Bruce Berkowitz Stays In The Sunshine

Joshua Lipton 08.14.08, 6:45 PM ET

Bruce Berkowitz must be disappointed that the current Olympic Games program doesn't include professional money management in the competition. If it did, the veteran stock picker's neck would be weighted down with gold right now.

Berkowitz is CEO of Fairholme Capital Management in Miami, which oversees about $9 billion, most of it in the value-oriented no-load Fairholme Fund (FAIRX), of which Berkowitz himself is lead manager.

In Pictures: Bruce Berkowitz's Top 10

The 50-year-old Berkowitz started Fairholme Fund in December 1999, and he's consistently crushed the competition. The five-star, large-blend fund has clinched the No. 1 spot in its Morningstar category for the one, three and five-year periods. Through Aug. 12, Fairholme's five-year annualized return of 16.51% bests its peers by 7.54 percentage points.

Forbes.com recently checked in with Berkowitz to talk about his take on the market, his strategy and his top stock picks.

Forbes.com: This has been an obviously volatile, frustrating market for investors. How do you see the market behaving for the rest of 2008 and into 2009?

Berkowitz: There are two ways you can invest: You can try to predict or you can react. We react. We look for stressed situations and buy if appropriate.

I hope that the market stays weak and tough and that it doesn't go up much. In the last eight years the market has done nothing, and we are up 300%. This is our kind of environment.

Some companies have been destroyed, such as Sears, which is a big position of ours. It is a huge opportunity. It is so cheap. Everyone thinks that Sears will be worthless; meanwhile, the store generates $50 billion in revenue, significant free cash flow and has tremendous assets. So the fear, or the prediction of the death of the consumer, has allowed us to react and buy a retailer like this one.

What is your strategy for the fund? If I was to build a stock screen like Bruce Berkowitz, what would it look like?

We start with this basis: The only thing you can spend is cash. We want companies that generate significant cash in most times. That is how we start. We don't care much about what they make, but we have to understand it. The balance sheet has to be strong; we want to make sure there are no tricks in the accounting. Then we try and kill the company. We think of all the ways the company can die, whether it's stupid management or overleveraged balance sheets. If we can't figure out a way to kill the company, and its generating good cash even in difficult times, then you have the beginning of a good investment.

How important is management to you?

A bad person can cause you pain every time, no matter how good the company is. Management is important. They should have a paper trail of succeeding.

So strong cash flows, solid assets and experienced, talented managers? Warren Buffett must be proud.

Right, he learned from Benjamin Graham. And others have learned from him. It's a simple formula. And it works.

Speaking of Mr. Buffett, you halved your position in Berkshire Hathaway in the November-May period. How come?

We take Warren Buffett at his word. He says the company will do a few percentage points better than the S&P 500. Don't get me wrong: that's great and most people should be over-the-moon happy with that. But a few percentage points better than the S&P 500 did not deserve the outsized position we had in the company.

How about the age of the company's key personnel? Did that factor into your decision?

Of course.

The fund has been busy buying health care stocks, ranging from generic drug makers to health maintenance organizations. What do you like about the health care sector right now?

There are predictions about the demise of this industry, with a new president coming in. The bottom line is that we want--especially baby boomers--to live until we're 100 years old. We want a very high quality of life until the last day. The unintended consequence is that health care costs are going to skyrocket. The only chance we have to control skyrocketing health care costs, while still trying to improve services, will be through the large HMOs.

But investors might be worried about committing capital to pharmaceutical and managed care companies because we don't know who will be in the White House next year and what that change in administration will mean for these industries.

So there is a simple question: Who else will do it? Barack Obama talks about having health care like they have in Congress. Who does the health care in Congress? It's the HMOs. The government can only write a check. When all you can do is write a check, you can't control costs. So costs will go through the roof, even more so. The government needs the HMOs. Who helps the government develop the pricing that's paid for products and services? It's the HMOs. The HMOs are the system. Then look at the pharmaceutical industry, which develops these miraculous drugs.

One of your top picks is drug giant Pfizer. How come?

$17 billion of free cash, which turns out to be over $2 per share of free cash for a triple-A quality company. This is the largest pharmaceutical company in the world trading under $20 per share.

Let me make sure we all understand what I mean by free cash: It's the amount of money that is possible to pull out of the business without hurting the franchise. Ten years ago, everybody loved Pfizer. It was trading between 40 and 50 times earnings. Today, it's under 10 times earnings and nobody wants it.

How come?

Because they are all worried about Lipitor and the new president. Lipitor doesn't come off patent for another three years, and the company is dramatically changing. There is a new CEO with a wonderful strategy.

You will see Pfizer, in my opinion, do a lot more joint ventures. I think they will become almost like Exxon Mobil, which is really a merchant bank that has the distribution, size and cash to partner up with a lot of people around the world. Pfizer will do that. People just don't realize the number of joint ventures they have and the power of their distribution channel.

Also, the pharmaceutical companies in the past have been quite stodgy and lazy in not pursuing generics. They have given the generics away. I don't think we will as much now. We will see Pfizer become a larger generic manufacturer. As their drugs go off patent, you will see them compete more with the generics too.

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How about WellPoint?

They are the 800-pound gorilla. They and UnitedHealth have one-fifth of the entire insured population in the United States. That's it. They are the answer.

The problem now is that everybody is blaming everybody else: the doctors, the insurance companies, the government, the patients. Things have to change. The system needs to change more toward wellness. You should not be able to get a new pair of knees if you are 300 pounds overweight and you haven't made a valiant effort to lose weight. What's the point? You will just blow out your new knees. There has to be a huge shift. It is starting with the baby boomers as they try to keep their weight down and do some exercise. If the shift doesn't happen, then the costs are going higher and higher.

Frankly, the companies aren't making that much money. They look great now because their prices have fallen 50%.

The fund has added significant investments in housing-related industries. Let's talk about some of your holdings in this space. You favor DISH Network. What's to like here?

Again, it has a lot of free cash. We like satellite TV a lot. Mobile TV will become very big. The company has a huge subscriber base. There is good management here. The company is growing. It is slowing down now because of the recession. Maybe TV isn't as needed as Lipitor, but it's as addictive. And it's better than Marlboros. We are shifting here. I haven't used this term with anybody, but the fund is now shifting toward this theme: health, liberty and the pursuit of happiness. Maybe that's the title of my next letter to shareholders.

You also like Mohawk Industries, which manufactures flooring products.

It's run by a great guy. [The CEO is Jeff Lorberbaum]. They are well diversified between hardwood floors, tiles, carpets. They have made a good push in Europe. What is amazing is that, for a difficult period of time, Mohawk is still generating a tremendous amount of free cash. So, you have a great manager that knows how to react when times get tough. He will come out of this with a great balance sheet, still making money during this entire period, and will be stronger and better than ever.

The stock is down about 20% in the past year. One worry here is that customers will move to cheaper, lower quality products.

Does it concern me? Yes. Does it make sense that people will do that? Yes. Business is not a smooth process. It's bumpy. You have to expect these periods. The price of the stock, in my opinion, already reflects that. You know, the greatest company in the world at too high a price is nothing more than a speculation. Another company, whose prospects are looking a bit negative for the next year or two, at the right price, is a great investment.

You've avoided most banks and brokers. Not much interest in bottom fishing here?

Well, we didn't know how to. It is impossible to know what they own and who they owed. Let me give you an example: a collateralized debt obligation squared. In order to understand that one security, you would have to read hundreds of thousands of pages of documents to get at the underlying assets. These products that have been made are so complex, they are impossible to understand. I almost think they were done so you could not understand them. Then, when you are doing swaps and derivatives with counter-parties, you don't know who you are dealing with anymore. Maybe you think you are dealing with the best. But you don't know who the best has been dealing with in terms of their counter party risk. That really gets to the point of JPMorgan and Bear Stearns.

How so?

Did JPMorgan buy Bear Stearns because it was a bargain? Or did JPMorgan have to buy Bear Stearns because if Bear Stearns failed the implications to JPMorgan were catastrophic? I don't know the answer.

Or look at American International Group. Five years ago, you could read AIG's report on derivatives and maybe it was a paragraph. It didn't tell you anything. You just had to assume the people knew what they were doing. Today, you can read 10 pages on it and you still don't know what is going on unless you can get to the underlying collateral. It's almost impossible.

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But you do like AmeriCredit, a specialty finance company that provides credit to buyers of new and used autos.

They got caught up in the shutting down of the securitization market, which is a tough business. At the end of the day, if you are dependent on securitizations and nobody can securitize for you anymore, it can be a death blow. But with AmeriCredit, they did it the right way. They give loans to people that need cars to get to work. They do the loans based upon the income of the person, not the collateral value of the car. They do their own work as to whether or not the person can afford the car. They don't want to sell the car to someone who can't afford it, unlike a dealer that just wants to sell the car, get the commission and thank you very much. So they do the work and the management is smart.

They are still making a few pennies and have good cash coming in the door. They will be a survivor. So good management, good strategy, the class act in the industry and the stock has been crushed. We started buying.

You're not afraid of wading into some of the scarier sectors of the market. The fund carved out a stake in the St. Joe Co., the largest land owner in Florida. What do you like about this company?

Something good usually happens when you can buy a debt-free company that has 300,000 acres of land within 10 miles of the Gulf of Mexico, with hundreds of miles of land that touch the Gulf or the bay or rivers or coastal waterways.

There is an international airport being built right in the middle of St. Joe that opens up in May 2010. What is amazing is that billions of dollars of infrastructure are going in, compliments of the state of Florida. This is the last big play that is open for the migration of people from up north and from other areas. Also, there has never been an easy way to access the beaches. It was never easy to get to. This airport will make a difference. Then there will be commercial business.

There is a new CEO. He's great and gets it. Once that airport opens up, that will be the catalyst. You know, we're buying beachfront for $12,000 a square foot. The pricing is depressed, but the value of the land is quite good.

What is the area like?

It's a beautiful part of the world. People don't understand. The biodiversity is amazing. These are some of the best beaches in the United States. You want an idea of St. Joe? Look at Hilton Head before it was developed.

Last question: What does Fairholme mean?

It was the name of the last street I lived on in London. I was there for eight years, between 1981 and 1989. I was a management consultant and then helped to open up the first private client office at Lehman Brothers.

What was so meaningful about the street?

Nothing. I couldn't think of anything better. And I was hoping, when we started, that it would be the "fair home" for people's money that I know that they work very hard for. The key to us is that we try to ignore the crowd--that's our tag line. We don't pay a lot of attention to what everybody else is doing. When you ignore the crowd and go to the places that others won't, that is when you have a chance of getting a good price relative to what you're buying.

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