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“Do an Excellent Job at a Few Things” — Howard Marks

Howard Marks is co-founder and Chairman of Oaktree Capital Management. Founded in 1995, Oaktree manages over \$60 billion of investments in a variety of less efficient arenas, including High Yield Debt, Distressed Debt, and Private Equity, among other asset classes. Oaktree’s excellent long-term track record and Mr. Marks’ unique investment philosophy have resulted in a loyal following of investment professionals. Since starting his career in 1969, Mr. Marks has seen a range of ups and downs in the financial markets, from the growth of the high yield bond market to the current leverage meltdown.

G&D: Can you tell us about your early career and what got you interested in investing?

HM: Well, I’m not one of those guys who started buying stocks at the age of six. The key is that unlike the rest of the guys you talk to who liked investing all of their lives, I did not. It was something I discovered late. My dad was an accountant. I went to Wharton and planned on majoring in Accounting, but I got more interested in Finance and changed majors. In those days we went straight to grad school, so I went to the University of Chicago where I did major in Accounting to compliment my degree in Finance.



Howard Marks, Portfolio Manager - Oaktree Capital

I had a summer job in the investment research department at First National City Bank (now Citibank) in 1968. When I was getting out of grad school, I had no idea what I wanted to do, so I interviewed with one large

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Welcome Back to Graham & Doddsville

As we enter our fourth year, we are pleased to present you with the seventh issue of *Graham & Doddsville*, Columbia Business School’s student-led investment newsletter co-sponsored by the Heilbrunn Center for Graham & Dodd Investing and the Columbia Investment Management Association.

This edition features an interview with Howard Marks, the founder and Chairman of

Oaktree Capital Management. His client memos have become must-reads for their insightful thoughts and entertaining commentary. We are privileged to have him share his investment philosophy with us.

Dave Samra ‘93, a CBS alum and portfolio manager for Artisan Partners’ International Value and Global Value funds, provides some unique insights into his investment

philosophy. Mr. Samra and his co-Portfolio Manager Daniel O’Keefe were named 2008 International-Stock Fund Manager of the Year by Morningstar .

Finally, we interview Kevin Dreyer ‘05, a recent alum of the Applied Value Investing Program to gain the insight of a recent alumni whose career has spanned a very interesting time in financial

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

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markets. Kevin provides an interesting perspective for investors and students alike. Along with providing our readers with insightful interviews, we also aim to offer specific investment ideas that are relevant today. Inside are two student investment recommendations, Amedisys (AMED) and Care Investment Trust (CRE). Please feel free to contact us if you have comments or ideas about the newsletter, as we continue to refine this publication for future editions. Enjoy!



Seth Klarman, David Abrams, and Howard Marks at the 2008 Security Analysis 75th anniversary symposium.

Howard Marks (continued from page 1)

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management consultant, one small management consultant, one investment bank, one public accounting firm, one corporate treasury operation, one investment manager, and in the end, I ended up going back to Citibank because it had been a good experience.

So I started off 40 years ago in September of 1969 as an equity analyst following conglomerates and office equipment other than computers, which meant mostly copiers and facsimile. I did investment research from 1969 until 1975 when I became director of research. One of the things that really added to my experience was the oil embargo that

took place during this period. Citibank was a growth investing shop and practiced what was called “nifty-fifty” investing. As a result, everyone who was in the non-growth areas – oil and gas, basic materials and so forth – kind of slipped away, and by the time the embargo happened, we had no energy analyst, forest products analyst, chemicals analyst, metals analyst, etc. So I was asked to put together energy and basic industry research groups, and it was great to study the cyclical businesses to compliment the growth research.

In 1975 I became director of research and that was a job that I sorely disliked. I was a 29 year old guy with what

were considered major responsibilities for both budget and people, and it was my job to know two sentences on three hundred companies – which I found very unsatisfying. It was a period in which I would say that I was disaffected. One of the great challenges in investing is captured in the saying that an analyst is someone who knows a great deal about a few things and learns more and more about less and less until he knows everything about nothing. And a portfolio manager knows a little bit about a lot of things and learns less and less about more and more until he knows nothing about everything. That is a dilemma,

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and I was very unhappy knowing a little about a lot. We had a new chief investment officer join in 1977, Peter Vermilye. Since we had been practicing “nifty-fifty” in a terrible environment for it, our performance was terrible, so the whole existing team deserved to be sacked. I was very fortunate that he asked me to start up a portfolio of convertible bonds, which I did on August 1, 1978. Then a couple of months later Peter came to me and said, “there is some guy named Milken or something out in California and he works with junk bonds – whatever that is – and can you figure out what that is because one of our clients asked for a junk bond portfolio.”

So I started managing both high yield and convertible portfolios. I went from having these big organizational responsibilities to just being me at a desk, knowing all I could about some narrow market niches, and I was ecstatic. In our business, success is a relative game. If you know X and everybody else knows X, then you haven’t succeeded because you don’t have an advantage. The key to success in our business is beating the other people. To do this, you have to know more than the other people. The smaller the arena you try to know about, the more it is possible to know more than the next person. So our motto is “know the know-

able” and know it better than others do.

High yield bonds have given me the best possible seat for observing what took place in finance over the last 31 years.

**“The single
most important
adage in the
investment
world is “what
the wise man
does in the
beginning, the
fool does in the
end.”**

G&D: Why do you say that?

HM: Everything interesting has taken place via the high yield bond market – buy-outs, recaps, and leverage. The private equity industry has had a very significant effect on altering the financial landscape. For all of these things, the high yield bond market gave you a front row seat.

In 1980 I asked the bank to move me out to California because I didn’t like New York anymore. I said to myself, “I’ll have a great

quality of life, but there goes my career.” However, it is very important to be doing what you like in circumstances that you like if you can arrange it. I stayed with Citi until 1985, and then I was hired by Trust Company of the West (TCW) to build their high yield bond department. In 1987 my partner Sheldon Stone and I decided to start a fund for distressed debt, and that’s when I joined up with Bruce Karsh.

It helps to be early. I think both our high yield bond fund at Citi in 1978 and our distressed debt fund at TCW in 1988 were the first funds of their kind to be offered by mainstream financial institutions. The single most important adage in the investment world is “what the wise man does in the beginning, the fool does in the end.” I don’t know how wise it was – maybe it should be what the lucky man does in the beginning, the fool does in the end. But by the time all the fools jump on a trend and take it to excess, it is a disaster. I left TCW in 1995 with the MDs who reported to me and we started Oaktree. The rest is recent history.

G&D: When did you read *Security Analysis*?

HM: While at Wharton, I took an undergraduate course in investments in 1965, when there was no talk about CAPM or efficient markets or any of that

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Howard Marks (continued from page 3)

“What we want to practice is the intelligent bearing of risk for profit — not the avoidance of risk.”

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stuff. You learned security analysis. They held up a piece of paper and said, “this is a security certificate” and they held up a picture and said, “this is the stock exchange. And if you want to buy this, you call over there.” It was very nuts and bolts, like being in trade school. “This is an income statement and this is a balance sheet. You take this number and you multiply it by six and divide it by that” — very real world and non-theoretical. So yes, Graham & Dodd was required reading in my first investments course.

G&D: Did it have any impact on your investment philosophy or discipline?

HM: I would say, not in its specifics. Remember, I read it in 1965 and started managing money in 1978. That’s a lot of water under the bridge, and I forgot a lot of the specifics. Have you read my chapter in the new edition?

G&D: Yes

HM: The main thing I remembered about Graham and Dodd was the feeling that there were too many absolute rules. Do this. Do that. Multiply by three. Divide by six. Don’t buy if the ratio exceeds 1.7x. I am an enemy of generalizations and constants. As I mentioned in my commentary, however, when I re-read the book in preparing to

write about it, I was pleased to find that my recollection was erroneous.

G&D: You have mentioned in your memos that the number one priority at Oaktree is to avoid losses. Can you talk a little bit about the role of risk management in your process and how you think about risk?

HM: I wouldn’t say prevent losses. I would say control risk. The two are different. You can make sure that you never have a loss in a bond portfolio by buying Treasuries. What we want to practice is the intelligent bearing of risk for profit — not the avoidance of risk. Investing deals with the future. Dealing with the future means dealing with risk.

What does risk mean? I’m not talking about standard deviation or volatility. Peter Bernstein once said that “risk means more things can happen than will happen.” That is the way to think about risk. There is a range of possible outcomes. What does that range look like? What is the breadth of it? How many of the potential outcomes are positive? How many are negative? Is it a narrow or wide distribution? How many outcomes are in the middle, and how many are in the tails? These are the things that an analyst or portfolio manager should think about.

The other question is what

is your attitude toward taking risk (and what is the attitude of your clients)? Are you a high-risk, high-return manager or a low-risk, low-return manager? And if you think you can be a low-risk, high-return manager — Good luck! It is not hard to have a beta of 0.5 and return half of what the index does, or a beta of 1.5 and return 150% of what the index does. The challenge is to have a return that is more than commensurate with your beta. The difference is alpha, and if you produce it consistently, then that is the mark of a true professional: producing return that is more than commensurate with risk. It is hard to do.

So we are not a “low-risk” investor. It is easy to say “low risk.” It only takes two words. It takes a lot more words to say “risk less than commensurate with our return,” but that is our objective.

G&D: It seems that most investors focus more on the return side of the equation than on risk, whereas you take the opposite perspective.

HM: That is important, and that is one of the reasons we are still around. Sun Tzu said if you sit by the river long enough, you’ll see the bodies of your enemies float by. The key is “long enough.” If you live long enough, you have to be the

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survivor. When I was a kid, we didn't have the video games you have today, so we used to listen to comedy records. One of the greatest ones was Mel Brooks doing the 2000 year old man. Carl Reiner says to him, "how did you get to be the world's oldest man?" And he says, "Simple. Don't die." How do you get to be the world's oldest investor? The answer is don't crap out.

So if you look at distressed debt where we started in 1988, I could tell you who our number one competitor was in every year through 1995 and not one is a main competitor today. And it's not because of what we did; all we did is perform consistently. They crapped out. It sounds simplistic to say, but the first requirement for success is survival. And I think the best way to ensure your survival is to put an emphasis on risk control – not on achieving high returns. Controlling risk is our number-one goal, and I believe if more people had that as their number-one goal, we wouldn't have experienced the crisis of the last two years. People forgot about risk control and risk aversion, and they emphasized return maximization. Return maximization and ensuring investment survival are mutually exclusive. That is very important to bear in mind.

Being a high-risk, high-return investor is in my

opinion like operating without a net. You can do it spectacularly . . . for a little while. There's an old saying in the business – "There are old investors, and there are bold investors, but there are no old, bold investors." It is very simplistic, but I think that it's true.

Back in the days when we were trying to get business in US high yield bonds, which we largely stopped doing in 1998, we used to compete in dog-and-pony shows that the consultants would run. Consultants would bring in ten high yield managers and they would come to us afterwards and say, "Howard, you got the job of being the core manager – the steady-Eddie, the dull guy – and you're getting \$50 million. Bob and Carol are each getting \$25 million and they are the satellite managers. Their job is to have more aggressive portfolios and juice up the return." I can't tell you how many times those people disappeared. To have the job of being a high-risk manager is risky business.

G&D: On your website you contrast inefficient markets where Oaktree operates with so-called efficient markets where it is hard to gain an advantage. Why does Oaktree not do more with public equities, and do you believe that public equity markets are efficient?

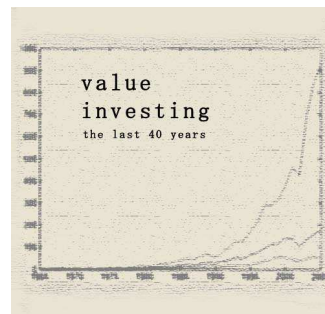
HM: There are no markets that are perfectly efficient, and there are no markets

that are completely inefficient. It is all a matter of degree, but I do think that the public stock market is generally more efficient – especially as you get into the larger stocks. It is certainly more efficient than other markets. We are not in public stocks and we are not in high grade bonds. If you go back 30 or 40 years ago, saying that you were an investor meant that you bought high grade bonds and stocks. These are the things that people have been very comfortable doing for the last hundred years. Inefficiency largely comes from the fact that people don't know about a market, don't understand it, don't have the relevant information, aren't comfortable with it, or have some kind of prejudice against it. These are the factors that create inefficiency. You're less likely to find that in the mainstream markets – stocks and bonds.

G&D: I think that a lot of value investors would say that their key advantage is their time horizon. They play a so-called time horizon arbitrage by being willing to look a little further down the road and wait. That is certainly something Oaktree does as well.

HM: I think that is true, and one of these days we could conclude that being a long-term value investor in mid-cap or small-cap stocks is consistent with our philosophy. It is not impossible. Up to now though, we've

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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.

"There's an old saying in the business – "There are old investors, and there are bold investors, but there are no old, bold investors."

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Howard Marks (continued from page 5)



Howard Marks at the Security Analysis 75th Anniversary Symposium.

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had a lot to chew on in the markets we are in. Everything we do is pretty much related to credit, and we've gotten pretty good at that. I don't know that we've milked all of the opportunities with that. It is not important to do everything. In the investment management business, there are two kinds of people: investment managers and asset gatherers. We don't want to be the latter. The latter have an emphasis on doing everything and getting every dollar that is available for it. Point one under our business philosophy is excellence in investing, and we'd rather do an excellent job at a few things than try to cover everything.

G&D: You offer specialized, niche products and allow the client to handle portfolio weightings and allocation. Many investors like the flexibility of moving to the markets where the opportunities are the best. How do you think about that?

HM: That is certainly a valid discussion point. I can think of one investor in particular that said, "we aren't going with you because you have these separate pools and we have to decide on a fixed allocation between them. That is too rigid for us because you won't move from A to B if B gets cheaper. We like Bob over there; he can do A, B, and C and he'll move the money around and so forth." I say

that's fine. That's a legitimate point. On the one hand, there can be return from reallocating capital. We understand that some people are interested in pursuing that. On the other hand, we think there's merit in setting up individual pools

"In the investment management business, there are two kinds of people: investment managers and asset gatherers. We don't want to be the latter."

of capital so that the clients know what they are going to get and managers don't change the composition of the portfolio without the client's knowledge and when the client doesn't want it to change.

Our approach also lets the people who work in differ-

ent areas know how much capital they have. How would you like to be in the leveraged loan department at a fund and all of a sudden the manager says, "I'm not going to own any loans for the next two years, so have a nice life." Or, "you can continue doing your analysis, but regardless of what you suggest, I'm not going to buy any of it because I think MBS is cheaper." At our firm, each team has its capital. They know what their capital is. They don't have to fight for capital. All they have to do is optimize the investment of that capital. Neither approach is right or wrong in my opinion. They're two different but potentially valid approaches.

G&D: Switching gears a little bit: You have said in the past that the third and last stage of a bear market is when everyone believes that things are only going to get worse. Do you think that we've had that point and that it happened in March?

HM: When you say March, you are talking about the stock market, which is not my main area of operation. I equate the final stage of the bear market with the fourth quarter of 2008, when most people thought that the world was going to end and the credit markets bottomed. If company XYZ had been bought by a buy-out firm one or two years earlier at \$10 billion, you could buy a senior claim on

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it through the first-lien bank debt for \$2 or \$3 billion dollars in November of 2008. That was a bear market blow-off. The fundamental outlook was terrible. The psychology was miserable. The technicals were horrible, because there was a lot of forced selling from hedge funds getting redemptions and CLOs getting margin calls. That is the kind of buying opportunity that every value investor dreams of: people assuming that the outlook was terrible and could only get worse – forever.

G&D: Do you think the pendulum has swung too far in the other direction now?

HM: Well, that is my personal view. The reason we got into this crisis was that up until the middle of 2007, everything was priced for perfection. Then of course by the end of 2008, it got priced for the end of the world – which so far hasn't happened. Now it isn't priced for perfection, but it is priced for prosperity. Everybody is comfortable assuming that there will be a recovery and it will be a vigorous, normal recovery. When the expectations that are factored into prices are overwhelmingly sanguine, as I think they are today, then the risk is on the side of paying too much. Another important investment adage is "Being too far ahead of your time is indistinguishable from being wrong." We started saying this around April and we are still

saying it today . . . and the markets continue upward. We have macro opinions, but we don't base our actions on the assumption that they are correct. So we haven't been selling or refusing to buy in the last four or five months. We've just been increasing our level of scrutiny.

G&D: Given the rebound in the markets, are you seeing any investment opportunities?

HM: I don't think that there are great opportunities, in terms of whole asset classes. You can find great individual opportunities, but not the opportunities you see in phase 3 of a bear market. We have already passed that – between September 15 and December 15 of last year in the world of credit.

G&D: During that time, there were lots of dislocations in financial institutions. That must have created some interesting investment opportunities. Were you able to capitalize on what was going on in financials given your historical expertise in more industrial areas?

HM: We remain fairly allergic to financials because financials are very, very hard to analyze compared to industrials. Under the conditions of the fourth quarter, most financial institutions existed largely at the pleasure of the government. The ones that they decided to support survived and are now doing better, and the

ones that they decided not to support went bankrupt or were bought out at low prices.

It is very hard to analyze financials. They just don't have analyzability. Earlier this year, there was an article in the New York Times Sunday Magazine section about the last weekend of Lehman Brothers. Bank of America and Barclays were the two primary candidates to buy it. They took a look at it and saw there were two million interest rate swaps. How long would it take you to figure out the net exposure of two million interest rate swaps, forgetting about all of the other derivative positions they had on the books? In total they could be very strongly bullish on rates, very strongly bearish on rates, or neutral, but you would have to analyze them all to know which was the case. That is a herculean task if you are inside and have access to the data. If you are on the outside, then how can you ever figure it out? That is just one example from one part of the balance sheet.

We generally consider the analysis of financials incompatible with our approach to investing. What is a financial institution? Number one, it is opaque. Number two, it borrows short to lend long. Number three, it is subject to a run on the bank. Number four, it is in the risk assumption business. How do you make money doing financing? You

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 put it out at returns that exceed your cost of capital. You borrow at low risk and lend at high risk. You are a risk assumption machine. We rarely get comfortable with that. The things that I say don't imply that we are right and others are wrong. There are lots of ways to skin a cat, and that's why there are so many kinds of investment firms.

“It is important to remember to be skeptical. It is important to not invest in things you don't understand. It is important to remember that leverage is not a good thing or a bad thing.”

However, in the fourth quarter of 2008, there were glaring opportunities, even in financials. We bought debt of profitable non-bank subsidiaries of banks and insurance companies. We bought debt of holding companies that had unprofitable bank subsidiaries, because we thought that there was enough value in other assets. We invested in non-bank finance companies outright. So, there were things for us to do in financials, but limited in number.

G&D: What lessons do you think we should learn from the crisis and what changes should be made in response?

HM: I wrote a memo called “The Lessons of 2007.” Most of the lessons surround risk aversion. It is important to remember to be skeptical. It is important to not invest in things you don't understand. It is important to remember that leverage is not a good thing or a bad thing. It is like they say with gun control. Guns

don't kill people; people using guns kill people. Leverage kills people if used wrongly. Leverage does not improve investments. It only magnifies gains and losses. So when people get silly and think leverage is a good thing and forget to be risk averse, they take on too much leverage. When you take on too much leverage and things go bad, then it can be a disaster.

I mentioned two adages earlier – “what the wise man does in the beginning, the fool does in the end,” and “being too far ahead of your time is indistinguishable from being wrong.” Well, the third important adage is “never forget the man who was six feet tall who drowned crossing the stream that was five feet deep on average.” It is not sufficient in the investment world, or any other world, to survive “on average.” You have to get through the low points and the bad days. What leverage does is that it reduces your ability to survive the bad day. So you have to realize that using leverage is a tradeoff.

It's interesting if you think about it. As investors, we only enter into investments that have positive expected returns, right? If something has a positive expected return and you add leverage, then the expected return will be even higher. This is the trap. All of these things are very simple. This is not a complex business. People

say, “I expect 15%, and if I double up by borrowing at 5% and investing at 15%, then I'll get 25%.” But they forget that part of their probability distribution consists of losses, and leverage will more than double the losses. This is why people must remember that maximizing returns and ensuring investment survival are incompatible.

I think another important lesson that has been understood at Oaktree for a long time is that the key to investing is not the art called portfolio management. The key is risk management. You can't just buy some US and some foreign, some large and some small, and some industrial and some financial and then think you're safe. You can't be so simplistic. You have to thoroughly understand the risks in the portfolio.

G&D: Some say that one thing that the US needs to do is to reduce consumption both at the individual and governmental level and increase savings. However, it seems that much of what the government has done so far has been to avoid that adjustment by spurring greater consumption. Do you think this action might be setting us up for an even greater correction in the future?

HM: This is a great challenge. One example of the conundrum is that we want

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consumption at the macro level, but at the micro level, we need savings. The US will be a risky place until we have more savings, but the process of creating those savings will be a drag on the economy. So what do we do about that? That is a real conundrum. Everybody knows that the economy needs a stimulus, but the stimulus will be designed to support consumption.

If I run a business and my revenues are off because the economy is bad and I want to support my profitability, then the best way to do that would be to fire a few folks. That would be good for my business and bad for the economy. So the government might create a tax credit for every person that I hire. That would be good for the economy and bad for my business in the long run, because it might cause me to keep employees that I otherwise wouldn't. There are no easy answers to these problems. If you believe we need more savings and less consumption, then that implies that we are not going to have the usual snap back in business, and we should be cautious at the prices at which assets are now selling.

G&D: Over recent decades, manufacturing industries have been declining in relative economic importance versus service industries. What are your

thoughts on this trend and its importance to our economic outlook?

HM: That scares the hell out of me – on the economic side – more than anything else. I wrote a memo in August of last year called “What Worries Me.” It's not that the market is going to decline by a few percent, or that Oaktree will lag by a few percent, or that some employee will quit. It is not that bus that everyone asks about – “what happens to Oaktree when you go under the bus?” One of the things that worry me is this: what does it mean to have an economy that doesn't make anything? I do your taxes. You do my legal work. Somebody else cuts my hair. Somebody else flips the burgers, or drives a taxi. But what supports all of us if our economy doesn't make anything? I am not smart enough to know the answer, but I worry about that.

In addition, in the industries where we are still trying to make things like cars, our workers expect the highest wages and highest standard of living in the world. How do you compete in a world where everything is fungible and transportable and yet your salaries are the highest in the world? How are you going to be able to compete with your higher wages unless your cars are vastly superior? It is not clear.

G&D: There has been some finger pointing, arguing that investment managers should have been much more conservative leading up to the crisis. However, only near-Armageddon scenarios would have prepared people for what actually happened. So how do you at Oaktree balance being conservative with remaining competitive in a more normal environment?

HM: The main thing is that we tell clients that we are not high-octane investors. If you want high-octane, there are managers you can call. There are clients who don't want to optimize and ensure survival, but we don't have any difficulty populating our clientele. We say we give good returns with less than commensurate risk. If the market booms, then somebody else may do better. But if the market collapses, we'll probably lose far less. The good news is that, once we've enunciated that position, the people who come to us are the people who want that. Then, if we give it to them, they say, “thanks a lot.”

There might be a boom year in which we do 25% and somebody else does 30%. I'll call up the client and say “sorry it wasn't 30%.” They say, “we got what I expected.” There is nothing better for a money manager to hear than, “thanks, we got what I expected.” It would be great to be able to

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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

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“The best formula in this business is to tell the clients what you can and will do, and then do it. If you just follow that formula, you’ll avoid 80% of the problems that arise between clients and managers.”

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beat the market when it does well and fall less when it does poorly, but it is almost impossible. What we generally deliver is market performance or a bit better in the good times and distinctly above-market performance in the bad times. The clients who want that come to us, and we give it to them. The best formula in this business is to tell the clients what you can and will do, and then do it. If you just follow that formula, you’ll avoid 80% of the problems that arise between clients and managers. I’ve been in the money management business for 40 years, and I have never had a client say “that wasn’t what we expected you to do.” To me, if a client says that, it’s the kiss of death. That means you mis-advertised what you were going to do.

G&D: Why do you think your clients are so different from shareholders? If Dick Fuld or Chuck Prince had said something similar, they would have been fired. They would not have lasted, because they would have been underperforming.

HM: Right. To some extent there has been a dumbing down of the mainstream investment business. Too much emphasis on the short term, and too much on return rather than risk control. It is too easy to put the highest returning manager in a given year on the cover of a magazine.

You never see a picture of the manager who had the lowest risk, or the best risk-adjusted return; just the one with the highest return. People flock to him, and the next year he drives off of a cliff. It is part of the popularization of investing. We had a long period from 1982 to 2007, with a couple of months of exceptions, where investing worked and aggressive investing worked better. So people tended to forget to be scared. But risk aversion is the most important element in a rational investment market.

You know that in the capital asset pricing model, the line slopes up to the right. The reason is that people are risk averse and demand higher returns on riskier investments. When they forget to be risk averse, then the line flattens out as it did in October 2004, when I wrote my memo “Risk and Return Today.” What I said in the memo is:

“Not only is the capital market line at a low level today in terms of return, but in addition, a number of factors have conspired to flatten the line. That is to say that the slope of the line is low. Meaning that for each unit of additional risk assumed, you get little incremental return... The combination of low expected returns on safe investments and high recent returns on risky investments is pushing investors to dangerously high branches of the invest-

ment tree. Those branches are subject to cracking under all that weight. Therefore, until conditions change, I suggest something closer to the ground.”

G&D: That is a great analogy.

HM: People forget. That is why Buffett’s greatest quote is, “the less prudence with which others conduct their affairs, the greater prudence with which we must conduct our own affairs.” When other people are petrified, then we can be aggressive. When other people are aggressive, then we should be scared stiff. People forgot to demand risk premiums in 2005-07. The great thing is that risk aversion is observable. You can see it in the yield premium on high yield bonds. When people are feeling sanguine, high yield bonds yield 250 basis points more than Treasuries, and when people get terrified, they demand 1000 basis points more than Treasuries. That’s an indicator of risk aversion. Your relative returns improve as the risk premium at which you buy increases. That is a simple truth which is very important.

We say we are not market timers – we are market observers. We try to observe the behavior which is going on in the market and figure out what that means for risk premiums. We try

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Howard Marks (continued from page 10)

(Continued from page 10)

to be aggressive when risk premiums are high and defensive when risk premiums are low.

G&D: With the dumbing down of investors and everything that investors have been blamed for over the last year, do you think investment managers serve a societal purpose?

HM: I have more bad to say than good to say. There's a problem: An investment manager has lots of occasions where his interests are in conflict with those of his clients. When those moments arise, the question is, how does he deal with those conflicts? Does he put the client first or himself first? Who was ringing the bell in 2005, 2006, and 2007 saying "this is risky, you shouldn't do it"? Who was turning away money? Who was returning money to clients? Some mega-buyout funds kept raising more and more money as the prices of the companies they were buying went higher and higher. Did they serve the clients? They either didn't know what was going on or they knew and didn't cut back anyway.

In theory, it is helpful to society to help people participate in the profits from the capitalist system and, in theory, money managers help them do that. In practice, I don't think the industry has always done such a great job. None of my com-

ments are meant to be all-inclusive. There are good guys and exceptions to everything I say. If you look at the mutual fund industry, how many of them beat the S&P? How many of them produce a superior risk-adjusted return? How do they advertise? They say, "our mutual fund does better than the other mutual funds." Few hold themselves to an absolute standard. Are the fees the right fees? Do they charge the same fees to the mutual fund as they do to their institutional clients? If not, why not? Some mutual funds charge clients 150 basis points. Is that really a reasonable price for the service?

Some money managers forgot their role as a fiduciary. When you are a fiduciary, your first responsibility is to someone other than yourself. How many people acted that way in the lead-up to the crisis? Not very many.

G&D: Your memos have become must reads in the investment community. What investors do you like to read and tend to follow?

HM: I like to read Jim Grant a lot. I read Seth Klarman at Baupost. For color, I read the *Gloom, Boom, and Doom Report*. However, if you read other guys, you have to be careful. When I read Seth Klarman, I say, "this guy's a genius." But what I am really saying

is, "he thinks the same as me." When I was a kid following Xerox in the 1970s, a portfolio manager at Citibank came to me and asked, "who's the best Xerox analyst on Wall Street?" And I said, "the one who agrees with me the most is so-and-so." Isn't that our definition of someone who's bright: the one who agrees with us? You read other people and you dismiss those who disagree with you and respect the people who agree with you.

I spend a lot of my time reading newspapers and magazines, because I think the most important thing is to try to figure out what is going on around us. When I was a kid in the early 1960s, there was something called, I think, the Johnson Inference Service. I always loved that title, because what we should do as an analyst is to try to infer what is going on. Everybody can see the headlines. The challenge is to infer what they mean. When you saw a headline in 2006 saying that there was a worldwide wall of liquidity coming toward us and it was going to raise the price of assets and lower risk forever, the most important thing was to infer from that that we were living in a world in which there wasn't enough worry and enough respect for risk.

G&D: Thank you Mr. Marks.



"I spend a lot of my time reading newspapers and magazines, because I think the most important thing is to try to figure out what is going on around us."

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Amedisys (AMED)
Price: \$39.55
(Sept 11, 2009)

Ken is a second year MBA student and a participant in Columbia's Applied Value Investing Program. Over the summer he worked in the Specialty Pharmaceuticals and Generics equity research team at UBS. Prior to school, Ken worked in breast cancer research at the Memorial Sloan Kettering Cancer Center.

Ken is a New York Native and received a BA in Molecular Biology from Kenyon College.

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Amedisys Home Health Services

Buy Recommendation—Price Target: \$54 (37% upside)

Kenneth Leslie
KLeslie10@gsb.columbia.edu

September 2009

Thesis Summary: The current AMED share price implies little to no revenue growth, presumably due to margin contraction as a result of potential Medicare reimbursement reform. I believe that margins will remain static to expansionary in the near future. These perceived negatives present an opportunity to buy a best in breed, regional to national growth story with a reasonable margin of safety.

Investment Overview:

Underestimated Growth Opportunities:

Amedisys is growing revenues and earnings through acquisitions, a deep pipeline of startup agencies, new services targeting preventative medicine, a growing Medicare beneficiary population and improved operational efficiencies. Amedisys is capitalizing on the inability of smaller agencies to operate efficiently without economies of scale or knowledge of how to navigate changing Medicare regulations. Amedisys has ~160 pipeline startup agencies awaiting regulatory clearance, which would grow their agency number by nearly 30%. New startups require ~\$300k in investment, and the payback period for these agencies is ~2 years. After 2 years, these agencies contribute more than \$250k of EBIT each year. At the same time, established locations are growing revenues by treating a sicker patient population and providing preventative services such as their "Balance for Life" program targeting falls in the elderly. Lastly, large acquisitions in both 2005 and 2008 hide the true operational efficiencies realized by established Amedisys locations. As the large 2008 acquisition is fully incorporated, margins should exceed 15%, and may even reach 16% in my estimation.

Information and Infrastructure Advantages: Amedisys has developed a proprietary "Point of Care" IT infrastructure which standardizes treatment protocol, documents services performed and provides a framework in which to remain in full compliance with Medicare standards. Additionally, this system ensures that physicians can view services rendered to prevent accusations of "up coding" patient conditions. The result is excellent transparency, superior patient outcomes and expanding operating margins. This system allows for rapid integration of changing Medicare regulations and faster accretion of acquisition and startup locations.

Uncertainty is an Opportunity: Uncertainty of the direction of healthcare reform and the reasons for recent management departures weigh on AMED shares. Home healthcare and hospice represent a cheaper alternative to traditional inpatient hospital care and represent a solution to the Medicare liability. I expect any healthcare reform to incorporate proposals by the Government Accountability Office, the Independence at Home Act of 2009 and the Baucus Bill. Any of these measures would be neutral to potentially positive to Amedisys. I believe that any Medicare reform will adopt a pay for performance reimbursement structure. This would also benefit Amedisys, as their care profile displays better outcomes than the national average in spite of the fact that they treat a higher acuity patient (Amedisys has >10% Case Mix Acuity Index relative to the industry average; <http://www.medicare.gov>). Further scrutiny into compliance and billing practices should not affect Amedisys. Their IT systems lend transparency of billing and services to the referring physicians and ensure that up-coding and overbilling are avoided.

The previous corporate structure was sufficient for a small to mid cap company. Amedisys is now a billion dollar company and needs management with experience and an understanding of operations on this scale. The market sold off 25% (intraday) of the AMED market cap with the announcement of the COO departure. I feel that this magnitude of drop was in expectation of greater problems in either compliance or financial manipulation, but neither are on the table.

Background: Medicare pays providers under a prospective payment system for 60 day episodes of care based on assumptions of the severity of each patient. Episodes of treatment with higher acuity patients



Enterprise Value Calculation

Share Price (09/11/09)	\$39.55
x Shares Outstanding	27.78
= Market Capitalization (\$MM)	\$1,099
+Net Debt	240.8
= Total Enterprise Value	\$1,040
52-Week High	\$59.24
52-Week Low	\$25.20

Amedisys Home Health Services (Continued from previous page)

(sicker) are reimbursed at higher rates. Amedisys is one of the largest providers in the highly fragmented home healthcare and hospice industry with ~7% market share. They have made accretive acquisitions to increase their geographic footprint from a regional player in the southeast United States to a national enterprise. Revenue growth is fueled by increased admissions, increased patient acuity and increased recertifications for additional episodes of treatment. New trends in healthcare and proposals by government officials focus on preventative medicine. Amedisys is in tune with this trend and is rolling out multiple programs, including their "Balance for Life" program, which focuses on preventing falls among the elderly. This program is reimbursed at higher than average Medicare rates and has already been introduced to 50% of Amedisys agencies. Non-organic growth is accomplished by acquiring non-performing, smaller home healthcare and hospice agencies. These agencies are unable to operate efficiently without economies of scale and an understanding of how to navigate Medicare regulations, yet can be easily integrated into Amedisys' Point of Care system.

Risks to Thesis: Healthcare reform could induce cuts to Medicare reimbursement rates, lowering operating margins across the sector. In years past, any cuts have been offset by increases in the market basket (inflationary index). A second risk is that Amedisys may be unable to successfully integrate future acquisitions. Finally, the recent management departures could have a negative affect on the efficiency of operations going forward or be an early indication of issues yet to be realized by the public.

Catalysts: Medicare reimbursement for 2010 should be announced in October, and further clarity into healthcare reform legislation should be forthcoming. The announcement of a succession to the COO/CIO positions would impact AMED shares. The announcement of additional acquisition targets in more profitable geographic regions, or an illustration of further accretion of past acquisitions would also benefit shares. Finally, opening of agencies in their startup pipeline would fuel growth in the immediate future.

Industry and Competitive Overview: Home healthcare providers operate at lower costs to the Medicare system than inpatient hospital care while maximizing patient comfort. There were 9200 home healthcare agencies and 3000 hospice agencies in the United States as of 2007 and 2006 respectively. The industry is highly fragmented and consolidating. There are few barriers to entry, although some states require a Certificate of Need (CON) to operate under an agency number. Agency numbers allow providers to service patients within a 50 mile radius of the agency. Many agencies are single site locations which lack the scale and ability to navigate a changing Medicare reimbursement landscape. I predict that healthcare reform as it pertains to this sector will focus on improving transparency, limiting the ability of companies to game the system through overbilling and focusing on reimbursing providers based on the quality of their care and the outcome of their patients.

Valuation: I approached the valuation of AMED shares in three ways:

- 1) I acknowledge that forecasting operations into the future is a difficult exercise. To be conservative, I used an earnings power valuation based on expected 2009 revenue and a trailing twelve month EBIT margin. I used an 11x multiple for this calculation.
- 2) I utilized a DCF sensitivity analysis with 10% WACC and 2% terminal growth rate. My terminal rate is in line with a doubling of the number of Medicare beneficiaries over the next 40 years. A 13% EBIT margin reflects a 2.5% Medicare reimbursement rate decrease without a concomitant increase in the price basket. I see this as a worst case scenario for the near future. I utilized a 14% margin to reflect the impact of new acquisitions and pipeline growth opportunities operating at lower margins. I project that Amedisys will grow at 15% over the next 5 years due to acquisitions, pipeline startups, preventative services and a higher acuity population.
- 3) Finally, I used a comparative multiple valuation to value AMED shares using the industry average forward P/E of 11x based on 2009 estimated earnings.

Earnings Power Valuation				
2009E Revenue			1484	
EBIT margin (TTM)			14.3%	
EBIT			212	
Tax rate			38.7%	
NOPAT			130	
Earnings Power at 11x			1431	
2009 EPV Valuation			\$51.47	
DCF Sensitivity Analysis (10% WACC; 2% Terminal Growth Rate)				
		Forward 5 Year Operating Margin		
		13%	14%	15%
5 year	10%	\$46.51	\$51.86	\$57.22
Growth	15%	\$57.77	\$64.32	\$70.87
Rate	20%	\$71.07	\$79.02	\$86.97
DCF Valuation				\$61.05
11x Industry Earnings Multiple Analysis				
EPS 2009E				\$4.92
2009E Multiple Valuation				\$54.12

Company	Price	Market Cap	EV	P/E		EV/EBITDA	P/B	Levered FCF Margin		Gross Margin	Op. Margin	ROE	ROA
				LTM	P/E For			Margin	Margin				
Amedisys	\$39.50	\$1,098.7	\$1,340.4	9.6	8.0	6.0	1.7	10%	52.5%	14.6%	19.7%	12.0%	
Gentiva Health Services	\$22.75	\$662.3	\$797.1	4.0	10.6	6.3	1.2	6.90%	49.1%	8.4%	38.0%	6.6%	
LHC Group, Inc	\$29.53	\$544.8	\$561.9	13.1	13.4	6.7	2.6	11.30%	50.9%	17.1%	22.6%	21.0%	
Almost Family, Inc	\$28.42	\$232.4	\$261.9	11.0	10.3	7.1	2.2	5.80%	53.7%	13.6%	22.4%	16.8%	

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Care Investment Trust
(NYSE: CRE)
Price: \$7.40
(Sept 21, 2009)

Eric is currently a member of the Applied Value Investing program at Columbia Business School. This last summer, between his first and second year, Eric was a summer analyst at the long/short hedge fund Stelliam Investment Management in New York. At Stelliam he focused on the transports and industrials sectors. Prior to Columbia, he spent two years as an associate in private equity and three years an analyst in investment banking.

Eric holds a BA from the University of Michigan.

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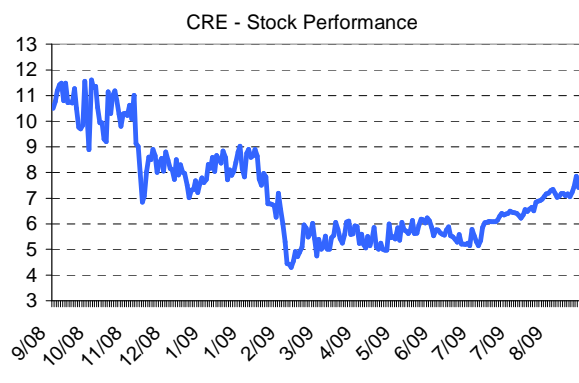
Care Investment Trust (LONG)

Eric DeLamarter
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September 2009

Trading Summary (US\$ in Millions)

Ticker	CRE
Stock Price	\$7.40
Book Value per Share	\$11.79
Est. NAV	\$10.53
Shares Out. (Basic)	20.1
Market Cap	\$148.4
Net Debt	\$28.4
Enterprise Value	\$176.9
Price / Adj. LTM FFO	13.5x
Price / 2009E FFO	13.7x
Price / Book Value	0.63x
Price / NAV	0.70x



Thesis:

I propose a long position in the common shares of Care Investment Trust (NYSE: CRE or the Company) as the stock is meaningfully undervalued on the basis of its assets and near-term catalysts leading to value realization are probable.

Background:

Care Investment Trust is a healthcare focused REIT. Following the evaporation of the securitization and repo markets the Company has repositioned itself from a finance/ mortgage REIT to an equity REIT focused on direct ownership of property. The Company has a high quality asset base consisting of \$101M in first mortgages to skilled nursing and assisted living facilities with a weighted average LTV of 78% and coverage ratio of 1.5x, \$106M in wholly-owned, single tenant, triple net leased assisted living facilities and a \$61M JV (85% equity interest) in third-party managed class A medical office buildings. CRE itself is externally managed by CIT Healthcare, a subsidiary of troubled CIT Group.

Investment Overview & Catalysts:

- **Depressed Stock Value:** CRE is an under-followed orphan and mis-priced for the following reasons: 1) most coverage has been discontinued and interest has been lost as it is no longer classified as a finance REIT; 2) analysts that do cover CRE value it on FFO, seem to overlook the underlying asset value and likely lack an understanding of the healthcare sector; 3) concerns surrounding the solvency of external manager CIT and; 4) misperceived risks associated with healthcare reform/ regulation. Consequently, CRE currently trades at 63% of book value and 70% of my estimated NAV.
- **Catalysts:** CRE is in the process of harvesting assets and returning capital to shareholders. Starting on December 31, 2008, CRE reclassified its mortgages from held-to-maturity to held-for-sale and has subsequently sold-off \$67M or 35% of its mortgage portfolio (representing \$101M of its \$268M in real estate related assets at 6/30). The Company has an agreement to put an additional \$80M of mortgages to CIT by September 30, 2009. There is pressure to realize value in the near-term by: 40% shareholder CIT Group who is facing insolvency and a looming deadline from regulators to present a capital plan and hedge fund groups (GoldenTree and SAB) holding 35% of CRE's shares.
- **Strong Balance Sheet & Liquidity Position:** Unlike many REITs, CRE has no debt due before 2015, over \$53M in cash and total debt of \$83M. Its current fixed charge coverage ratio is 1.5x .
- **Dividend:** The Company's dividend yield is 10%. Should a partial or complete liquidation occur, this would obviously increase meaningfully.

Care Investment Trust (Continued from previous page)

Valuation:

On the basis of conventional FFO, CRE is trading slightly above most of its peers. However, FFO is not the appropriate metric to use. The most likely scenarios facing the Company over the next 6-months are an outright sale or liquidation. Assuming a 90% recovery value, the implied value for equity holders is \$9.92 per share, representing an upside of 34%. CRE's discount to book (which should be a good representation of value since mortgage loans are marked-to-market) and estimated net asset value provide substantial margin of safety should assets sales not materialize or if operating results were to deteriorate. It should be noted that CRE is one of only several REITs identified that is not facing solvency challenges and is still trading below book value.

NAV / Portfolio Liquidation Value

(US\$ in 000s)

	Est. NAV	Liquidation - Percent Recovered				
		100%	90%	85%	80%	75%
Mortgage Loans	101,199	122,501	110,251	104,126	98,001	91,876
Owned Real Estate	103,116	106,020	95,418	90,117	84,816	79,515
JV Investments	54,758	60,842	54,758	51,716	48,674	45,632
Less: Est. man. Term. fee		(15,400)	(15,400)	(15,400)	(15,400)	(15,400)
Less: Accrued exp. payable	(1,137)	(1,137)	(1,137)	(1,137)	(1,137)	(1,137)
Plus: Accrued Int. Rec.	557	557	557	557	557	557
Less: AP	(6,029)	(6,029)	(6,029)	(6,029)	(6,029)	(6,029)
Less: Other Liab.	(2,803)	(2,803)	(2,803)	(2,803)	(2,803)	(2,803)
Plus: Cash	53,751	53,751	53,751	53,751	53,751	53,751
Less: Total debt	(83,445)	(82,183)	(82,183)	(82,183)	(82,183)	(82,183)
Net Value	219,968	236,119	207,183	192,715	178,246	163,778
Value Per Share	10.53	11.30	9.92	9.22	8.53	7.84
Premium to current Stock Price	42.3%	52.7%	34.0%	24.6%	15.3%	5.9%

Notes:

Mortgage loans are classified as held-for-sale and listed at book value for NAV calc

Owned RE is undepreciated with 10.2% cap rate applied to NAV calc

JVs almost exclusively consist of interests related to Cambridge Holdings, discounted 10% in NAV calc

Debt for NAV calc is the LTM average

Risks to Thesis:

- CIT Bankruptcy:** The original impetus for the CIT-CRE relationship was to enable CIT to take advantage of REIT tax benefits and concurrently provide CRE with access to CIT's loan origination network. Since CRE no longer originates loans, CRE's reliance on CIT has declined. If CIT Group were to file for bankruptcy the external manager may need to be replaced at an estimated termination fee of \$15M (3x average annual management fee received during two years). Depending upon the scope of the bankruptcy and terms of the arrangement, this compensation could potentially be avoided and even serve as a catalyst for the sale of the Company. CRE also has a mortgage purchase agreement with CIT whereby it has agreed to buy \$80M of CRE's mortgage loans. CRE's dependence on this source of liquidity is mitigated by the fact that it could sell these mortgage assets or simply its entire business in the open market. CRE has already marketed its mortgage portfolio to 83% of cost (ie. taken \$23M of valuation allowances), so a sale would likely result in minimal dilution to book value/ NAV and possible accretion given the recovery in the mortgage market.

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“Points of Leverage” - Dave Samra



Dave Samra—Portfolio Manager, Artisan Partners International Value and Global Value funds.

David Samra is the lead Portfolio Manager for the Artisan International Value Fund and is also a Portfolio Manager for Artisan’s Global Value portfolios. Mr. Samra and co-Portfolio Manager Daniel O’Keefe were named 2008 International-Stock Fund Manager of the Year by Morningstar. From its 2002 inception through 2008, the Artisan International Value Fund has returned a total of 126% vs. 43% for the MSCI EAFE index. Prior to joining Artisan, Mr. Samra was a portfolio manager and a senior analyst at Harris Associates. Mr. Samra holds a BS from Bentley College and an MBA from Columbia Business School.

G&D: Tell us a little bit about your background, how you got interested in investing, and how your time at Columbia Business School has influenced your investment philosophy.

DS: I first got interested in investing when I was an undergraduate, when I realized that my finance professors were, in general, much wealthier than my accounting professors. That attracted me to the finance business.

It became immediately apparent to me which style of investing I was interested in because of the first project that I had in my finance

class. The project was to select a pharmaceutical firm to analyze and I was paired up with a guy who picked Merck. At that time, Merck was a growth business that traded at a very high multiple. I selected a company named A.H. Robbins; a company I think eventually went bust. They were being sued for problems with one of their products. But if you looked through the litigation and looked at the valuation you were paying for the underlying business, it was extremely cheap. For whatever reason, my natural inclination was to look for cheap equity.

When I finished undergraduate school, I started an investment club with some friends. Four or five years later, with mainly just accounting experience, I applied to Columbia. It was the only school I applied to because of its rich investment history and because it’s where Benjamin Graham taught and Warren Buffett went to school. I spent two years there and worked for Gabelli [GAMCO Asset Management] on Fridays. I also wrote the newsletter and ran an investment club during that time period. When I got out, I took a job at a place called Montgomery Asset Management.

The interesting part about Columbia while I was there is that it was more or less an efficient market program. Back then, the value investing concept had been lost by

the faculty. So we tried to promote value investing through the Investing Club and we brought in Jim Rogers, Chuck Royce, Leon Cooperman, Mario Gabelli, and other investors to speak to us about value investing.

Shortly after we left school, the Robert Heilbrunn seat for value investing was endowed and filled by Bruce Greenwald. Once he got involved, he turned that program into something of much higher quality than anything we had while we were there. I think the administration eventually realized that there was an underlying base of interest in value investing.

While I was at Columbia, the most profound influence was actually an adjunct instructor named Joel Stern, who was basically an efficient markets guy. Joel was mainly a management consultant who worked with someone named Bennett Stewart, who wrote a terrific book called *The Quest for Value*. They coined the EVA concept that, from a financial standpoint, helps you to understand the difference between a good business and a bad business. What matters to you as an investor is how that difference, compounded over time, can be very beneficial as it accrues to the shareholders of that business. Marrying the concept of investing in a good business

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Dave Samra (continued from page 16)

(Continued from page 16)

at a cheap valuation is what has driven my philosophical approach to investing, both as an analyst and now as a portfolio manager.

G&D: That's a great transition to some questions about your investment philosophy and style. You mentioned that you look to invest in good businesses. What are some of the characteristics that you most like to see in a business?

DS: In business school you have to sift through all of the concepts to find what is truly valuable. The concept of investing in good businesses is what I gravitated towards. Once you get out in the real world, identifying good businesses using ratios is the easy part. Identifying a great business by understanding the reality of the marketplace in which a company operates and the sustainability of that model, along with how much you should pay for it, is the art which we exercise on a day in and day out basis.

The way to generate returns over and above market returns over time has to do with leverage. There are a lot of points of leverage in which to operate in the investing world. The easy one to identify is financial leverage, where if a company has a lot of debt and is growing rapidly, the equity value of that company will grow in a magnified way. There's also operating lev-

erage where you have a high fixed cost base, so when revenue grows, profitability swells and you benefit from that form of leverage. The third point of leverage is through valuation.

“Marrying the concept of investing in a good business at a cheap valuation is what has driven my philosophical approach to investing, both as an analyst and now as a portfolio manager.”

Let's say you identify a business with economics that would imply a relatively low multiple on earnings, because in the short-term the business is being hampered, either cyclically or for company specific reasons. However, the work you've done suggests that the valuation

multiple should be much higher because, longer-term, it's actually a high quality business and has the ability to grow and the returns on the business will become very high. That's what I call multiple leverage. The last point of leverage is earnings growth on a non-financially leveraged basis.

As you develop your style within investing, you eventually pick a point along that scale. If you are a growth stock investor, often times you'll buy a company at a fair valuation and look to underlying earnings growth to generate returns as the value of the business grows. Another style, if you don't mind financial leverage, is to buy highly operational and financially leveraged businesses on a highly diversified basis. Then you just play the odds that if you pay low enough multiples, enough of them will work out, and you will do well overall.

What we have developed over the years is a style that is much more reliant on underlying earnings growth on a financially unleveraged basis combined with leverage that we are getting through valuation. So what we try to do is to skim off the top by running a reasonably focused portfolio of companies that fit between the juxtaposition of high quality and cheap valuation. The way we generate our returns is from growth of the underlying value of the

(Continued on page 18)

Dave Samra (continued from page 17)

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business, along with valuation leverage because we are buying at a cheap price.

The reason we invest the way we do is because of risk. If you look at the other ways to generate returns—take financial leverage for example. The obvious consequence of owning a financially leveraged business is that, if you get it wrong, you can put the business in a challenging position. It may not be able to raise capital and because the equity is a relatively small portion of the capitalization, very small movements in the operating performance of that business can have a damaging impact on the equity value. We have a very broad and large universe, so we don't need to get involved in those types of investments. We can find cheap equities across the spectrum.

With regards to investment styles that rely on leverage through earnings growth, in most time series, you're subject to valuation risk. So if the high rate of earnings growth declines, the multiple is also likely to shrink, which results in a permanent loss of capital. We shy away from those two forms of leverage, financial or operating leverage and earnings growth at a high P/E.

We want to build a portfolio of undervalued businesses that are good companies that generate cash

flow. We also want to see strong management teams that are wisely allocating that capital. We think this type of portfolio will generate very good absolute returns over time.

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

G&D: You want to find high-quality businesses at low valuations, but theoretically, these opportunities should be rare. Where do you find these ideas and what types of situations give rise to these opportunities?

DS: The world is a large place and we have a very large universe from which to choose. We typically have 40-50% of our portfolio

in ten equities, so we aren't looking for hundreds of stocks. There are lots of reasons that a good business can trade at cheap valuations. One of the obvious reasons is macro issues.

One example was late last year; we bought Google below \$300 per share, which was implying around 13x earnings. You could argue that the whole market was undervalued and it probably was. But the point is: we were picking up a great business, with a terrific secular profile, that dominates its industry, with a very high level of profitability, and we picked it up at a very un-demanding price. Clearly, it was a macro shock that led to an undervaluation of the business.

Other events can lead to these situations: management makes a bad acquisition or poor strategic decision, the government changes the rules on a business, management changes. There are a variety of different reasons good businesses can get cheap.

G&D: A lot of value investors fared poorly in 2007-08, but your fund performed very well despite being fully invested throughout the period. To what do you attribute your stronger performance?

DS: We don't feel that we are particularly good at call-

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ing market tops and bottoms. What we do is identify certain investment profiles that make sense to us. We always make sure to really look under the hood of the companies we are buying.

For example, we were largely absent in the highly-leveraged financials space, such as banks and insurance companies. We were uncomfortable with the amount of leverage that had built up in these companies. We viewed this as nothing short of a carry trade exercised by borrowing short and lending long, particularly in an environment which was much less liquid outside the US in terms of securitization. In the end, earnings growth was overstated quite a bit because there weren't enough loss provisions going through the balance sheet. A lot of value investors thought they looked cheap. For instance, the price-to-book looked out of whack. But the reason they were cheap is because of their considerable leverage and their earnings were overstated.

G&D: *When the financial stocks collapsed earlier this year, did you look at that as an opportunity to buy them at really cheap prices or were you just not comfortable with the highly leveraged financial model at any valuation?*

DS: We didn't step up into

any traditional banks. We spent an enormous amount of time going through a lot of the banks, but because the financial system was so close to melting down, it came down to pure speculation. Instead, we took ad-

“Commodity businesses are not good businesses at the end of the day; they're capital intensive, the products don't have any differentiation, and returns tend to be low over time.”

vantage of financial services companies outside of the traditional leveraged financials.

We bought a meaningful stake in IGM Financial, which is in the money management business in Canada. It is a terrific business that has a strong balance sheet and a very good market position. That turned out

to be a terrific investment. We also have a long-term holding in Arch Capital, which is one of the premium franchises in the Property & Casualty insurance business. We bought Arch at a cheap price-to-book, at a time when the book value was understated because some of the investments they had in their portfolio had been marked down unnecessarily, in our opinion.

We didn't buy equities in the areas with the most leverage points, though we did increase our weight in the surrounding area. These turned out to be good investments.

The oil industry is another area we were largely absent. What we knew about the price of oil at \$150 per barrel was that it was way above the marginal cost of production. When commodities are priced at that level, it typically encourages production and discourages consumption. This is a lesson in value investing: you can't just look at the numbers. All of the oil stocks looked really cheap when oil was at \$150 per barrel. We didn't know if oil was going to \$200 per barrel, though we didn't think so. Either way, we didn't take much of a position on the direction of oil at all. We did make the determination that the price of oil was well above the marginal cost of production and that we did not

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want to own these stocks with oil at those prices. Commodity businesses are not good businesses at the end of the day; they're capital intensive, the products don't have any differentiation, and returns tend to be low over time. We've decided that we would only get involved in commodity businesses if we can identify the low cost producer, the commodity is priced well below the cost of production, and the balance sheet is clean.

As we went into the commodity downturn, we preferred to own a company like Samsung Electronics. We believe that's the same type of business as oil or copper; at the end of the day it's a commodity. Most of Samsung's competitors were operating with negative gross margins. Samsung was break-even or barely making money, so they are the obvious low-cost producer. They also have a very strong balance sheet. We were simply waiting for what inevitably happens with a very low-priced commodity: consumption is encouraged and capacity started coming off-line. The increased consumption and decreased production eventually moves the market back in-line. As this occurred, Samsung turned out to be a good investment through the downturn.

G&D: Back to the oil industry, you have been buying

some of the integrated oil companies more recently. Do you need to get comfortable with macro backdrop before you can be confident enough in their sustainable earnings power to invest?

DS: We haven't found it to be a valuable use of our time to try to forecast any macroeconomic outcome. We did look at the marginal cost of production per barrel of oil and compare that to the price of oil that was implied in the equity valuations. We made the determination that \$40 oil, which was where the price of oil was when we bought these equities, was below the marginal cost of production. Oil reached nearly \$150 per barrel and bottomed near \$35, but over the last ten years, our internal models have assumed that the marginal cost of production has moved up to \$75-\$80 per barrel. There has been above trend inflation in the cost of doing business in the oil space, so we estimate that a more accurate marginal cost is probably closer to \$65-\$70 per barrel today.

G&D: Your cash position has moved up to approximately 10% of the portfolio, which is the top of the range you target, according to the fund's prospectus. Is this an indication of your view of valuations in the equities markets currently?

DS: Obviously, valuations

are higher today than they were in the earlier part of the year. But we have transitions that we go through from time to time in which our cash position may build temporarily. Typically, we are either working on something new or waiting for better entry points on particular stocks. The cash increase is not a call on the market; it's more a reflection of what we currently have on our plates and also from exiting a couple of big positions. IGM rallied from the mid-\$20s to the low-\$40s, which we think is fairly valued, so we sold out of that position. As we go through the process of reinvesting that capital, the cash position will increase somewhat as part of that process. It's definitely not a market call.

G&D: You made an interesting comment in one of your shareholder commentaries, regarding the government's impact on the economy and financial markets. Your point was that the massive government intervention is emerging as an immediate risk to earnings power and valuation. What did you mean by that and how have you adjusted your investment process to account for that risk?

DS: Government changes are slow and they frequently encroach on businesses in less than obvious ways. The most obvious impact is on our healthcare stocks.

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We've seen bills come out of congress and a proposed \$4 billion per year tax increase on medical device stocks. Covidien is one of our largest positions and one of the largest medical device companies in the world. It's a global business, but a meaningful portion of its revenues come from the U.S. The question becomes, how much of any tax increase gets passed on to the end consumer. It could really hurt the business in the sense that there will be less money to spend on R&D and that profitability will simply decline. We think current valuation multiples already reflect the market's concerns about the resulting impact on growth, profitability, and cash flows associated with these businesses.

We're also hearing a lot of noise about clamping-down on compensation structures, not only in the US, but also across the globe. I also think the cap-and-trade bill could do significant damage to the Midwest manufacturing base, because it penalizes smaller power companies that rely on coal plants. Sometimes I don't understand what politicians are thinking: on one hand, they want to create jobs, but then they are doing things that are obviously bad for job creation. I'm concerned that the current administration's strong focus on labor could start to have a negative impact on operating

profitability.

We share others' views that ROEs will be lower, growth will be slower, consumers need to deleverage, and the government is going to be

“We share others’ views that ROEs will be lower, growth will be slower, consumers need to deleverage, and the government is going to be more interventionist.”

more interventionist. The government is imposing itself on the economy more and more, which will have an impact on the underlying growth rates of businesses. As a result, it is ever-more important to make sure that you own good businesses, that are attractively priced, that have good management teams, that can creatively figure out ways to grow their businesses, whatever the headwind might be – whether it's macro, micro, or government. The key for us is to make sure we own

businesses that are well placed to grow, even if someone builds a brick wall in front of them.

G&D: Given our huge and growing national debt, another issue we potentially face down the road is inflation. In another shareholder commentary, you referenced a 1977 piece by Warren Buffett regarding inflation's negative impact on stock returns. Do you think we could be heading for a similar environment to the 1970s – a period of high inflation and poor equity returns?

DS: We just don't make macro projections. What we wanted to do was create awareness among our shareholders that this is one possibility that could emerge as a result of the current environment. We haven't changed anything that we own in our portfolio. We think that if you own competitively well positioned businesses that have a relatively low level of capital intensity, you are better placed than most to retain the returns of the business. It doesn't mean that you won't be impacted, just that you are better positioned. We aren't sure that this will happen; we just think the odds are higher now than they were when we were running smaller deficits. It is very hard to predict these things.

G&D: Thank you Mr. Samra.

Lessons of an AVI Alum—Kevin Dreyer, GAMCO



Kevin Dreyer ('05) — Associate Portfolio Manager, GAMCO Asset Management.

Kevin Dreyer is an Associate Portfolio Manager of both the Gabelli Asset Fund and the Gabelli Healthcare and Wellness Fund. Mr. Dreyer received his undergraduate degree from the University of Pennsylvania and holds an MBA from Columbia Business School.

G&D: Can you tell us a little bit about your career before business school and how you got interested in investing?

KD: After completing my undergraduate degree in engineering at the University of Pennsylvania, I went into investment banking with Bank of America Securities. I worked in M&A advisory for three years, which gave me a good introduction to finance and understanding companies. After some time, I decided that I wanted to actually use that analysis to make investment decisions as opposed to just giving advice. I read the Intelligent Investor and started getting hooked on the value investing books and applied to Columbia. Fortunately, the value investing program was just starting to become formalized. I was in the first class to go through the program in its current form. Following school, I went to work for Gabelli covering food and beverage companies. The first companies I looked at were confectioners.

There are only a handful of publicly traded firms globally, so it is a pretty small sub-industry, but Mario wants us to dominate the knowledge of an industry. It turned out to be an active area since 2005, with Wrigley being acquired by Mars last year and Cadbury in the news right now with Kraft offering to acquire the company. We were involved in both of those companies.

From there, I ended up following a broader section of food and beverage companies globally. In addition to my analyst role, I took on a few Associate Portfolio Manager duties – on the GAMCO Global Opportunities Fund and a sector fund called the Gabelli Healthcare and Wellness trust. As of last month, I am also an Associate PM on the Gabelli Asset Fund.

G&D: What was the job market like coming out of school?

KD: There were some opportunities. In my first year at school, the hedge fund industry was just starting to boom. The big mutual fund companies and some hedge funds came to campus to recruit. Investment management has always had a much different recruiting process than other business school career paths like banking, trading, and consulting. A lot of internships and jobs were secured through job postings and networking rather than formal recruiting. It is really

important for students to talk to a lot of people at firms for informational interviews. Some people I know didn't find their jobs until late in the spring or even until the end of summer after graduation.

G&D: What was your experience with the AVI Program and how did that help prepare you for your current role?

KD: It helped me get used to doing full and complete analysis on companies and writing them up and talking about them. The Applied Value Investing course that I took with William von Mueffling was the best course I took in school. I really learned how to be an analyst. We were essentially functioning no differently than if we were working as analysts following an industry, and we met some great guest speakers. The Greenwald value investing seminar was also terrific. It was interesting to hear the perspective of all of the great value investors. Everyone has their own flavor of investing and it helps to crystallize where you want to gravitate towards and what makes the most sense to you.

G&D: Is there any investor that made a particular impression on you?

KD: Well, obviously Mario Gabelli. The whole notion of Private Market Value with

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Kevin Dreyer, GAMCO (Continued from page 22)

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a Catalyst was not that much different than the way that I had looked at companies as an M&A banker. That was helpful for me in transitioning into investment management. Tom Russo was also very interesting. He follows a lot of the same companies that I do. I also liked how he took a global approach.

G&D: Do you still interact closely with the other AVI students from your class?

KD: I do. Right out of school, a group of us would try to get together every few months or so to talk about stocks and how our jobs were going. As you get older, it becomes a bit more difficult to meet up, but I definitely still keep in touch with quite a few people from the AVI program.

G&D: Are there quite a few AVI alums at Gabelli?

KD: There are a few. We recruit at Columbia every year so we are always adding people from Columbia.

G&D: It sounds like you have been pretty successful in your career, progressing from being an analyst to having an increasing amount of portfolio management responsibilities. Can you tell us some more about your progression and how you think about those two different roles?

KD: I don't know that I

view being an analyst or a portfolio manager very differently. It is just that you are looking at more companies and more industries. Mario would probably still consider himself an analyst. We are very stock specific and bottom up. We focus on what private market values are, particularly if there is an opportunity to realize those values through either a financial or strategic transaction.

“As an analyst, it is really easy to put your head down and just be thinking about your industry. It is always important to step back.”

G&D: What have you learned from Mario?

KD: First, that it is important to define your circle of competence and stick to what you know, and to learn something in particular and know it extremely well.

As I mentioned earlier, Mario wants us to dominate the knowledge of a particular industry. At school, I initially had this notion that you just do screens and try to find some cheap stocks, whereas we really want to know everything there is to know about an industry and what the dynamics are and how those are going to play out over time. We meet with management and talk to competitors, suppliers and customers to get an informed view of what is going on. Focusing on that, regardless of what the market is doing is of critical importance.

G&D: Often analysts make recommendations to buy what they think are the best ideas in the industry and not buy the worst ideas, but they fail to take a step back and think about the macro position of the industry and whether you want to be involved in it at all. How much do you think about the macro issues when you are covering an industry?

KD: It depends what you mean by macro issues. If you mean the external factors that are going to affect an industry and all of the companies in an industry, I would say yes. If you are talking about short term fluctuations in stock prices for particular sectors, I would say no. In food and beverage we are definitely thinking about consolidation of retailers, input cost infla-

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tion or deflation, or any of those types of macro factors. However, we aren't sitting around thinking that we need to be defensive so we need to buy more consumer staples this quarter. There are quite a few people in the industry who do think like that though.

As an analyst, it is really easy to put your head down and just be thinking about your industry. It is always important to step back. The advantage that we have at Gabelli is that we are getting grilled by Mario on these questions every single day. What is the company worth? Who would buy it? What will earnings and cash flow be over the next five years? That keeps us honest and prevents us from having tunnel vision.

G&D: How much do you think about comparing yourself to a benchmark and underweighting or overweighting various sectors?

KD: The firm has an absolute return goal of 10% annually, plus inflation. When you have consultants or clients, they want to benchmark you against something. We don't really care what it is, whether it is the S&P 500 or Russell 2000. We are long only but still really focused on absolute returns. If you don't think you should buy any companies in your industry, you can say that as an analyst here. You don't feel pressure to rec-

ommend a company within your industry just because you are given a certain industry to cover.

G&D: When you are thinking about private market value, a lot of times transactions take place at elevated earnings or elevated multiples. How do you make an

“We focus on what private market values are, particularly if there is an opportunity to realize those values through either a financial or strategic transaction.”

adjustment for whether or not a comparison transaction makes sense?

KD: First, it depends on what kind of acquisition it is. Is the company giving shares or paying cash? Cash acquisitions tend to be a lot more meaningful. You also don't just look at these things once. You look at them over time and how they are trending and if they are being reaffirmed. In the spirits industry, you have had acquisitions as high as

20x EBITDA which is what Pernod paid for Absolut. I wouldn't instantly put a 20x multiple on any spirits company. Each company is different and unique. Absolut was a very unique asset that all companies were willing to pay up for, and Pernod was willing to pay up the most.

Today, in a very different environment, Campari paid 12x for the Wild Turkey bourbon brand, which is a less dynamic brand than Absolut. Looking back historically, 12x to 15x has been more of a norm for acquisition multiples and more in the range that we would use. Finally, don't leave your brain at home. You don't take the highest multiple that is being paid in a bubble environment and use that forever. You try to be conservative and look for a margin of safety. We are looking three years out and expecting 50% upside on our investment.

G&D: Are you just using these multiples as a benchmark or reference or are you actually looking for a specific transaction that will realize the valuation?

KD: Both. We always look at it as a benchmark, but practically speaking, some companies are not going to be acquired. However, we get very interested when a company trades at a meaningful discount, we like the internal dynamics of the

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company, and we also think it could be acquired. Cadbury is the best example of that kind of company that I follow. A few years ago it was Cadbury Schweppes and had a confectionary business and a beverage business. We thought that they weren't getting credit for their confectionary business, and they subsequently sold off their European and Australian beverage businesses and spun-off their America's business as Dr. Pepper Snapple Group. This left Cadbury as a pure play confectioner, which is a very attractive business. They are a major player, have good brands and are in attractive markets. So, for Cadbury we did think that they were an acquisition candidate and that Kraft was the most logical buyer.

G&D: Do you think that a deal will eventually get done?

KD: I do. I think that Kraft will just have to bump up their bid a little bit.

G&D: What other ideas are you excited about?

KD: Generally speaking, valuations are still pretty reasonable although obviously less attractive than they were a few months ago. One company that I like is Constellation Brands (STZ). They have the largest wine business in the US. They have a small spirits business. And then they

have a 50% stake in Crown Imports, which is the importer of Corona and the other Grupo Modelo beer brands.

For a bunch of reasons, the stock had gotten very cheap. The company is con-

“Don't leave your brain at home. You don't take the highest multiple that is being paid in a bubble environment and use that forever. You try to be conservative and look for a margin of safety.”

trolled by the Sands family. Richard Sands is the Chairman and Robert Sands is the CEO. They have supervoting stock so that they can nix any potential deal. They have rolled up a lot of wine brands over the years and were what you would call a “serial-acquirer.” Some of those acquisitions worked well, such as Mondavi, although they paid a very high multiple. And

some, like Hardys, didn't go well at all. They are also fairly highly leveraged and were really punished for that at the end of last year. Finally, there are some dynamics with their beer business that aren't well understood. So concerns about management, acquisitions, leverage, and the general consumer environment pushed the stock as low as \$10 or \$11. We had been negative on the name but started looking at it again in that range.

For their core wine business, the trade down to less expensive brands is actually benefiting them as a lot of the wine that they sell is in the \$6 to \$12 per bottle range. The people that typically shop for \$20-\$25 bottles of wine are now looking at bottles like a Clos du Bois for \$10 or a Woodbridge for \$6.50. As a result, those brands are actually doing well in this environment.

G&D: So comps in the wine business have been holding up through the downturn?

KD: Yes, growth has slowed for the industry and for Constellation, but some brands are doing well. In aggregate, sales are hanging in there and certainly haven't fallen off a cliff.

G&D: Given the trade-down to lower-priced bottles, have margins con-

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 tracted at all?

KD: There has been some gross margin pressure, but the company is also going through a cost-reduction program. They've found ways to offset the margin pressure. They've also sold off some brands, such as the value spirits and wine portfolio, and reconfigured the reporting segments somewhat, which has had an impact on margins as well. But overall, EBITDA margins for wine and spirits are in the mid-20s, so it's not like this is a low margin business. It's also not nearly as capital intensive as one would think, because most cases they are sourcing their grapes as opposed to owning the vineyards.

Transaction multiples for wine and spirits companies have historically been in the 12-20x multiple range, but I use 10x to be conservative and because it's family controlled and there won't be a take-out. Applying a 10x multiple to the wine business, the current market valuation implies you are getting the beer business for free. In 2016, Constellation's JV partner, Grupo Modelo, can take over Crown Imports at book value, pay 8x EBIT and switch to another partner, or renew the contract. But no matter what happens, it's all upside. Also, A-B InBev has a 50% economic interest in Grupo Modelo, and may be interested in acquiring

the whole company. If that happens, they would probably be precluded from taking over Crown outright because they already have 50% market share in beer in the U.S.

The wine & spirit business is worth \$14-\$15 per share. The beer business, in a worst-case scenario, is worth \$4-\$5 per share, just based on the cash flows to 2016. If the beer contract is renewed in 2016, it bumps the value up to at least \$8-\$9 per share. We think this is also based on conservative multiples. At the time, the stock was trading at \$11-\$12 and I thought it was worth \$18-\$19 conservatively; maybe \$24 or more in an upside scenario. The stock has moved up a bit since then, but there's still a good deal of upside.

Talking to other investors about the stock, the bear thesis was very well known. However, most people missed some of the changes that were going on internally. The company brought in a new CFO, sold off some low-return brands, and increased its focus on return on capital, generating cash, and paying down debt. We thought management had a good understanding of what needed to be done to increase the value of the business and were moving in the right direction.

The final point is that risk is somewhat mitigated by the fact that management is

somewhat hamstrung right now with regards to big acquisitions. Debt-to-EBITDA is around 4.3x, so I don't think management could make any big moves in the near-term.

G&D: As an Associate Portfolio Manager, what is your role at Gabelli? Do you have a specific portion of the capital that you manage directly or is it more of team-oriented, round-table type of process?

KD: It depends on the situation. One of the funds is the Healthcare & Wellness Fund, for which I manage a portion of the assets of the fund. Another fund, the Global Opportunity Fund, is managed by Caesar Bryan. That fund is more of a cooperative style, where I will pitch stocks. For the Asset Fund, which is a newer role for me, I am managing a portion of the assets of that fund.

G&D: Is the Asset Fund Gabelli's primary fund?

KD: It was our first mutual fund and has about \$2 billion in assets. We have a total of about \$21 billion in AUM – it's split roughly 50/50 between mutual funds and separate accounts. We also have a small hedge fund business as well.

G&D: As a PM for the Healthcare fund, have you done a lot of work in the healthcare space?

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KD: It's really a Health and Wellness fund, so my portion has more of a consumer theme. The health-care portion is managed by someone else. I manage the consumer portion of the fund.

G&D: What are some of the names in the consumer portion of that portfolio?

KD: The largest holding of mine is Danone, the leading global yogurt manufacturer. They've done a reconfiguration of their business; for example they used to have a biscuit business, which they sold to Kraft. They bought Numico, which is a baby food business. It's a growing category and they provide a healthy product. It has attractive returns, not just for their business, but also for the retailers as well due to the negative working capital for both their business and for the retailers as well in the fresh dairy category. There are a lot of reasons why the category is growing. Per capita consumption is much lower in the U.S. and emerging markets than in Western Europe. From a strategic perspective, they are the clear leader and can spend more on R&D than anyone else, which leads to blockbuster-type products with specific health benefits, such as Activia, which helps with digestion, and Actimel, which helps immune defense. The company trades

roughly in line with a lot of its food and beverage peers, but it has a natural top line growth rate that is 2x to 2.5x as fast. We thought it would be an attractive acquisition candidate, and a few years ago Pepsi was looking at them.

G&D: How do you think about international investing?

KD: We follow companies on an industry basis so to a certain extent you have to

**“We follow
companies on an
industry basis so
to a certain
extent you have
to be
international.”**

be international. If you are following the spirits industry, you can't just follow Brown Forman and Fortune Brands. You need to know what Diageo is doing and what Pernod and Remy are doing. You have to follow the companies anyway because they are competitors. So from there, it is a natural extension to evaluate whether these would be

attractive investments as well.

G&D: Any final words for business school students?

KD: Do as much research as you can and try to come up with strong stock ideas. That is how to differentiate yourself— to show that you can do the job from day one. Try to find your edge, something that you can do better than someone else. That is how you can add value to an investment management firm.

G&D: What characteristics should we be looking at in investment firms that we are targeting for recruiting?

KD: I think the biggest thing is investment philosophy. You guys are in the AVI program so I am guessing that is where your interest is. Within that context, there are different styles of value investing. Some firms focus on a particular market cap range. Some are long only and others are long short. Making sure that you are comfortable with a firm's particular style is important. A big part is also personality. If you are going to work for a portfolio manager, you have to be able to get along. That will make or break how successful you are.

G&D: Thank you Mr. Dreyer.

AVI Class of 2009



Also Pictured: Mohnish Pabrai, Kevin Oro-Hahn, Bruce Greenwald, and Erin Bellissimo.

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Graham & Doddsville 2009 / 2010 Editors



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