A Bargain Hunter Stands Tall

Bruce Berkowitz survived the carnage better than nearly all his peers. Now he sees plenty of good values.

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As a wretched 2008 draws to a close, Bruce Berkowitz displays mixed emotions. On the one hand, Fairholme fund, which he's run since its late-1999 launch, is again beating the stock market (by eight percentage points in early November). On the other hand, the fund is on track for its worst year ever (down 28%). And yet the swoon in share prices that is responsible for Fairholme's losses also brings a smile to Berkowitz's face. The candy store is wide open, and the bargain-hunting Berkowitz, 50, feels like a kid again.

Despite the 2008 loss, Fairholme's long-term record remains solid. From its inception through November 7, the fund returned 11% annualized. During the same period, Standard & Poor's 500-stock index lost 3% a year. Fairholme, which typically owns only about 25 stocks, has trailed the index in only one calendar year.

What really stands out about Berkowitz's performance, though, is how he escaped the ignominious fate of so many other value managers over the past year. He applied strict value criteria when he assessed stocks, and he adhered to the simple (but wise) rule of not investing in anything he couldn't understand. So Berkowitz was never tempted by the likes of AIG, Bear Stearns or Lehman Brothers, no matter how cheap their stocks had seemingly become.

To learn more about how Berkowitz operates, we visited him in his Miami office, located the length of a football field from Biscayne Bay.

KIPLINGER'S: What were you doing as the markets gyrated so dramatically in the fall?

BERKOWITZ: Although the fall in stock prices hurt our performance, it has been a blessing. We've been buying companies at prices that even when I was in my most pessimistic mood, I didn't think we would see so quickly. These are 1974-type valuations, and what's fascinating is that stocks fell to these levels not because of earnings issues but because of the sheer magnitude of the forced liquidations. So this is still a bargain hunter's dream.

We are selling that which is cheap to buy that which is cheaper, in order to make more money in the future and to help manage taxes for our shareholders. And we're pairing our stock positions with senior subordinated debt.

So you're buying the bonds of companies whose stock you own?

Yes. Some of the stocks we hold are so cheap that we fear the companies will be taken over at too cheap a price. So we're buying discounted bonds that have anti-takeover triggers, meaning the price of the bonds will immediately rise to 100 cents on the dollar on a change of control. And if we like the stock, we don't mind owning bonds that are yielding 15%, 16%, 17%.

A lot of well-known value investors fell on their faces the past year or two. Why did Fairholme hold up as well as it did?

Maybe it's because I don't invest in things I can't understand. Eighteen years ago, after the financial stocks got killed, I was a big buyer of Wells Fargo, Freddie Mac and MBIA. They were simpler businesses then -- and they were cheap and understandable. You could read an annual report or a 10-K and you knew what you were getting.

Or take American International Group. If you looked at an AIG annual report six or seven years ago, you saw one paragraph on derivatives. You look at an AIG annual report today and you see 15 pages on derivatives. I don't think company insiders fully understand what's going on, let alone outsiders. So if I don't understand something, I've learned to walk away.

Do you try to anticipate which sectors will do best?

We tend to react rather than to predict. We look at companies, count the cash, and then try to kill the company.

Kill?

We spend a lot of time thinking about what could go wrong with a company -- whether it's a recession, stagflation, zooming interest rates or a dirty bomb going off. We try every which way to kill our best ideas. If we can't kill it, maybe we're on to something. If you go with companies that are prepared for difficult times, especially if they're linked to managers who are engineered for difficult times, then you almost want those times because they plant the seeds of greatness.

What's the worst that could happen to Sears, one of your biggest holdings?

It gets slowly liquidated, or Eddie Lampert, its chairman, takes the company private. But I don't think he'd do that to shareholders.

We didn't buy Sears based on the business. There's too much retail in the U.S. If the retail works, then it's a grand slam home run. We invested because of the company's real estate holdings. It has some fabulous locations -- a Kmart in Bridgehampton, N.Y., and a Sears on PGA Boulevard in West Palm Beach, Fla., for instance. The real estate alone is conservatively -- and I mean conservatively -- worth $90 per share [the stock traded at $53 in mid November].

How do you find opportunities?

By ignoring the crowd, we find opportunities in stocks that people are running away from. Earlier this decade, when oil and gas prices were much lower and people were very down on the sector, we found a few companies that we thought did exceptionally well in almost all price environments. We focused on Canadian Natural Resources. It wasn't well known in the U.S., but it was run by a man named Murray Edwards, who is a human computer.

You've cut back on that position, haven't you?

Yes. When the stock approached $100 a share and people started saying oil had to go to $200 a barrel, we dramatically cut that position. But lately we're seeing some energy stocks at levels that assume oil prices of $35 a barrel, and so, in a very short period of time, we've reversed course again on energy stocks.

Are your health-insurance and drug stocks examples of your contrarian bent?

We bought Wellcare Health Plans after the FBI raided the company in October 2007 in an investigation of overbilling practices. The stock quickly went from $120 to the $20s. We took a couple of months to study it and started buying in the $30s. We saw that the company had a good reputation, its customer service was great, insurance brokers were still sending business to the company, and it was still growing.

Wellcare shares tanked November 13 after the company said it was being hurt by higher medical costs and was in default on some debt covenants. WellCare is fine. Nothing has changed. If we are wrong on the company, we do not deserve to be in business. What an opportunity!

And now you also have major positions in UnitedHealth and WellPoint.

UnitedHealth and WellPoint serve one out of every five insured. They are the insurance system of the United States, and they'll continue to be the insurance system. These companies were the darlings of the investment world not long ago. Whether their stocks are down because of forced liquidations or because of fear that the government is going to put caps on what they can charge, I don't understand the rationale for why these stocks are trading where they are. UnitedHealth will earn between $3 and $3.50 per share of free cash in 2008. That's a significant amount.

Do you pay any attention to earnings?

No. I look at free-cash-flow yield.

And free-cash-flow yield is?

The free cash a company generates divided by its market capitalization. If we can get a double-digit free-cash-flow yield, I'm interested, especially if we can't kill the company and especially in a world of 3% or 4% risk-free yields.

Why, of all health companies, did Pfizer become your top holding?

We counted the cash. Pfizer generates $17 billion a year in free cash flow -- an unbelievable amount. At the current price, the stock trades at about seven times free cash flow per share. And that's from a company with a triple-A balance sheet.

Investors are staying away from Pfizer because they think that losing patent protection on drugs like Lipitor will kill the company. They believe it's not going to find another drug like Lipitor and that free cash flow will just fall off a cliff. Most people have no idea how many patents the company has, the size of its new-drug pipeline and the other moves it's making. There's a lot more cost-cutting ahead.

Moreover, I see Pfizer becoming a merchant bank to the pharmaceutical industry. Pfizer is the perfect partner for smaller companies that may have good new drugs but need cash to fully develop those drugs, go through the FDA approval process and distribute them in the market.

Isn't the loss of patent protections a legitimate concern?

The drug companies were really stupid in the past. They essentially gave away the business in their mature products, which some people vulgarly call generics. They're not going to do that anymore. Why shouldn't Pfizer have its own generic version of Lipitor? People don't understand that a generic formula is not exactly the real McCoy. When it comes to chocolate, people don't put an unbranded piece of chocolate in their mouth. But you're okay ingesting a generic drug whose formula may differ from the real thing that you used to use? We think Pfizer can be the world's number-one provider of established-brand products.

Have you met with Pfizer's people?

After I first bought the stock. Given the availability of so much information on the Internet, I'm not so interested in meeting management today. You can get seduced too easily. I'm more interested in finding out how a person has behaved in the past. If I can listen to a few of the CEO's speeches and read the transcripts of earnings calls, that is more important than talking to him. A smart, dishonest person can fool you, especially when he's talking about his own business.

One of your big holdings is Leucadia National, which some have described as a mini Berkshire Hathaway.

Yes, I've been involved with the company and its key people for 15 years. They're very smart, very sensible, honest and decent businesspeople, and Leucadia has a better record than Berkshire. But I don't really want to talk much about them because they've asked me not to.

They're secretive?

They just want to live normal lives. They want to be able to go into the local pizzeria just like anybody else and sit down with their friends. And when the CEO, Ian Cumming, and the president, Joseph Steinberg, retire, they'll probably give all the money to their shareholders and call it a day, and I like that.

How soon will that be?

I'd say in another ten years.

You've been trimming your stake in Berkshire.

Yes. I'm doing that because I'm taking Warren Buffett at his word. He says Berkshire has gotten so big that at best it will do two or three percentage points a year better than the S&P 500. Don't get me wrong. Two or three points better than the S&P over a long period of time is pretty good.

One of your other major holdings is St. Joe, the biggest private landowner in Florida. Will the Florida real estate depression kill St. Joe?

It was being killed by a bad CEO, who is no longer there. The new guy, Britt Greene, is good. The company owns more than 600,000 acres of land in northwest Florida. About 50% of it is within 15 miles of the Gulf Coast. It is the largest piece of good, privately owned land left in the U.S. And the first new international airport since Denver is right now being plunked in the middle of St. Joe's land in Bay County, about 41 miles from Tallahassee.

And St. Joe own everything around this airport?

Yes. The weather is great, the beaches are gorgeous, and the ecosystem is comparable to the rainforest. Every real estate guy in the world would love to own this land, but they all depend on borrowed money, and they don't have it now. Granted, the company doesn't have the free cash flow, but it's debt-free and we're buying beach land for swamp values.

We paid, on average, $32 or $33 for our shares, and I know Joe is worth more than what we paid. It has a stock-market capitalization of $2.6 billion. Over the next ten years, the state alone is going to put $2.6 billion of infrastructure into the land. Suppose you owned a plot of land on a beach and the state came up to you and said, "I'd like to build a road to your house. I'd like to give you the water system and electricity. I'd like to plant some trees, make it all nice. By the way, I'm going to plunk down a little airport right next to your house so that you can get in and out easily. And we'll also maintain the land, forever." You could consider that to be free cash flow.

What's been your biggest mistake?

Probably IDT, a telecommunication company. It was a total misjudgment of the character of management. Our biggest mistakes have always involved overestimating management.

Do you still own it?

We still own some. We spend a lot of time on mistakes and asking why we make them. It's great for the investment process. I've met IDT's CEO, Howard Jonas. I thought he did some very creative, smart things, but the investment just turned out to be a value trap.
