ADVISOR PERSPECTIVES

Bruce Berkowitz on the Keys to Success for the Fairholme Fund

By Robert Huebscher
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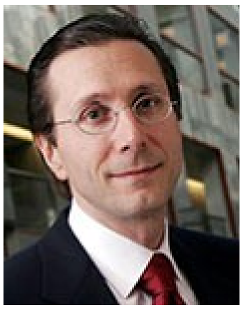

Bruce Berkowitz is the founder and manager of the $11 billion Miami-based Fairholme Fund, which just celebrated its tenth anniversary. Along with Charles Fernandez, he runs the fund's portfolio management team. Last week, Mr. Berkowitz was named Morningstar's US stock-fund manager of the year for 2009. In addition, he was named Investment Guru of the Year by GuruFocus. On January 4, Fairholme introduced a new fund, The Fairholme Focused Income Fund.

We spoke with Mr. Berkowitz on January 8.

Congratulations on the honors you have earned recently.

You know what they say: first comes success, then comes death. It's nice, but there's nothing like success to breed failure.

Hopefully there is a long gap in between.

As long as we stay focused on that concept and know that was yesterday's news and move forward, we will be okay. I've seen too many really good people who are killed by success; they get too big or become managers of people rather than managers of investments.

I've had a lot of fun and continue to enjoy myself. We expand our circle of competence - slowly. We hopefully get better and wiser and don't make the same mistake twice. After about 30 years I've made my fair share of mistakes.

I have a trick I use: I put all of my family's money into the fund.

I'm using every device I know of to make sure we maintain a level playing field and put ourselves in the shoes of our shareholders. The only way to do that is to become as large a shareholder as possible.

Last year, when we spoke, you said that stocks were "as attractively priced as you have seen in your career." How have things changed between then and now?

Credit markets are thawing and pricing now reflects this. Last spring the credit markets froze up. All of a sudden an equity investor was able to get really good equity-like returns buying higher up in the credit structure. I view equities as the most junior of bonds with a coupon that should equal earnings left after all expenses are paid.

We were able to buy senior credits of companies yielding 20-plus percent per annum. That was a real hallmark of the period.

The markets have improved. Equities remain cheaply valued relative to their free cash flows – at least for the companies we invest in.

We got a little lucky last year. Besides the near collapse of the financial markets, we also had the threat of the nationalization of the health care system, which is about one-sixth of our economy. After our analysis, we determined that could not happen. We were able to benefit in bigger and better ways in the health care sector, especially with the insurers.

Last year, what also helped us is that after 30 years in this business and a decade with the fund, we learned never to pay Russian roulette – no matter the odds. When times are tough, everything gets correlated. That insight helped us avoid a sector that we have lots of experience with – the financial services sector. A lot of smart people got caught up in that.

Maybe not much has changed in the year since we spoke. We are out of the abyss and the worst is over. We are facing less uncertainty, but of course you don't know what you don't know. We're okay with that, because we keep lots of cash on hand on purpose. I don't know how to predict the future, and I've proven that throughout my career. With our experience and enough ready cash you can react to whatever may happen

The biggest worry in my mind right now is if the environment gets too good and we have nothing to do and we have to close down the fund and patiently wait. But that's okay.

You and your competitors must report your holdings regularly. Do you look at the activity of others for ideas? Will you tell us which ones?

No. I used to. At one point I had a person whose main job was to do surveillance work. It didn't work. I don't want to be biased by anyone. Our tagline is "ignore the crowd." If a big voice came down from the sky and said "buy this," we wouldn't unless we did the homework. Shame on us for buying something just because someone else did.

The trick in life is not to die. The trick in investing is not to lose.

We assume, like my family, that most of our shareholders have put all their long term-wealth with us and that wealth will be needed down the road.

Do we actively search for what other people are doing? No. Are we interested if we accidently read about what someone else is doing? Yes, of course. The investment process is waiting for something to happen, whether it is the economy or a shift in industry winds, or an action by a regulator or an individual. We would react.

I don't like when people look at my holdings and I try not to look at theirs.

Is deflation – particularly with respect to asset prices – eroding the margin of safety at Sears Holdings?

Deflation eroded the margin of safety, in that real estate values came down as the housing market was destroyed. There is a significant correlation between the housing market and Sears. The answer is yes.

On the other hand, Eddie Lampert was quite astute in the way he handled capital allocation in the last couple of years. In hindsight, you can say it was a mistake for him to buy stock at $150 to $170 – it was a different environment. But by creating a company such that there is significant free cash flow being generated, the company has a huge number of degrees of freedom. If deflation was causing a decline in value and Sears' shareholders overreacted or very smart people start shorting the stock, then the company has more than enough cash to buy all the shares that Lampert and I don't own – and together we own over 60% of the company.

It was a real win-win situation, in that I believe it was a temporary condition, but he configured the company for adversity. If you count how much cash he generated in the last few years you will see it. Sometimes it is a little hidden, for example because he had to fill a gap in a pension fund liability because the market turned south and the rules required him to put more money in. He's also paid off a nice chunk of debt. The company does not have a lot of debt. He has bought back a ton of shares.

If you add up all the money used to do that, it's a significant amount of free cash.

Now, some people have argued that he is starving the company. If you look at the revenue of the company, however, it doesn't look like the company is starving.

Is the value in Leucadia National affected by the tightness in the credit market? Do they have access to capital at attractive rates, and if so why have they not been more active?

Yes, they have been affected by tightness in the credit markets, but they have access to lots of money. With the right idea they have no issues with access to capital. We would loan money to Leucadia. In this environment, it may not be a lack of ideas; it may be an unwillingness to share. Clearly this environment killed cheap money. Could they still get money on reasonable terms? Absolutely.

You have to have a little blind faith with Leucadia, like with Berkshire Hathaway. You can't predict what they will do. You measure what they have versus what you have to pay for it, and make a determination as to whether you will get the future for free. Of course, you have to assume the future is going to be good.

Fairholme owns a little less than a quarter of AmeriCredit common stock a sizable amount of their debt. You have done quite well with it, congratulations. Now that the stock trades close to book value, where is the margin of safety?

The margin of safety is that the company is just coming out of a horrendous environment and there still remains a lack of liquidity for people with less-than-stellar credit to buy cars. Because of how badly the environment has been decimated, they have a couple of really bright years ahead of them. When during a difficult period you have to lower your business by 80% or 90%, bad loans run off and new loans are fabulous.

It's what I call the pig in the python. You are digesting a large amount of bad loans while starting to ingest very good loans. Now this company faces a period of growth, and they are very good at what they do.

It was the closing of the securitization markets that killed them – a low probability, high severity event. The one negative is that they are subject to the kindness of strangers – bankers. That's where we came in. We helped them out, and our shareholders received a very good return, in terms of the securitization we did, the corporate bonds we bought, the stock we bought, all of which gave AmeriCredit the ability to stay the course of restructuring in this very tough environment.

Now they are coming out the other side – lean and mean. Good business is coming in. All they need now is to make sure they have enough capital to grow the business. It's a very cyclical business, but they just came out of at least two very difficult years. Now, given how few organizations remain and how few want to be in the industry, they are in a good place.

It's a tough business, in that you have to know when to grow and when to stop growing. It's not easy to know when to stop growing. It's usually when you have the highest level of testosterone. You have to look in the mirror and say "stop." They are good managers. I was on the Board for a while and now I am not. They made a lot of money for our shareholders. I like them a lot and our ride is not over.

We interviewed Bruce Greenwald, the Director of the Heilbrunn Center for Graham & Dodd Investing at Columbia University in November. He was less than impressed with Berkshire Hathaway's decision to buy the balance of Burlington Northern they do not already own. You own a good deal of Berkshire Hathaway, what is the value investor's case for using Berkshire Hathaway stock to buy this company?

Last year I sold all my Berkshire and then I bought back what we now own. Last year I said that you have to take Warren Buffett at his word that he will do a couple of points better than the S&P going forward. And he did. That's not bad at all. But I believe that we are still of the size where we could do a bit better. But that is absent some type of cataclysmic event – and then we faced this cataclysmic event, which allowed Berkshire to put tens of billions of money that was earning less than 1% to work, to earn 10%.

I can't see how Burlington Northern was a great deal. The greatness of Berkshire is its deployment of float and profit. They are deploying other people's money in terms of float - premiums on insurance policies that don't have to be paid out for years and years. If you are going to use part of that float to pay for an investment, you have to make sure the investment is going to make good money. With Burlington Northern, if you adjust for a buyer with cash and don't think much more about it, then it was not a great deal. But if you bought it using cheap debt and good chunk of other people's money and you were highly confident that the company would give you a cost-plus return over a decade, then it's a good investment.

Borrowing money is a sure way to die. But if you are buying toll booths and roads and regulated industries – pipelines or railroads or electric utilities, where you know you are going to end up with some type of cost-plus pricing – you are going to do very well, given that the actual equity you have in it is low.

It's like buying a house with a low down payment. If you judge the return after expenses, after taxes, and on the profits on shareholder equity, the return can be two to three times what it looks like to an all-cash buyer.

Aren't we taught to divorce the financing of an investment decision from its economics, and to evaluate the investment on its own merits?

In most cases you should, especially if the financing is uncertain or can be taken away. Buying a business that can only succeed on leverage is not good idea unless it reaches an illogical extreme low price point. You could potentially knock AmeriCredit and most every other financial institution for being dependent on their financing.

Take away the leverage, and Burlington Northern is an okay investment. The economics of railroads over trucking are great, especially given what could happen in the Far East. I don't know if it's a brilliant investment on its own, but if you can guarantee or figure out a way to fund a huge chunk of the investment at a near-zero interest rate and you are highly confident that the terms and conditions will last for a very long period of time, at least through the repayment of that debt with the cash flows of the company, then you have a heck of an investment.

Berkshire has really figured out how to behave with large insurance exposures that could potentially pay out billions from catastrophic events. There is a huge benefit to having so many non-insurance operating businesses affiliated with their insurance businesses, especially large utilities and railroads, where you are highly confident that you are not going to take a big hit. You can't have a bunch of operating businesses that could potentially lose much and also face a Katrina or a Wilma. That's where you have brilliance.

I believe that Pfizer is now your largest position. Pfizer earns about half of its revenue from non-US markets. How dependent is this investment on the future of US health care versus your desire to be globally diversified? Do you see this as a stock you could hold forever?

The last decade has taught investors in public equities that forever is an awfully long time. At some price any investment is a sale, unless you are Berkshire with a big neon sign that says "I love businesses and keep them forever."

At some price, a great business becomes a speculation.

The healthcare industry has been hurt badly by the new administration causing tremendous fear and uncertainty. It's not just about investors not going there. It's about a fear to reinvest because of an uncertain playing field. There is always some uncertainty, but it was overdone. The US government is only capable of writing checks. They do not have the infrastructure or ability to take anything over. That was pretty obvious. And there are already good public options in Medicare and Medicaid, making the fears overblown.

Healthcare is vital. I am getting older. We have a population that wants to live to 100 and tap dance every day to the end. That costs a lot of money.

The people who administer our country aren't stupid, but they can't figure out how to get it done. For example, you are not going to have a big success rate replacing a hip if the patient is obese. If you have someone smoking two packs a day odds are they are going to get lung cancer at some point, and in the last year of their lives those costs are going to be crippling.

You can't lower costs when every doctor knows that every bad result is a lottery ticket to the recipient of that bad result, because there hasn't been tort reform. Everyone knows that nobody is 100% perfect. Sometimes you are unlucky. But every doctor has to order every test and do everything possible and behave as if they are going to be sued. That builds tremendous redundancy into the network.

Then of course, you have crazy rules that bring huge friction into the system. For example, the government pays much more for hospital beds than private enterprises.

At the end of the day, if every citizen ended up with the health care policies of our legislators, we would be very happy and we would really be broke.

Union members who have fabulous benefits and are not going to pay Cadillac taxes – these are the people who helped elect the administration. Every person who receives health care is a voter. The 65-and-over crowd is very smart and they understand what a public plan would have meant – it would be a lack of choice.

Once tort reform wasn't touched it was over. It was not that long ago when the government tried to privatize Medicare – that is how Medicare Advantage came along. They understood that they can't just write checks; you need a gatekeeper to try to help people make decisions.

One of the big positions you have added in the last year is Hertz. I have read that you bought shares when it was priced as if it might go out of

business. How strong is the margin of safety in this company, particularly in light of concerns about tightening of travel budgets amid a depressed economy and renewed fears of terrorism?

People will probably drive more and take planes less.

The new management at Hertz is doing a good job at being more efficient. The business is picking up.

Much of the bargain that we received was not based on the company doing wildly better. It was based on the price we paid, which was based on the company in their then-current state of business. We are just coming out of the malaise. There is plenty of time.

There is Mom, apple pie, and some really great brands. One of them is Hertz. We paid a good price and people didn't understand that all Hertz had to do was stop growing and shrink during the recession. That was all it had to do to survive.

Do you add or recommend any layers of analysis when looking at companies' cash flows in light of potential inflation or deflation, aside from the hardiness or sustainability of those cash flows? Have you tilted your portfolio based on a forecast likelihood of either scenario?

Inflation takes its toll at the end of the day. You have to take into account the rising costs of goods and services. The best protection against the possibility of high inflation is to be in good businesses that generate lots of free cash flow and can reinvest that cash at higher rates or can increase pricing or own assets that are very sensitive to inflation, such as St. Joe.

St. Joe owns hundreds of thousands of acres of some of the most beautiful land I have ever seen in the US, including 140 miles of frontage on the Gulf of Mexico and 70 miles of land that touches inland waterways. The "Redneck Riviera" or "L.A." [lower Alabama] is unknown because it was very difficult to get to. The new international airport opening this May opens the Panhandle to the US. It's the last large parcel of land in the great income tax-free state of Florida.

The nice thing about land, is that it appreciates as opposed to a house, which depreciates.

Recognizing that you don't make macro forecasts, what key macro thinking leaks into your analyses at Fairholme?

What happens if a small nuclear device goes off in a city? Or what happens under extreme conditions of inflation? The idea is to think of the worst and hope for the best. That is why we hold, on average, significant cash. Cash becomes extremely valuable under extreme adversity.

With approximately $11 billion in assets under management in your equity fund, do you expect to earn similar returns as in the past? Is there a chance you would close the fund to new investors to stop the fund from getting too large?

Size has helped to date and when it doesn't we will close the fund. I'm going to pride myself by seeing this first. But I know we have great shareholders and, if I don't see this, I know they will.

Cash has been helpful and size has allowed us to buy in scale. Of course, it has hurt in smaller investments. It takes longer to deploy. In a difficult environment, that is fine. In a very good environment, size hurts.

The big issue is not going to be whether or not we have inflows. It is our success. If we continue to perform, $11 billion will become $22, and $22 will become $44 without any inflows. That's a bigger issue than closing the fund.

Closing the fund is a very high class issue. Keeping my feet in the shoes of shareholders, I hope to make the right decision when the time comes.

My last question is an unusual one: Since you are obviously in a very competitive business, why do you do interviews with people like me?

We have no marketing. Our shareholders are wired for wealth creation. They are well-informed by using channels such as yours. Whatever I say here becomes public. It's a great way to communicate with existing shareholders.

I can make points to you that I would be uncomfortable making to shareholders, because what you do is in the public domain. We don't talk to that many people. You are an extremely efficient channel for our existing shareholders. It's not cheap to reach 80,000 readers.

It's also important for Fairholme to attract the right shareholders. For example, if someone called me up for the five-minute timing digest, we are not going to have a chat. The same would be true with the technical analysis channel.

If I can communicate with our shareholders and with other great potential shareholders, then it is very effective, because there is a natural ebb and flow. People leave us during difficult times. We want to keep in touch with our shareholders and keep a high-quality shareholder base.

This is why we charge a flat 1% fee with no loads and have never used a 12(b)1 fee and actually abolished the ability for us to use such a fee.

Last year, there were outstanding managers who had significant amounts of capital withdrawn, who were unable to execute their strategies. Fairholme did not have significant net outflows. It's hard for me to remember if we had even a month of net outflows. That is a huge weapon and a big advantage – having the right shareholders who will stick with us while others are running for shelter. Without that we couldn't execute.

I have to find ways to talk to smart people who can present our concepts to the kinds of people we would like to have as shareholders. That's why we do it. I'm not giving anything away. I would never talk to you about what I am going to do today, what we plan for the future or what is not in our public reports.

The real service is for our shareholders, to let them know who we are, how we behave, how we maintain our level of integrity, how we perform during difficult times and whether we eat our own cooking. That is what's important. Now that we've finished our tenth year, it's good that people can look back and see what we had to say every six months and how we behaved during very difficult periods. They can stress test us.

At the end of the day, however, I know talk is cheap. You'll know in three to five years whether I had anything interesting to say today.