WINTER 2009

Graham & Doddsville

THE INVESTMENT NEWSLETTER OF COLUMBIA BUSINESS SCHOOL

Heilbrunn Center for Graham & Dodd INVESTING

THE INVESTOR'S DILEMMA

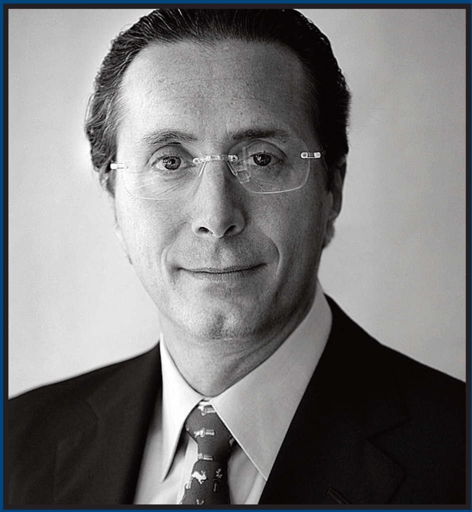
IF NOT NOW... THEN WHEN?

WHAT WOULD WARREN DO?

THAT IS THE QUESTION

FOR FAIRHOLME'S BULLISH BRUCE BERKOWITZ, THE RIGHT TIME TO INVEST IS ALWAYS

By Charles Murphy & David Silverman



Mr. Berkowitz, you've said that you manage the portfolio as if shareholders have 100% of their money in your fund, which is unique in a world in which professional investors increasingly aim for specific style boxes. How did you develop and refine the approach to investing you employ at Fairholme Capital?

BB: Well, there are many elements. If you are going to manage other people's money and do it well, you have to put yourself on the same level, the same playing field as your investors. The only way to do that is by being one of your own investors. In order to make as few mistakes as possible, I assume that investors have entrusted me with all of their money, and then I try to understand the implications of that. Essentially, it means we can't lose. The only way to fully understand that is for me to put as much of my own money as I possibly can in the fund. So, we are trying to create level playing fields. I am constantly trying to put myself in the shoes of our shareholders and our investors. So, "*don't lose*" is always going to be rule number one because no one wants go back and start again. And again, that is easy to say and easy to think about, but until you put yourself in the situation where if you did lose, you would have to start all over again, then you can't fully comprehend it.

G&D: At the Graham & Dodd Symposium this fall, you talked about working as a bookie growing up. Of course, a lot of other great value investors have had early experiences that involved gambling. For instance,

The Heilbrunn Center for Graham and Dodd Investing and the Columbia Investment Management Association are proud to present the fifth edition of the *Graham & Doddsville* newsletter.

With the tumult in the financial markets and economy at large, we at ***G&D*** have found ourselves more excited than ever to report on the theory and practice of Value Investing – which we believe to be more relevant than ever.

FEATURED ASSET MANAGER:
BRUCE R. BERKOWITZ
THE $6 BILLION FAIRHOLME FUND

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

Columbia Business School

Warren Buffet handicapped horses as a kid. How do you think those skills relate to value investing and how did "making a book" shape your evolution as an investor?

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

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

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

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

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

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

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

THE MANAGEMENT FACTOR IS IMPORTANT, BUT THE ABILITY OF A COMPANY TO INTRINSICALLY GENERATE CASH IS PROBABLY MORE IMPORTANT.

BB: The management factor is important, but the ability of a company to intrinsically generate cash is probably more important. It is always nice to own a company that your idiot relative could run. Great managers have failed at lousy businesses, so really the nature of the business and its ability to generate reasonable amounts of free cash flow—even in stressful environments—in relationship to the price that you paid is the most important factor. Bad management or a bad person can really screw up a good company so the management factor has become more and more a part of how to kill a business. Once you ascertain the free cash flow of a company, one of the ways that you can try to kill a business is through poor capital allocation.

More and more I think it is going to be important to study the paper trail of existing management. You have to understand how a manager behaves and how that manager has behaved in past situations. In general, you have to understand the history of that person's behavior to get an idea of what the future is going to look like. While very smart people and good managers don't all of a sudden get bad, it is possible. I think the **Madoff** affair shows that. I am stunned by the people who seem to have fallen into some kind of trap, which I just never would have expected. It also shows that one bad thirty-second decision could possibly destroy a lifetime's worth of work.

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

...WE NEVER MADE VERY GOOD MONEY TRYING TO PREDICT THE FUTURE... THEREFORE WE TEND TO REACT IN RESPONSE TO THE ENVIRONMENT

G&D: You mentioned on a public shareholder conference call last fall that you hadn't actually spoken with [**Sears** Chairman] **Eddie Lampert** before making your investment in Sears. Is it fair to say that you were able to assess Eddie Lampert's background from what he had done in previous stressful situations?

BB: Yes, we examined his career – how he behaved, his performance, and what kind of person he is. Is his hero in fact **Warren Buffett**? Does he take to heart the tenets of **Buffett, Benjamin Graham, Phil Fisher**, and **Charlie Munger**? That helps us think about how he is going to behave in the future. The man is not as smart and he's not the messiah that he was made out to be at one point, but he's definitely a very sharp guy. And he's nowhere near as bad as he is being portrayed right now. All of a sudden, people think that he is over the hill—in the same way, people once thought that Buffett was over the hill.

G&D: In your earlier comments, you referenced this idea of "killing the company"—figuring out what it would take to destroy or impair a company's ability to generate cash flow. How do you go about killing a company you are considering investing in? I guess each case might be different, but maybe you could walk us through an example with the HMOs and how you thought about killing those businesses.

BB: To kill the HMOs, you just have to answer the following question: Who would do what they're doing if they weren't doing it?" The big issue with HMOs is a radical restructuring of the healthcare system and whether or not someone else can do what they are doing, or whether they can be forced to do it at much lower prices. By studying the industry and the participants, you can come to the conclusion that the only thing the government can do is cut a check. And every time they've tried to run a healthcare system by cutting checks, such as with Medicare, the costs just escalate.

The HMOs have become gatekeepers and they do it for reasonable prices. There is no other organization or other industry that we believe is a competitive threat, and there are no other people that have the scale or skills by which to carry forth the future healthcare system, whether it is universal health or corporate healthcare policies.

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

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

BB: I think killing a business *is* the research process.

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

Then it goes into a more macro environment. What happens if a small, dirty nuclear bomb goes off in the New York port? You go through crazy, man-made and natural catastrophes such as going into a deep recession. And then, after asking all the questions and testing your thesis that a company will be able to maintain a set level of cash flow, you get to more and more questions about a company and an industry and an environment. You just keep going. The process is continuous.

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

What better time is there? If not now, *when*? Was it a better time to invest three years ago? Six years ago? *And the answer is No.*

BB: We've gone further than that now. We no longer think about a normal environment, we think about an abnormal environment. We focus on a difficult and continuing environment where credit markets are still rigid. They're just not working. If the current difficulties keep going for another year or two years or more, I want to understand whether or not a company can survive. Just look at what is going on with the banks and the brokers. For years, we could not understand what they owned and what they owed. It was nearly impossible for the insurance companies or any financial institution that had a large or not-so-large derivatives book. Today it's not even clear to me who owns them. I can't tell you who owns **Citigroup**. My default answer would be that the government owns Citigroup. It is pretty obvious with the auto companies that some combination of bondholders and retirees have owned the big three auto companies for quite a long time, so the stock prices of **GM** and **Ford** never made sense to me. It just seemed to be a fallacy. And we are going that way now with our large banks.

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

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

It has always paid to be very greedy when everybody else is quite fearful of the environment, because that fear factor is priced in.

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

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

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

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

BB: Yes. The news is focused on the top dozen financial institutions, but there are good companies out there. If you can actually read their reports to the SEC and they make sense to you, that's great. When you read the report of **AIG** half a dozen years ago, the section on derivatives was one paragraph. How could you know? And today it is page upon page upon page and you still don't know. How do you know the ultimate counterparty? So that is a form of killing a business. You end up saying, "I can't figure this out. It's too tough. Move on."

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

BB: Oh, I think you've got it right. Yeah, I think you pretty much have it exactly right. Wall Street was the biggest casino, and it just doesn't make sense for so many people to be doing what they were doing. It had to end. What happens is that the worst possible results usually happen when you take a good idea to some kind of illogical extreme. It is a crazy idea that you can take a whole bunch of crap and chop it, dice it, mix it, shake it up and then paste it back together again and all of a sudden it gets a AAA rating. It is the same idea with off-balance sheet financing. Even if you could do it, if you had an off- balance sheet company blow up, you've lost your reputation. Reputation is critical even if it's not part of the Q's and K's of a company.*

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

BB: We are driving less and we need more healthcare as we get older, so we have made a significant move away from oil and gas to healthcare companies such as pharmaceuticals or the HMOs. Our largest position today is **Pfizer** which we think we have a better handle on than most. It has a AAA-rated balance sheet, a 7%-plus dividend yield, trading at seven to eight times free cash flow, and generating about $17 billion in free cash, which works out to be $2 to $2.50 per share of free cash flow. The stock is trading below $20 per share. **Pfizer** has a great new CEO that everyone hates because he's not going out there and acquiring a whole bunch of competitors at stupid prices. The company is learning that it doesn't have to be fat to be happy, and there is tremendous cost-cutting going on. The company has the largest global distribution capabilities in the industry and realizes that everything doesn't have to be created at the company, but that it has the distribution, the cash, and the know-how to be a great partner with any other pharmaceutical company—especially in phase three drugs.

It faces **Lipitor** going off patent in a couple of years, and everyone's perception is that it is going to kill them. What no one realizes yet is that **Pfizer** is the sixth or seventh largest generic drug manufacturer now. It most likely will continue to increase sales of generics that everyone is worried about. It is interesting that people will spend more time thinking about the kind of chocolate they eat than the kind of medicine they're swallowing. People just blindly accept chemical compounds without realizing that generics are not exactly the real deal. They may be as effective, but then again they may not be as effective. The big pharmaceutical companies have historically just given that business away, but they're not giving it away anymore. There is nothing wrong with the profit margins of mature products, so you are going to see big pharma move more and more toward mature products and think about competing in that space.

So we like the company, we like the strategy, we like the paper trail of the chief executive, and we love the amount of free cash flow the company is generating. The only reason that it has such a high free cash flow yield is because the price of the stock has fallen off a cliff. Many of the companies that are very interesting right now are interesting because their price has

* Companies issue SEC-mandated *10-Q* and *10-K* filings that summarize quarterly earnings and material changes that will impact operations and profitability.

declined in relationship to their earnings. **Pfizer** was a company that a decade ago people were willing to buy at 40 times or 50 times earnings, and today it is trading at seven to eight times earnings. This is a level that I can't find the last time that the company ever traded at. So again it goes back to the old days as a bookmaker or at the corner grocery shop I grew up in, watching the register and the money go in and out. I learned a lot about the perverse psychology of the human condition. It all adds up to what Munger calls these lollapalooza effects that exist today.

Pfizer was a company that a decade ago people were willing to buy at 40 times or 50 times earnings, and today it is trading at seven to eight times earnings.

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

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

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

BB: It germinated based on our role-playing activities regarding how we could lose money. The idea that we buy a company cheap doesn't mean that we'll live to see it do really well if companies are taken over, and taken over cheaply as has happened in the past. So we started to look at the credit structures and the bonds of companies that had covenants that insisted upon paying them in full upon change of control. From there we started to look at all of the covenants and indentures such as cross defaults, rankings and repayments during defaults.

There are a lot of bonds out there yielding 20% to 30% that had to be as good as the equity—maybe even better—given that you had to see something improve in that credit structure before you would start to see the equity of that company improve. If your bond is yielding 30%, the market thinks there is a real risk that you're not going to make it. However, if the bonds start to improve and the yields go down dramatically it would be an indication that the equity structure is stronger than most thought. So by marrying the two together, we thought that each part made the package stronger.

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

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

G&D: Regarding short-selling, in the past you have said that you have no problem with shorts. In fact, you've pointed out that shorts are sometimes beneficial because they may create opportunities for you to buy stocks cheaper. But you don't do any shorting yourself. Why not?

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

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

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

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

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

Also, in the early 1990's I was a big investor in **Wells Fargo** when it was being shorted heavily and considered by many to be a bankrupt bank because of the huge reserves they were taking on in their real estate portfolio. But the bottom line was that the reserves were being forced by the government agencies because of all of the disasters that they were facing taking over banks. Their so-called bad assets for which they had to reserve billions and billions of dollars were also generating a 5%-plus cash return on cash. I don't know how you can call that a bad asset. And our insight from trying to kill **Wells Fargo** was enough to make a very big investment in Wells Fargo.

The lesson of the past few months is that cheap has become cheaper. Never before have I sold so much of that which is cheap to buy that which is cheaper.

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

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

The lesson of the past few months is that cheap has become cheaper. Never before have I sold so much of that which is cheap to buy that which is cheaper. You can do it in large caps, but it is difficult when the trading in a security trickles toward zero.

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

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

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

BB: We restructured the fund somewhat in the past year. We've redone our foundation documents such that we have a lot of flexibility. We have as much flexibility as you can have under the 1940 Investment Company Act, and I believe that the fund can do much of what a partnership can do. It is done in a more regulated fashion, which I think is good for my shareholders. And I don't have a problem that we charge a flat 1% fee. With the scale that we have now, we have the ability to pay, achieve, hire, and do whatever we need to do.

I think that the fact that we are a mutual fund with a low fee structure also attracts a certain type of shareholder. We've tried very hard to attract the right shareholders that understand our philosophy, our strategy and the long term nature of our investments. Investing is not that much different than business. I have been extremely humbled and impressed by our shareholder base. Our shareholders have really stuck with us. If we had a gigantic partnership structure at one-and-twenty, I don't know if that would be the case. We have engineered **Fairholme** such that I would be happy if I were the client. As a client, I like the concept of a 1% flat fee. I like the transparency of the fund. I like the public reporting and auditing. I like the safety and the separate custodianship and independent appraisal. Mutual funds have a system of checks and balances that I feel very comfortable with.

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

BB: I don't know. At the end of the day the fees should not matter. What should matter is the after-fee, after-tax return of the fund, and with an assessment of how that return was generated. If it was generated through a mediocre return leveraged up, then you have a problem. Very smart, talented people deserve to make a lot of money. Mediocre people shouldn't be making anywhere near the money that they are making. I don't know where this issue will go, but I know that I personally think that lower fees make a lot of sense. It takes away a lot of the perverse psychology. A one-and-twenty structure* allows someone to go for the gusto, knowing that you only need a couple of years of great success to achieve the same as a decade of hard work. That can cause some serious problems. But once again, the idea isn't bad—it has just been taken to an illogical extreme. I think that a lower fee structure without leverage—and an investment process that is fairly simple—is probably a better way to go through life.

G&D: You are considered to be a contrarian investor. Other contrarian investors prefer to stay under the radar, but you have committed yourself to continued

* 1% management fee and 20% performance incentive

media interviews and public calls with your shareholders. How do you think about communicating with the public and with your shareholders?

BB: The balance is between not hurting the performance of the fund due to taking up one's time doing interviews on one side and effectively communicating with our 200,000 shareholders on the other side.

You can speak openly in a public forum in a way that you cannot openly speak one-on-one. For example, that which I say in a webcast becomes public. That which I say to an individual investor may not become public. If I want to tell our shareholders how I feel and where we're going, it is best for me to do that in a public format. It is done to keep our shareholders informed in this environment. The big danger for a shareholder in our fund is that other shareholders sell at the worst possible time. I don't know how you can talk to 200,000 shareholders and give them your views and let them ask questions and give them answers. I try to accumulate the toughest questions I can find and even come up with some of my own, and then go through them on public conference calls. At the same time, I don't think I'm giving away the candy store talking to them. I could talk to you about **Pfizer** until I am blue in the face. But in this environment, there is not much you can do about it. It is not as if I have a strong desire to invest much more of the fund's money in these names due to concentration rules.

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

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

BB: The point I made is that, if this isn't the time to more aggressively buy public equities in recent years, then I think that is correct. I have always suffered from what I call premature accumulation, because that is just part and parcel of not having a crystal ball and the fact that cheap can become cheaper. If you don't step up to the plate when you can find high quality companies at mid-to-high single digit multiples, then when are you going to do it? If performance suffers from mistakes, then I don't deserve to be in business. I'll be the first one to pull the plug.

If you don't step up to the plate when you can find high quality companies at mid-to-high single digit multiples, *then when are you going to do it?*

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

BB: I don't judge. I'll talk about sins, but I won't talk about sinners. I must admit that I have enough of my own mistakes to focus on than to look at others so I can't comment. Let me put it in the words of **Buffett**;[*] I know that I was swimming partially naked last year with a lot of other great people, but that is no excuse. We don't want to be naked. You can't control the

[*] *"It's only when the tide goes out that you learn who's been swimming naked."*
Warren Buffett

mania of the markets. The trick is to not let the mania negatively influence you. The markets are made to be taken advantage of, not to be persuaded by. That is **Ben Graham's** *Mr. Market*. The market in the short term is a voting machine and* in the long term it is a weighing machine. The voting is quite pessimistic right now and it should** be something to take advantage of. If I have dramatically misjudged the free cash flows of companies or the safety of their balance sheets and businesses, then I shouldn't be in business. Over the long term, your performance record will tell you that. We have great shareholders and smart shareholders and I am not going to be the only one to come to that conclusion. It is harsh to judge yourself that way, but that is the way it should be. In the long term if you're not good at what you do, then you're not doing anyone a favor, including yourself.

The market in the short term is a voting machine and in the long term it is a weighing machine.**

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

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

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

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

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

G&D: Thank you, Mr. Berkowitz.

grahamanddodd.com

* Graham's favorite allegory is that of *Mr. Market*, an obliging fellow who turns up every day at the shareholder's door offering to buy or sell his shares at a different price, which the shareholder may accept or reject.

** *"...the market is not a weighing machine, on which the value of each issue is recorded by an exact and an impersonal mechanism, in accordance with its specific qualities. Rather should we say the market is a voting machine, whereon countless individuals register choices which are partly of reason and partly of emotion."*
Graham & Dodd, *Security Analysis.*

*** Mr. Berkowitz has been happily married for over 25 years.