105.00)	range of \$100-120MM

International box office 98.00% per MVL est

Theatrical Rental Revenue

Domestic	55.00%	traditional split
International	43.00%	

Reserved Territories

Min guarantees	33.00%	traditional split
Pct of Int'l Ultimate	40.00%	

Home Video

Domestic	78.00%	historical avg
International	55.00%	

TV

	Cap	(contractual)
Domestic		
PPV	12.50%	\$7.50
Pay	45.00%	\$17.50
Free	18.00%	\$40.00
International		
Pay	33.00%	\$30.00
Free	50.00%	\$30.00

P&A

		Margin est
Home Video Costs	-37.5%	62.5%
TV Costs	-5.00%	Standard

Residuals

Home Video	-11.00%	-13.0%
TV	-9.00%	Standard

Participations

Marvel Producer Fees	-5.00%	Contractual
3rd Parties	-2.50%	MVL est

Distribution Fee -10.00% 10-12% typical distribution fees

WACC	Perpetuity Growth Rate						
	-	0.5%	1.0%	1.5%	2.0%	2.5%	3.0%
10.0%	\$18.91	\$19.62	\$20.40	\$21.28	\$22.26	\$23.38	\$24.65
10.5%	\$18.03	\$18.66	\$19.35	\$20.13	\$20.99	\$21.96	\$23.06
11.0%	\$17.22	\$17.79	\$18.41	\$19.10	\$19.86	\$20.71	\$21.67
11.5%	\$16.49	\$17.00	\$17.55	\$18.16	\$18.84	\$19.59	\$20.43
12.0%	\$15.81	\$16.27	\$16.77	\$17.32	\$17.92	\$18.59	\$19.33
12.5%	\$15.18	\$15.60	\$16.05	\$16.55	\$17.09	\$17.69	\$18.35
13.0%	\$14.60	\$14.98	\$15.40	\$15.84	\$16.33	\$16.87	\$17.45

Financials:

(\$ in millions)

	Fiscal Year Ending December 31,								
	2004	2005	2006	2007	2008	2009	2010	2011	2012
Total Revenue	\$513	\$391	\$352	\$486	\$622	\$412	\$575	\$492	\$381
% Growth		(23.9%)	(9.9%)	38.1%	28.0%	(33.8%)	39.6%	(14.4%)	(22.6%)
EBITDA	\$228	\$176	\$127	\$280	\$302	\$225	\$316	\$171	\$224
% Margin	44.4%	45.0%	36.1%	57.7%	48.6%	54.6%	55.0%	34.7%	58.8%
(-) Depreciation	(\$4)	(\$5)	(\$14)	(\$6)	(\$7)	(\$5)	(\$7)	(\$8)	(\$5)
EBIT	\$224	\$171	\$113	\$274	\$295	\$220	\$309	\$165	\$219
% Margin	43.7%	43.8%	32.0%	56.5%	47.5%	53.4%	53.7%	33.5%	57.6%

Gross Film Revenue

	Amount	After Reser	Notes
Domestic			
Theatrical	\$82.5	\$82.5	
Home Vid	\$117.0	\$117.0	
PPV	\$7.5	\$7.5	
Pay TV	\$17.5	\$17.5	
Free TV	\$14.9	\$14.9	
International			
Theatrical	\$63.2	\$37.9	
Home Vid	\$64.4	\$38.6	reflects intl non-reserved
Pay TV	\$20.9	\$12.5	territories where they sold
Free TV	\$30.0	\$18.0	rights to distribute
Min Guarantees		\$46.2	
Total Gross Revenue		\$392.6	

Film Costs

	Amount	Notes
Distribution Fee	(\$33.2)	
Domestic Costs		
P&A	(\$70.0)	assume ~2/3 of WW P&A
Home Video Costs	(\$43.9)	spent dom. (consistent with
Total	(\$113.9)	old film model)
International Costs		
P&A	(\$35.0)	
Home Video Costs	(\$14.5)	
Total	(\$49.5)	
TV Costs	(\$3.5)	
Residuals		
Home Vid	(\$17.1)	
TV	(\$5.7)	
Total	(\$22.8)	
Participations		
Marvel Producer Fees	(\$16.6)	
Third Parties	(\$9.8)	
Total	(\$26.4)	

Total Film Opex (\$249.2)

Negative Cost (\$140.0)

Capitalized Interest (\$15.4)

Film Profit (\$12.0)

Marvel Production fee \$16.6

Operating Income \$4.6

"Marvel needs to generate \$150MM in DBO revenues to break even...Excluding outlier franchises...the company has generated an average DBO of \$122MM."

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Horsehead Holding (ZINC)
Price: \$4.46
(Feb. 6, 2009)

Horsehead Holding Corp. (LONG)

Grant W. Bowman
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November 2008

Horsehead Holding Corp (ZINC)		2005	2006	2007	LTM	
Current Stock Price	\$ 3.10	Revenue	273.8	406.4	545.6	473.3
52 wk high	23.51	EBITDA	23.3	127.7	162.1	95.8
52 wk low	2.26	NI	3.1	54.5	90.7	50.4
Book Value per Share	7.91	EBITDA Margin	8.5%	25.7%	29.7%	20.2%
		NI Margin	1.1%	11.0%	16.6%	10.6%
Market Capitalization	112.3	EPS	0.12	2.01	2.85	1.43
Net Debt	(80.4)	P/E	26.3 x	1.6 x	1.1 x	2.2 x
EV	31.9					

Summary: ZINC is the lowest cost producer of specialty zinc and zinc-based products as a result of their refining process which uses EAF dust, a byproduct of the steel mini-mill production process which the mills pay ZINC to dispose of. While zinc prices have fallen precipitously in the past few months, the long term fundamental outlook has improved due to the cancellation or closure of several new and existing zinc refining and/or production facilities. In addition, ZINC has no debt, a cash balance that makes up 70% of their market capitalization, hedged production through 2009, and an activist shareholder who is pushing the company to return capital to stockholders.

Valuation: ZINC is currently trading at approximately 40% of book value, and 70% of the value of current assets minus all liabilities not including the value of their in the money zinc put options. The company purchased zinc put options at \$1.00 per pound with expirations during 2008 and 2009 early in 2008. On its recent conference call the company stated they sold their 2009 put options at \$0.54 a pound, which will result in \$64.5 million and \$30.6 million in cash income and earnings in the fourth quarter, respectively. The company still holds the 2008 options which at current prices are valued at approximately \$20 million. Therefore, the after tax value of the options (\$55 million) plus their current cash balance equals \$135 million, compared to their current \$112 million market cap.

Value realized on 2009 put options	64.5	Value of Cash and Hedges	135.4
Value of remaining 2008 put options	20.0	Other Current Assets	147.9
Total	84.5	Less Total Liabilities	71.5
		Net/Net Value	211.8
Hedge Value less 35% tax	54.9	Market Cap	112.3
Cash Balance at 9/30/08	80.5	Market Cap as % of Net/Net Value	53.0%
Total	135.4		

“The current valuation is below liquidation value.”

Business: ZINC is among the lowest cost producers of zinc products because of their negative cost to acquire the majority of their feedstock (through being paid to dispose of the EAF dust) compared to the majority of zinc refiners whose feedstock is purchased or mined. ZINC currently recycles more than half of all EAF dust created in the US and is the only zinc smelter in North America who can refine zinc using 100% recycled feedstock. As a result, the majority of their feedstock is not subject to fluctuations in LME zinc market prices.

EAF dust also contains a significant iron by-product, but until recently the company had not had the technology needed to recover it. ZINC is currently in trials with a customer to test the quality of iron made from the by-product. ZINC estimates they can recover 350,000 tons of iron from their current process, which would translate into almost \$8 million in additional revenue per year at the current depressed price of \$22.50 a ton, the majority of which should flow straight to the bottom line.

The company is also taking aggressive steps to reduce their cost structure by implementing a \$35 million cost savings program which garnered \$5.5 million in savings during the September quarter, idling its recycling facilities for the last week of 2008, reducing its salaried workforce, and revising the construction strategy for its new South Carolina facility.

Zinc Prices and Hedging: ZINC prices have recently plummeted to around \$0.50 per pound from around \$2.00 per pound at the beginning of 2007. ZINC hedges its production output in two ways. If they enter into a contract with a customer to sell ZINC at a fixed price, they also enter into a fixed-to-variable swap contract and therefore do not carry any fixed price contract risk. The company has also purchased additional put options with a \$0.50 strike to cover any additional downside.

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Horsehead Holding Corp. (Continued from previous page)

Customers and Suppliers: ZINC has supplied eight out of their 10 largest customers for over a decade, despite going through a bankruptcy during that time. In addition, the company believes they are the sole supplier of zinc to the majority of their customers. The company has long term contracts with its EAF dust suppliers that have a weighted average length of approximately three years.

Shareholders: Cobalt Capital currently owns about 5% of their shares and is pushing the company to use their excess cash to buy back shares, and to shut down their higher cost operations. The company responded by idling their highest cost operating furnace in Pennsylvania during October, one of six they have at the location. In addition, the company stated on their 3Q08 conference call on November 7th that “the stock is an attractive investment ... as a company we need to take a closer look at it and we will be discussing it with the board at our upcoming board meeting.” In addition, Mohnish Pabrai filed a 13G disclosing a 5.1% stake in ZINC on December 4th.

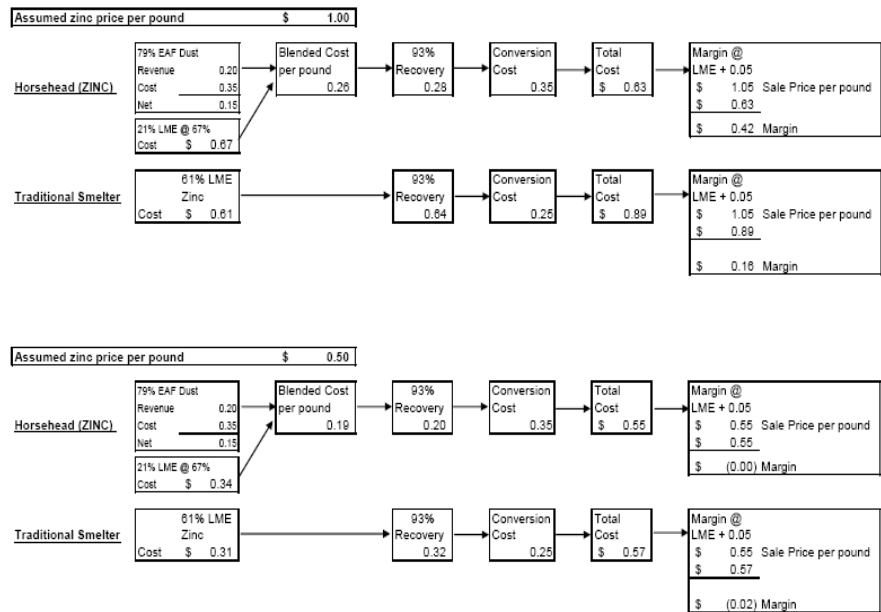
Balance Sheet: As noted, ZINC previously has no debt on its balance sheet. This is the result of the CEO choosing to retire all outstanding debt with their IPO proceeds. In addition, ZINC has an undrawn \$75mm revolver under which they currently have approximately \$60mm in availability (due to letters of credit).

Cancelled Zinc Projects: Due to the decrease in zinc prices, a significant amount of zinc production has been cancelled or closed. For example, Strategic Resources Corp (SRZ) recently announced it would shut down one of its mines and cancelled two other zinc mines scheduled to go into production. Lundin Mining’s (LMC) announced its zinc mine in Ireland will enter a three-year phased shut-down, Hudbay Minerals announced it will be shutting down one of its zinc mines in upstate New York in August, and Teck Cominco (TCK) said it will be closing down one of its zinc mines in Australia.

Why is the stock so cheap?: The primary reason is because zinc prices, which have fallen significantly. Additionally, there appear to be some technical factors. 1) The company has only been public since August of 2007, so some of the holders were likely betting on the continuing commodities bull market and have dumped it as prices have declined. 2) The company has large hedge fund ownership including some who have been rumored to have had poor performance. 3) The company has committed to an \$80 million capex program to build a new EAF facility in South Carolina which worries some investors because of the size of the cash outlay. The new facility will allow ZINC to run its refining with a higher EAF dust input which will lower costs. Note that if you subtract the entire capex program out of their cash balance and add back the value of their zinc hedges they are still trading below net current asset value. In addition, the company is delaying its South Carolina project in order rein in capex spending levels.

Conclusion: ZINC is a low risk stock due to their cheap valuation and rock solid balance sheet. In addition, there is a possibility of significant upside because of (a) shareholder friendly activities, (b) the positioning as their industry’s low-cost producer with a cost base that will decrease further when their South Carolina facility is open, and (c) an improved outlook due to the cancellation or closure of several significant supply sources. While a fall in their stock was warranted given the fall in zinc prices, I believe the current valuation is below liquidation value, and is likely the result of forced or irrational selling rather than fundamental analysis.

Comparative Operating Profile – ZINC vs. Traditional Smelter



ZINC has no debt, a cash balance that makes up 70% of their market capitalization, hedged production through 2009, and an activist shareholder.

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A Marriage of a Contrarian Streak and a Calculator

“The real-world results depart meaningfully from normal distributions. And historically when there have been the greatest arbitrage opportunities of all—and we may be in that situation today—arbitrageurs have failed to show up.”

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Michael Mauboussin, Legg Mason’s Chief Investment Strategist and adjunct professor at Columbia, recently discussed his current market views with Graham & Doddsville.

G&D: You’ve written a great deal about investor behavior and how that contributes to market prices. What’s your take on investor behavior right now in the current market? More specifically, what changes have you seen recently in the way that investors behave, and in your view, does the recent behavior that you’re seeing reinforce or depart from historical norms?

MM: To answer that I want to take one step back and talk the theories of how market efficiency comes about. We’ll first ask, how and why do markets get to efficiency? And then from there we can figure out why they become inefficient.

There are three classical ways to explain market efficiency. The first is mean-variance efficiency, which is what we teach in business school. Here, investors understand their utility functions and how to trade off risk and reward. A lot of models in finance are based on mean variance efficiency, including the capital asset pricing model and most of portfolio theory.

The second way to get there—and I think it’s the

camp most finance professors are in—is the idea that there are no arbitrage opportunities. That is when two assets become mispriced relative to one another, an arbitrageur will come in and buy one, sell the other, and close the aberrant price gap. Under normal circumstances the idea that there are no \$100 bills lying on the street is a reasonable one. No arbitrage is also a very plank in finance theory. For example, the Modigliani and Miller capital structure invariance propositions from the late 1950s are based on an arbitrage argument. And of course the most famous application of arbitrage is the Black-Scholes option-pricing model.

The third way to get efficiency is what is colloquially called the “wisdom of crowds.” More formally, it is viewing markets as a “complex adaptive system.” The simple story is that under certain conditions, when a diverse group of agents get together to solve a problem, they tend to come up with the right solution even when any individual agent doesn’t know very much. Dumb agents and collective smarts.

The first two approaches, mean variance and no arbitrage, pose some problems. First, both make assumptions about the mechanism. That is, we have to assume the existence of rational agents or well-financed arbi-



trageurs. Second, these theories fall short when we test them empirically. For example, most mean variance models assume normal or log-normal price changes. But we know that the distribution of asset price changes is fat-tailed. The real-world results depart meaningfully from normal distributions. And historically when there have been the greatest arbitrage opportunities of all—and we may be in that situation today—arbitrageurs have failed to show up. Researchers documented this pretty well for Long Term Capital Management in 1998. I think it very much characterizes today’s market, but only time will tell.

So let me turn to the “wisdom of crowds” argument. For the wisdom of crowds to work, you need to have three conditions in place. Condition number one is agent diversity—that is, the decision rules or approaches that the individual investors use have to be diverse. Long-term ori-

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Interview with Michael Mauboussin (continued from page 20)

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ented, short-term oriented, fundamental, technical—whatever you want to say—but they have to have very different perspectives. Second, we need a properly-functioning aggregation mechanism—some way to bring that disparate information into one place. Exchanges obviously do this effectively. And the third thing is properly-functioning incentives, effectively rewards for being right and penalties for being wrong.

If you apply those three conditions to humans, diversity is by far the most likely condition to be violated. And when you lose diversity in markets—that is, when people become uniformly euphoric and uniformly despondent—you tend to get vast inefficiencies. To come back to your original question, I think we are now in a period of substantial inefficiency sparked by a diversity breakdown. In this case unlike the late 1990s, when it was very bullish, this is very bearish. And leverage has played a meaningful role in this as well, as it has in past downdrafts.

I will say is that it's hard to know what is normal in markets. But I do believe that the period we're going through today is not that unique. Obviously all of these periods are unique on some level, but in some ways it is not unique. We've seen elevated periods of volatility like we're seeing today; we saw it in the 1930s. We've seen periods

of very poor asset price returns; if you take 10-year rolling real returns, the S&P 500 today is similar to the 1970s, the 1930s, and the mid-1800s. So for people with long memories—or large databases—this is not unprecedented. But for most of us this is first time we've seen something of this magnitude in our investment careers.

G&D: Would you say that the things you've just observed—the types of mispricings due to lack of agent diversity and so forth—reinforce the investment process that you employ at Legg Mason Capital Management? Or does it imply that there are certain changes that you guys should be thinking about?

MM: It's a great question, and I think in large part the answer is a function of your time horizon. Short-term oriented investors have to be dialed in to sentiment and try to play off of it to some degree. But that is really what Ben Graham called speculation. There's nothing wrong with it, as long as you acknowledge it for what it is. For long-term oriented investors, this is an ideal type of an environment. These kinds of mispricings are fundamentally what you're looking for.

Once I was asked to give a talk about what it is to be a contrarian investor. I suggested there are two essential components to this: be prepared to go against the crowd but make sure

the market is mispricing the security. Baupost's Seth Klarman nailed it at the Graham & Dodd Symposium in October when he said: "Value investing is a marriage of a contrarian streak and a calculator." The first part is to ask what your edge is. And your edge must mean you have a view that's different from that of the market. Often, that is because the market is suffering from a diversity breakdown. So to me diversity breakdowns are a really good starting place to think about where you might be able to gain an edge.

But being a contrarian is not enough. In fact, the market is actually often right. What you then have to incorporate is Klarman's calculator—you have to determine the gap between price and value. The way I like to do this the best—and I think it's actually very applicable in today's environment—is to reverse engineer. So you take the current asset price—stock price specifically for equities—and you ask what kind of financial performance is required in order to achieve that stock price. In a lot of instances today, despite that the current economic environment will be very challenging for the foreseeable future, expectations for long-term cash flows are relatively modest.

G&D: It sounds like you use the behavioral phenomenon as a search strategy to look for areas and

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Interview with Michael Mauboussin (continued from page 21)

“I would argue that the single most common error in the investment industry is a failure to distinguish between fundamentals and expectations.”

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then you do the classic valuation analysis. To play devil's advocate and question the purpose of the behavioral phenomenon to begin with, at what point could you just value an asset, and if it's trading below its value then you should buy it, regardless of what's happening in the market?

MM: You're obviously looking for some sort of evidence of mispricing in your search strategy. Let me reiterate the obvious: it is very difficult for active managers to beat the market. We know for sure they don't do it in aggregate because of fees. We also know it's very difficult for anybody to do it on a sustainable basis. So this is not a trivial task. So step one is to figure out your search strategy. We look for diversity breakdowns as the headline, and there can be all sorts of indicators of a breakdown. Examples include statistically cheap stocks, for example high dividend yields and low price-to-earnings or low price-to-book ratios. Or it can be changes in management—so a new management comes in, reallocating capital in a new way—or a change in industry structure—for instance, the industry's consolidating, or expanding geographically, or cutting capacity. So there could be a host of items that might be a source of an edge and encourage you to investigate it further.

Let me make a separate point and underscore it as strongly as I can. I would argue that the single most common error in the investment industry is a failure to distinguish between fundamentals and expectations. And those are two very distinct things that you have to think about separately. Fundamentals are about value while expectations are the price. What happens typically is when fundamentals are good, people want to buy. And when fundamentals are bad, people want to sell. It's a very human reaction. But the goal is to be very explicit in separating those two things.

For example, let's say you went to the race track and I told you the [most probable] winner of every race in advance. That's not really the information you want. What matters is not so much which horse is going to win, but what odds are priced in. So you're not just looking at fundamentals—how fast the horse can run—you're looking at relationship between fundamentals and expectations. And it's the difference between those two things that is so essential. That's why I'm such an advocate for the reverse-engineering expectations investing approach. Often it is easier to say what is built into the price, and I think the fundamentals are going to be better or worse. It's more like betting on the over/under in a football game, versus betting on

a specific score.

G&D: In that framework, isn't it risky to use market expectations as a baseline for your own opinion on a stock—particularly in situations where the market might not be pricing efficiently? How do you manage that risk?

MM: I think it is essential to think probabilistically. So whereas we all have a view, or a most-likely outcome, it is really crucial to consider if/then scenarios. What I like to do is to take a current stock price and reverse-engineer the current expectations—which I think is a reflection of the current consensus. That gives me some sense of the baseline. And I then consider various if/then scenarios. This answers questions like: if things are better—for example, revenues are really going to come in higher or margins come in better—what does it mean for value? And likewise, if things come in worse, what happens to value?

Whenever I think about an investment I like to think about the range of possible value outcomes and the associated probabilities of those outcomes. The expected value is the product of those probabilities and outcomes. Of course, you need to compare that expected value to the current price. So while people may look at something and think

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Interview with Michael Mauboussin (continued from page 22)

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that it's cheap, they often don't think enough about the range of possible outcomes, or the probabilities of those outcomes coming to pass.

G&D: So in your process at Legg Mason Capital Management, how explicit are you in setting these outcomes and probabilities? Is it more of an overarching framework that you take into account, or do you explicitly set out your distributions and expected values?

MM: We set them out explicitly. I'll make one link to one of the behavioral finance biases that we all tend to bump into: overconfidence. Specifically, we tend to think we know what tomorrow's world is going to look like. One of the manifestations of overconfidence is projecting ranges of outcomes that are vastly too narrow. So I'll give you an example of how you might combat that bias.

One thing you can do is go to the options market and look at long-dated options. You need options that trade reasonably well—not something illiquid. If you look at a series of long-dated options, both puts and calls, you can construct the distribution of prices that are based on put and call spreads. I'm not saying the options market has the absolute right answer—certainly it's the market's answer—but what we found almost inevitably that in doing that exercise, the options market re-

flected a wider distribution of price changes than the analysts had. So this exercise allows for a way to recalibrate yourself, using market-based prices.

It's also important to be explicit. It's a really good idea to keep these distributions in a file so you can revisit them periodically. This allows you to effectively look back on how you were thinking about the situation at a given time, and keeps you from falling for hindsight bias. By the way, Warren Buffett and Charlie Munger say very explicitly that it's about probabilities and outcomes. I have a great Buffett quote to that effect. He's also said that it's an imperfect process, but it's the way you have to think about the world.

G&D: Getting back to the agent diversity point earlier, you mentioned that there's been a lack of bullishly-inclined investors recently and a preponderance of bears. What other agents are missing from today's market?

MM: I wrote a piece earlier this year called, "The Failure of Arbitrage." [See <http://www.lmcm.com/podcast/TheFailureofArbitrage.htm>.] The arbitrage idea is a plausible one and I think, on the first order, is really correct. So there clearly are arbitrageurs that cruise markets and—of course in more normal conditions—keep things reasonably efficient. But those arbitrageurs at

the same time also rely on access to capital and access to leverage. When we go through deleveraging phases like today the ability of arbs to operate is severely limited.

What typically happens in these cycles is at the top of the market, volatility tends to be low, access to capital tends to be very easy, rates tend to be attractive, and we get over-levered. And then there's a big transition, where volatility goes back up, leverage goes down, and



Michael Mauboussin talking with Paul Johnson at this fall's Security Analysis Symposium.

obviously asset prices suffer. Eventually, almost no one has access to capital. One of the key things missing today is an active community of arbitrageurs. And that's going to take some time to repair. We're seeing a number of new funds step in—bankruptcy or distressed funds—and they will eventually move the assets back in the right direction. But today there is an absence of arbitrage.

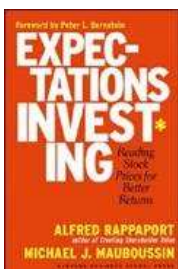
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Interview with Michael Mauboussin (continued from page 23)

Books by Michael Mauboussin:



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By the way, this is nothing new. Roger Lowenstein's book, *When Genius Failed*, starts off with the story of John Eckstein, an arbitrageur working in the late 1970s. Eckstein had put on a classic arbitrage position with leverage. But the position worked against him, and because he was leveraged, he ran out of capital. So he had to shop his position, and the guy who took it over was John Meriwether, then at Salomon Brothers. And then it turned out almost 20 years later Meriwether found himself in the exact same position as Eckstein when Long-Term Capital Management's portfolio started to bleed badly. By the way, Meriwether, and hence Salomon, made a lot of money on Eckstein's position as it worked out. But unlike Eckstein, Meriwether couldn't find anyone to assume his positions. What we're seeing today is an absence of arbitrage. While the government may try to step in and be the buyer of last resort, it'd be better to see these processes work out organically.

G&D: Earlier you talked about metrics that investors use to try to find the areas of the market that are priced inefficiently, such as price-to-book or price-to-earnings ratios. A lot of investors, particularly value investors, are excited about the statistical cheapness of stocks today. Do you share

that enthusiasm? Or are you concerned about some of the contextual factors that might skew those metrics, like inflation, taxes, composition of assets, and so forth?

MM: If you adopt a longer-term perspective—say three to five years, which to me is a pretty reasonable time to consider—and take a probabilistic view of things, I think the preponderance of evidence suggests that returns will be satisfactory and maybe even really good.

I'd add a couple of points. First, this is an ideal time to use some of the valuation techniques Bruce Greenwald has popularized. You can go back to the Graham and Dodd roots. Bruce has articulated value on three levels. The first is basic old-fashioned asset value, where you literally go down the balance sheet item by item, and mark things to where you think they are reasonable today. I think if you go through that exercise—an intrinsic value based on pure asset value—you can find a lot of things that are pretty attractive even in today's environment.

If that doesn't get you anywhere, then you step up to second level—earnings power. Earnings power today is probably below trendline. Trendline earnings are probably in the \$70-\$80 range for the S&P 500, and for 2009 it will be in the

\$50s, maybe less. But the idea is to take a steady-state level of earning and capitalize it. So you're only paying for the steady-state, not for the present value of growth opportunities.

The third level is calculating a franchise value, where you're paying for future value creation. There are a fair number of businesses out there that you can buy today without paying much, if anything, for franchise value. Bruce's approach is very reasonable in all environments, but especially applicable today.

The second comment relates to volatility. Volatility is a broad proxy for the cost of capital. Clearly credit spreads—both high-grade and high-yield credit spreads—have really blown out. High-yield spreads, for example, in the high teens suggests very elevated expectations for risk and reward. And then you can look at the VIX, which is the one-year implied volatility for the S&P 500. The VIX was at a ridiculous level, close to 90, in the fall. But now it's still in the mid-40s. If you're looking at the capital market line over time, a 40 or 45 volatility is consistent with returns in the high-teens to low-20s. So in summary you have below trend earnings and above trend perceived risk. As both of those normalize over time, equity markets can do okay.

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Interview with Michael Mauboussin (continued from page 14)

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G&D: You've written a lot about investor skill, including a piece in *More than You Know* in which you compared Bill Miller's streak to that of a free-throw shooter. The idea being that the greater the skill of the investor, the more likely the streak is to be longer. If you look at a lot of the great investors more recently, a lot of them have been pummeled pretty badly. How do you assess investor skill given that it's hard to look at investor's returns in the short term?

MM: I actually have a new book coming out this fall with a whole chapter dedicated to this issue. Let me start by saying that whenever you have a prolonged streak, either in investing or in sports, you are assured a component of skill. A streak is by definition a lot of luck and skill combined. That said, the interesting thing about investing is how much of the results you see are skill and how much are luck.

One of the best indicators as to whether there is skill in a domain is to the answer to a simple question: can you lose on purpose? For example, if you play the roulette wheel or the slot machines, can you lose on purpose? The answer is no. That means the game is all luck. With other games like chess or checkers, can you lose on purpose? The answer is of course yes because they are full informa-

tion games. So those games must be largely skill. Then there are some games that are in the middle, like backgammon or poker, where you can make a bad move and still win the hand or a good move and still lose the hand, so there is skill combined with an element of chance.

So here's how you might apply this to investing. Ask a person to create two portfolios: one they believe would be beat the market and one they believe would underform the market. If you did that experiment for a large sample of people, what would result? My gut is that the returns on the long portfolio and the short portfolio wouldn't be all that different. In investing, it's hard to win on purpose, but it's also hard to lose on purpose.

So in investing—and I do believe there is skill in investing—the edge conferred by skill can be swamped by luck in the short term. So it's virtually impossible to make any judgments about someone's skill in the investing over short periods of time. A year or a couple of years is vastly too short.

The problem is that the longer you have to wait to decide whether an investor is skillful, the greater chance the investor will suffer horrible returns in the meantime. What I recommend people do is rather than focus on outcomes, focus on the investing process. This is at the core of the

value investing tradition from Columbia Business School. A focus on process asks: Are we doing things that are economically sound, that are repeatable, and that are disciplined? When the answers are affirmative, you are likely to see satisfactory results over time.

G&D: Speaking of long and short portfolios: Do you think there is an inherent behavioral bias for long-only managers who, because they are not looking for shorts, tend to miss negative indicators in stocks they might have otherwise been willing to short?

MM: First of all, in equities there is inherent bias toward the long side because stock values should increase over time. Why else would you defer current consumption to invest? To compensate for deferred consumption, you expect a rate of return—really the ability to consume more in the future. So stocks should go up over time, which of course they have. That doesn't mean they go up every year or even every ten years. But over the long haul equities have delivered real rates of return in the 6-7% range.

Further, going long and going short are very different psychologically. To state the obvious, if you go long a stock and it does poorly, it becomes less consequential in your portfolio. If you go short a stock and it goes up,

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Interview with Michael Mauboussin (continued from page 25)

“Your need to think about the type of system you’re dealing with. Some systems are going to be much more predictable, and sticky, than others. Take, for example, the path of growth in GDP—you don’t get fat tails in GDP numbers.”

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it becomes more consequential. So there are a very different set of tools for the longs and shorts. It is true that if you are long-only you are looking for different signs than if you are also looking for shorts. But there are a whole host of other factors that make shorting very difficult.

G&D: We talked earlier about mispricings and bearish sentiment. Do you see any fundamental signals coming out of all the noise and volatility in the markets that worry you going forward? For example, are you looking at demographic changes or other fundamental indicators that you think are a legitimate cause for bearishness right now?

MM: There are clearly many reasons to be concerned in the short term. We will likely continue to see substantial increases in U.S. unemployment or if deflationary pressures continue. The one area that I would try to keep a close eye on is the housing market. It’s not an exaggeration to say that the roll over in housing has led to the current set of problems we are facing. Likewise, finding some footing in the housing market may provide an indicator as to when we come out of this downturn. Clearly, from a supply-demand perspective, we’ve seen pretty meaningful changes on both sides. From a supply perspective,

the housing start numbers are down dramatically. The homebuilders have been in a full-blown depression for a couple of years. On the demand side, the government has taken a lot of initiative to try to get financing costs down. Obviously, housing affordability should also improve from home prices coming down. But even with less new home supply and greater affordability, it will take some time for housing prices to stabilize.

I also like to look at wealth effects. The numbers are almost incomprehensible—the net worth of the U.S. consumer is down about \$7-\$8 trillion year-over-year. If you apply a 5% wealth effect to that number, you have about \$400 billion of evaporated purchasing power. Fortunately, that’s being offset in part by lower gasoline prices. But if we see more difficult equity markets and falling home prices, the U.S. consumer will continue to be very strapped. The U.S. consumer represents something like 17-18% of global GDP, so that’s a really important engine that’s sputtering in the global economy.

G&D: Nassim Taleb has written a lot about non-normal and non-stationary environments. When you mentioned that trendline earnings for the S&P are \$70-\$80, how confident are you in that level? How do you know that the last 20

years haven’t been a fat tail and we should actually be at \$45 of S&P earnings?

MM: You need to think about the type of system you’re dealing with. Some systems are going to be much more predictable, and sticky, than others. Take, for example, the path of growth in GDP—you don’t get fat tails in GDP numbers. The economy doesn’t grow 70% in one year and decline 70% the next year. So there are some systems that are a little more stationary. I believe the earnings outlook is something along those lines.

Let’s take corporate revenue in the U.S.—that number is going to grow at some number that approximates GDP over time and then there is going to be some kind of corporate profitability level—measured in margins or return on invested capital. It turns out that we have been in a steady 20-25 year trend of rising returns on capital. In fact, going into this market dislocation, returns on capital were among the highest they’ve ever been. So clearly returns are coming down and may even go back to where they were in the 1970s. But I suspect that because of the composition of corporate America—that the mix between the manufacturing businesses, service businesses, and knowledge businesses—I’m more sanguine and

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Interview with Michael Mauboussin (continued from page 26)

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don't see a full retracement in returns.

Those kinds of trends—GDP growth, earnings growth, margin structures—those are the things that don't so much lend themselves to the extreme events as do asset price changes or other natural things where that would come into play—earthquakes, power failures, and so forth. The point I want to make is that there is a continuum of distributions. Some distributions are prone to fat tails and others aren't.

G&D: Given the environment, are there certain areas in the market that you think are more interesting than others? You mentioned housing, but would you say that because of the uncertainty there, it is a good place to look.

MM: I gave a talk in December about what I call the “paradox of risk”—which is to say that sometimes the assets that appear to be the least risky are actually the riskiest and, on the other hand, assets that seem risky are sometimes the least risky. Of course, the way the paradox is reconciled is through expectations. To me, the area that seems to be overcrowded on the long side is Treasuries. I can certainly understand why, but I think that fact makes Treasuries unexciting.

On the flip side, I believe an attractive area is mortgage-

related securities or anything related to the housing market. I think you could probably move into some of these investments with relatively low risk and relatively low leverage and get a rate of return that has been very attractive on a historical basis. Even in the fixed income markets, whenever you see fixed income returns that are competitive with long-term equity returns, that's almost always a good time to get involved. I've seen reports saying what's priced into high-grade or at least the highest level of high-yield bonds are rates of bankruptcy and recoveries that are worse than what we saw in the Great Depression. Could we see something like the great depression? I personally don't think that's a huge probability.

G&D: For the asset management industry in general, do you have any thoughts as to how it's developing? Also, with the quasi-institutionalization of hedge funds and other investment vehicles, do you find changes in investor behavior or do you find that it's fairly stationary?

MM: I actually wrote a lot about this earlier this year in a piece called “The Sociology of Markets,” where I tried to address this question. To state the obvious, hedge funds up through a year ago had been an important factor and were coming on really strong. They didn't control a ton of the assets under management, but

they represented up to 30-40% of the trading volume. So they really had punching power above their weight. Clearly, there will be a role for hedge funds going forward.

There was recently a great interview with David Swensen of Yale, which is worth reading. You had a lot of people who saw the performance of alternative asset management strategies, and decided to model themselves after the Harvard or Yale endowment. They thought it was a road paved with gold. In reality, it's like anything in investing—the more people believe in something, the less attractive it becomes.

A lot of money that moved into hedge funds in recent years was not too sophisticated. Much of it was working through funds-of-funds or consultants without a full understanding of what was going on. That led to significant asset growth, but when things turned sour, investors turned tail. The estimates call for something like \$300-\$400 billion of net outflows from hedge funds on an asset base of \$1.5-1.6 trillion. Clearly, there will be a hedge fund industry, including quantitative strategies, but there has to be some sort of a healing process first.

Private equity too, is another area under stress. Access to capital tends to be very cyclical. Two years

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“Quite frankly, we are heading toward a very attractive mergers and acquisitions environment, in my opinion, for both financial and strategic buyers.”

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Interview with Michael Mauboussin (continued from page 27)

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ago the PE firms had access to financing at very attractive rates. Now they can't get a loan. Of course, there will be a time again when PE firms will have access to capital. Quite frankly, we are heading toward a very attractive mergers and acquisitions environment, in my opinion, for both financial and strategic buyers. I don't know who will be the first to dip their toes into the water, but we are setting up for a very attractive M&A market, maybe in the latter part of 2009 and 2010-2011.

G&D: Is that something you can try to capitalize on?

MM: It is something we try to capitalize on. We're thinking about, as part of our investment consideration, the probability of stocks that we own becoming takeover candidates. We are thinking about which industries are most likely to undergo consolidation. Clearly, financial services are still high on the list for a lot of obvious reasons. We are thinking about which industries are ripe for it and which companies are positioned well, both as sellers and buyers.

G&D: Is there a certain direction you are looking to pursue research or anything else over the next five years?

MM: One area that I think is exciting right now is the

intersection between valuation work and competitive analysis. For example, if you take a competitive strategy course, you will learn a lot of really cool things about industry life cycles, five forces, value chains, disruptive innovation, and game theory—all these things that lead to high returns on capital for businesses. Then you take a finance course and learn the valuation stuff. But they are treated as distinct disciplines. What I would really love to see is some way to combine these two disciplines. For example, companies with better strategic positions should be accorded higher valuations and poor companies should get low multiples. The market sorts this out pretty well, but to me that's one of the really exciting areas where we can get more rigorous.

About a year ago I published a piece about mean reversion and return on invested capital. It showed a very simple, economically intuitive conclusion, which is that high-return companies tend to see their return on invested capitals move down toward the cost of capital over time. Likewise, for firms that earn a very low return on capital see their returns drift up toward the cost of capital. It's very much what you would expect.

The problem is that when you peel back the onion, there is nothing that you

can point to that is explanatory or causal for high or consistent returns. In other words, the return patterns are not much different than what chance would dictate. So there's an interesting intersection between strategy and finance—we don't know enough about it yet.

G&D: Final question. It wouldn't be an appropriate interview if we didn't ask for your advice on pursuing a career in investment management, especially in the current environment.

MM: It's clearly a very tough environment. The one thing I would say is that it's very important to find an organization that you are intellectually compatible with. It's important to enjoy and respect the people there, but most important is the work they're doing and that the approach fits well with your personality. Being somewhere with which you are philosophically aligned is really important. Some people feel more comfortable in short-term, trading oriented organizations. Others feel comfortable in a long-term, patient type of an organization. The key is to do a really honest self-assessment and do good job of matching up your personality and temperament with an appropriate organization.

G&D: Thank you, Mr. Mauboussin.

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Security Analysis Symposium

Investors celebrate the 75th anniversary of Graham's Security Analysis

On Thursday, October 2nd, some of the world's most distinguished investors gathered at Columbia to celebrate the 75th anniversary of *Security Analysis*, the book hailed as the founding document of value investing. The symposium was organized as a series of forums with the ten contributing editors of the recently revised and rereleased 6th edition.

Security Analysis was published in 1934 by famed Columbia University professors Benjamin Graham and David Dodd. The book was modeled after the course that Graham taught at Columbia for almost thirty years.

The first panel, entitled *Value Investing Today*, was comprised of value investing titans Seth Klarman, president of The Baupost Group, David Abrams, founder of Abrams Capital, and Howard Marks, chairman of Oaktree Capital. The panel as a group oversees the management of \$77 billion. These speakers dealt with the application of value investing principles in today's tumultuous financial markets. Even as members of the panel were speaking, the S&P 500 was in the midst of a 4% decline as the market grappled with uncertainty over the second incarnation

of the mortgage bailout bill, which would face a House vote the following day.

All three panelists criticized the prevalence of leverage within the investment industry. When describing his



Howard Marx speaking on a panel with Seth Klarman and David Abrams.

investment philosophy, Klarman stated, "We don't leverage the funds, ever. Leverage is the enemy of a long-term approach." Effectively, leverage can overwhelm otherwise sensible investment decisions by subjecting them to unpredictable short-term fluctuations in the market. Klarman noted that extreme market conditions offer the greatest investment opportunities and emphasized that in order to capitalize on these periods, investors should not be afraid to hold large cash positions when there are few attractive alternatives in the market. By avoiding leverage and maintaining financial flexibility, savvy investors are able to find bargains while other market participants are forced to sell attractive assets at distressed prices.

Howard Marks highlighted

risk management as another factor that has fed the current financial crisis. In his view, most investors and financial institutions have operated with a seriously misguided view of risk. He said that his first tenet of investing is to control risk and never suffer permanent capital losses. He was very critical of statistical approaches to risk management, such as using concepts like value-at-risk and historical estimates of volatility.

"Risk cannot be measured in numbers," he said. "The business about volatility being risk is a con job." He stated that risk managers who knew everything about statistics but nothing about investments substantially contributed to the problems on Wall Street.

All three panelists were upbeat about the attractive opportunities that the market dislocation was uncovering. Abrams said that the availability of attractive investments in the current environment was "eye-popping." He is approaching the current market in the same way that he always approaches the market – by looking for good businesses with attractive margins of safety. With this perspective, he believes that it is currently one of the best times in his career

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Artie Williams (EMBA '02) and Beth Lilly.

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Security Analysis Symposium (continued from page 29)

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to be a value investor. To successfully capitalize on these opportunities, however, he thought it was critical for investment managers to have a client base with a long-term time horizon who would allow them to make courageous decisions against the flow of the market.

The second panel, entitled *Post Security Analysis: Developments in Value Investing*,



David Kessler ('08) and Bobby Buckley ('09).

was moderated by Columbia's own Bruce Greenwald and was comprised of Bruce Berkowitz of Fairholme Capital, Glenn Greenberg of Chieftain Capital, and Thomas Russo of Gardner Russo & Gardner. Greenwald kicked off the panel with a discussion of the market's attitude toward risk, arguing that euphoria and complacency had led to its global underpricing. At the peak of the market, he noted that an investor could have purchased CDS, or insurance against default, on Dubai's government bonds for only 4 basis points. Greenwald believes that it works in investors' favor that insurance is always the cheapest when it is the most desirable, and that investors should seek out high quality assets with insurance-like characteristics when everyone else is completely unconcerned with risk.

The panel was more divided on the topic of specialization versus generalization in the investment process.

Greenwald proposed that increasing complexity in corporate structures and investment alternatives necessitated a greater degree of specialization among investment analysts. Russo, who focuses primarily on media and branded consumer goods companies, agreed. Gardner Russo's analysts typically cover a single industry or a small set of industries, he said, allowing them to offer a greater depth of knowledge in their analysis. However, both Greenberg and Berkowitz strongly defended the generalist model because it offers greater flexibility to pursue attractive investment opportunities wherever they arise. All of the panelists agreed, though, that it was perhaps impossible for an outside analyst to truly understand the risk exposures on the large banks' balance sheets.

The final panel, *Security Analysis and the Evolution of Investment Philosophy*, was moderated by James Grant, the editor of Grant's Interest Rate Observer, and included noted financial author Roger Lowenstein and J. Ezra Merkin of Gabriel Capital.

Grant offered a cautious assessment of the government's bailout package, expressing concern that Congress might be "using the cause as the cure" by focus-

ing policy responses on easy money, low interest rates and malleable accounting. He feared that these actions might ultimately forestall the setting of asset prices at market-clearing levels. Merkin, citing the lessons learned from Japan's decade-long economic stagnation in the 1990s, agreed that housing prices should not be supported at unnaturally high levels, but defended the bailout package, arguing that "parts of the system are genuinely broken." In his view a government-led bailout was necessary to permit the offloading of securities from leveraged balance sheets and to avoid the downward spiral of a garden variety recession into a depression.

Taking a historical perspective, Lowenstein said that the market has never really changed, from the "go-go" stocks to the "nifty-fifty" to the dotcom bubble. He believes that the locus of speculation and excessive enthusiasm may change, but that the underlying market dynamic remains the same. Merkin concurred; however, he added that "the world always thinks that cycles get repealed only at the top," but that it holds true for the bottom as well, ending the symposium on the positive note that this crisis too shall pass.

—Graham & Doddsville

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A Conversation with Bruce Greenwald

On September 15, Graham & Doddsville had the opportunity to sit down with the “Guru to Wall Street’s Gurus,” Professor Bruce Greenwald. Over lunch at Camille’s on Amsterdam, we discussed everything from financial services firms, to the new Security Analysis book, to Greenwald’s winding journey from Bell Labs to the Heillbrunn Center. Known for his cutting insights and broad circle of competence, we gladly listened as he pulled few punches and told us exactly what he thinks.

In this environment, lunch doesn’t begin with appetizers—it begins with a discussion of financial services firms. In his characteristic clear thinking and concise analysis, Professor Greenwald began discussing how he looks at financial services:

BG: You’ll always have at least two businesses. One will usually be a local retail business. And there you’re looking for local economies of scale either in product space or geography. There are local banks that dominate and there are local banks that are spread all over. National indemnity is an example of an insurance company that is very specialized in a product space. So the first thing you do is look at the underlying profitability of that operation. When they throw off excess funds you adjust how much credit you give them depending on the quality of the business and reinvestment opportunities. There will be an operating business there—financial management, insurance, asset management, banking, what-

ever. But first you understand the operating business.

Then you look at the balance sheet. You need to look and see what it’s investing in. Often the second business is a

big money loser. So you have an operating business (where you can look at Earnings Power Value) and then you have a write-up or write-down based on the balance sheet. And looking at the balance sheet will give you an idea of where the vulnerabilities are.

Many value investors get into trouble with financials. Take Fannie and Freddie, for example. Everyone said they’re great franchises. And here you could evaluate the franchise—you could do a reasonable analysis of the earnings power – this wasn’t too hard to analyze. But then you need to do a vulnerability assessment. They started to lever up and started investing in risky assets. Freddie has \$750 billion in mortgages. So let’s write down the portfolio by 6%—this completely wipes out the earnings power value. Look historically at the write-downs relative to the declines in housing prices.

Or take Citi—it’s got, let’s



Bruce Greenwald talking with Berkowitz and Russo.

say, \$12 billion in normalized earnings. At an 8x multiple that gives you a \$96 billion valuation. But the book is \$50b so already that’s suspicious. But fine, let’s assume there’s a franchise there. What fraction is \$96 billion of \$1.7 trillion [Citi’s total assets]—about 6%? And let’s say that \$500 billion of those assets are completely safe. Well, all it takes is a 10% write-down of \$1.2 trillion and the equity is completely wiped out. How much is left? It’s all gone. With a 5% write-down, maybe \$36 billion is left. Forget about it—it’s a no brainer!

And this is all before we even look at their competitive position. Citi doesn’t have a retail franchise. Where do they dominate? Not in New York, that’s JP Morgan. How are Citi’s retail franchises going to compete profitably against JP Morgan? What about credit cards? Are they dominant there? No! We’re doing a quick and dirty here, but

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Bruce Greenwald (continued from page 31)

“With Citi, you have no idea what you’re buying. Surely that’s the first principle of value investing—know what you’re buying!”

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you get the point pretty quickly. So I don’t know what to say to you – with Citi, you have no idea what you’re buying. Surely that’s the first value investing principle—know what you’re buying! But you want to look in places where there has been pain and carnage and death and suffering—that’s definitely where you should look. That’s where the opportunities are going to be. But if you can’t say what’s going on with the company ... that’s not investing—that’s speculating.

Compare Citi to American Express. AXP has much better growth prospects. AXP dominates many markets. And AXP has high returns on pretax invested capital! [Editor’s note: AXP has outperformed Citi by 50% since September 15].

Security Analysis

In light of the publication of the newly updated version of Security Analysis, no conversation with Professor Greenwald would be complete without asking his thoughts on Ben Graham and the evolution of the great text.

BG: The extraordinary thing about the book is how prescient and right he was about so many things. One of the first things he writes about, which is absolutely pertinent today, is this – he talks about the difference between investing and speculating. And what it

comes down to is that you’re speculating when you don’t know what you are buying. And you never want to do that. Don’t you think that’s what is happening in this market? That even though a lot of investors did their analysis and looked at the balance sheet—they didn’t take into account the full range of outcomes. So that’s the first thing—to understand the discipline of knowing what you’re buying.

The second thing—which he really understood as early as the 1940 edition – is the essence of efficient markets. And there’s overwhelming evidence that markets aren’t efficient in the traditional sense. On the other hand, there is this inescapable sense in which markets are efficient—the average return before fees of all investors has to be the return of the market. So everybody can’t outperform the market. Another way of saying that is that every time you buy or sell something there’s someone on the other side of the trade. And one of you is wrong. And he literally talked about that. Then he talks briefly about technical analysis ... do you think if you’re doing technical analysis you’re better informed than the other person on the other side of the trade?

The third thing he says which is absolutely true today is that almost no one bothers to look at the balance sheet. Do you think

that’s not pertinent? So you’re looking at the balance sheet because that’s the best information. And you have a better model to understand franchises and where profitability comes from—and that’s the part he didn’t really understand—then that’s going to give you an advantage. And I think it’s absolutely pertinent to financials—how many of these people really tried to look at the balance sheets of these companies?

And there’s even another issue about looking at the balance sheet. There are two ways in which you can get in trouble with a balance sheet. One is that you go bankrupt. You go under and that’s the end. And sometimes you get in trouble when you shouldn’t—that if you could hold these to maturity you’d be fine – but you can’t. But the second way to get in trouble is if you have to go out and raise capital where you are doing it on very unfavorable terms. So when you look at the balance sheet you really need to forecast how it’s going to evolve.

Skills of Great Investors

We also asked Professor Greenwald for his view on—other than circle of competence—what really separates the great investors from the also-rans.

BG: There are three things that Buffett is good at—and

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Bruce Greenwald (continued from page 32)

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if anyone is good at two of the three, they do extremely well.

First, and it's something that, interesting enough, Graham wasn't that good at, because you have to be incredibly disciplined—but you can't take a flyer and say, well, isn't this an option? If you don't know, then you've got to have the discipline not to do it. And that's probably where Seth [Klarman] is the best person in the world at it. It's really what protected [First Eagle's] clients—because Jean-Marie [Eveillard] didn't know—so he didn't do any financials. You have to be incredibly disciplined—and most people aren't. Most people fall in love with companies and deceive themselves about things.

Second, it seems to me that you have to be really good at this—and it's something that's developed but most people still aren't good at it except for you guys [in the Applied Value Investing program]. It's understanding what a franchise is. You need to understand what a moat is versus an intangible asset. Where there's real earnings power and no one is going to enter and erode it away. Most people just don't understand this – they don't understand local economies. So the second thing is that you really have to understand the economics of the business. And Buffett is just exceptionally good at that. He really understands the difference

between when there's a moat and when there's not.

And then you've got to be good at valuation. And that's part of understanding the economics. You've got to understand the economics and understand what you're buying. Use all the information. Be very disciplined. Have a thorough knowledge. And it usually makes a big difference if you're an industry specialist. Buffett has three to four industries he knows really well—consumer non-durables like Coca-Cola and See's Candies. He's made a ton of money in insurance. And then media and communications.

The classic case is newspapers. But what Buffett understands is that when a franchise grows, it's earning above the cost of capital. When a franchise shrinks it's earning below the cost of capital so it destroys value. They're great businesses—everyone says they used to be such great businesses. But what they didn't understand is that a growing good business is phenomenal. But a shrinking good business is a disaster in terms of the multiple it can get.

So people were talking about 14-15x after tax operating earnings for newspapers historically. So when the papers traded down to 11x, people thought, how exciting! But what Buffett understands is that at 11x—and even if they return all of the cash without wasting

any—that's only a 9% return. And these are businesses that are shrinking at 5% a year and not throwing off much capital. So you take five away from nine and you get a 4% return. And he said a while back when we took the class out – that if he weren't emotionally attached he would have sold all of his newspapers. But he certainly wasn't buying them!

So one—be very disciplined. Two—really understand the businesses and the valuation implications. And three—you need to be a good judge of managers. You have to know who are clowns and who aren't. So you have to be good at judging people. So Seth [Klarman] is probably good at this, but he's exceptionally good at the other two.

Applied Value Investing

Finally, we asked Professor Greenwald for his take on the evolution of Columbia's Applied Value Investing program.

BG: Oh, I think it's the right way to do things. I think the way we do valuation is heads and shoulders better than what you're taught in traditional corporate finance courses. Doing DCFs and excel models is crazy compared to what we know how to do. And there are very smart people in the program. I really think we're going to turn out the best investors in the world. We've had huge success so far without the full program.

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“When you guys go out to work—it's one of the things to focus on—risk management. And forgetting this has gotten a lot of people into trouble.”

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Bruce Greenwald (continued from page 33)



Professor Bruce Greenwald posing for a photo at the Security Analysis Symposium.

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And you guys are doing really well. The top part of the class just does phenomenal. Do you think you'll have a better understanding of a franchise than at other schools? Do you think you'll have a better understanding of the economics? When you take the Advanced Investment Research course, you'll learn how to define the questions based on the financials and knowledge of the industry so you don't just run out there and do indiscriminate research. You'll do very focused research on specific issues.

So you'll take seven courses: Security Analysis, Applied Value Investing, Economics of Strategic Behavior, Special Situations with Joel Greenblatt, Distressed Value Investing, and then Advanced Investment Research where you'll put all these techniques to work so that before you out to work you know exactly what you

should be looking for. And lastly you'll take Value Investing where we'll talk about integrating valuation and the search process – and listen to great investors.

And all of you want to be a portfolio manager. And portfolio management is risk management. That's what you'll learn in Value Investing. It's a skill that's required of a PM but is very hard for us to train.

But you ought to listen very carefully to the portfolio managers that come in. It's risk management—that's what they do. And that's what Jean-Marie is superb at. And I never really thought about—but what he has is a good intuitive sense of what could undermine individual stocks. What sort of economic or financial environment could undermine the portfolio. And

then he builds a portfolio that will do under those circumstances and assets that will be reasonably resistant and that have high returns. But it's a balanced portfolio—and that was a really important lesson to learn. But even with diversification—he has an understanding of what the risks are across the portfolio. And when you guys go out to work—it's one of the things you want to focus on—risk management. And forgetting this has gotten a lot of people into trouble. And I don't get the feeling that a lot of investors were carefully constructing their portfolios from a risk perspective.

—Graham & Doddsville

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