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Interview With Bruce Berkowitz
Chief Executive Officer, Fairholme Capital Management

Betting Big, Winning Big

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Brian Smith for *Barron's*

BRUCE BERKOWITZ, PRESIDENT OF Fairholme Fund and CEO of Fairholme Capital Management in Miami, runs concentrated portfolios—and keeps a lot of powder dry to pounce on opportunities as he looks for companies that throw off a lot of free cash. This approach has paid off nicely for the firm, which now oversees about $9 billion, the vast majority of it in the no-load **Fairholme Fund** (ticker: FAIRX), of which Berkowitz is president. Since its launch at the end of 1999, the fund has finished near the top of its Morningstar category, with an annual "since-inception" return of 16.27%, trouncing the S&P 500's performance of minus 0.03% over the same period. The fund also bests most of its peers based on one-, three- and five-year returns.

***Barron's:* You run a very concentrated portfolio, with the top 10 holdings of the Fairholme Fund accounting for roughly 70% of the assets. Why is that?**

Berkowitz: If you can buy more of your best idea, why put [the money] into your 10th-best idea or your 20th-best idea? If we're confident in what we do, then that's the way we should do it. The only reason not to is a fear of being wrong. The more positions you have, the more average you are.

How do you go about mitigating risk in such a concentrated portfolio?

We consider risk to be the chance of permanent loss, as opposed to volatility. Volatility is more of an opportunity. There's nothing better than a one-time event that allows you to buy a reasonable company at a great price. So we are looking at the chance—in terms of risk—of a permanent loss, based upon our own security research.

What kind of companies are you looking for?

You can try to predict the future or you can react to it. We are not any good at prediction. So we try to position ourselves with companies that are capable of reacting to whatever environment comes their way, because in the good times companies take care of themselves. It's only in the bad times when you want to find companies that actually plant the seeds of greatness. There is **Berkshire Hathaway** [BRK-A], there has been **Leucadia National** [(LUK], a holding company with a lot of different businesses, and similar companies. They are always playing defense, because you never know when something bad will happen.

In looking for stocks to buy, why do you put so much emphasis on free cash flow?

Because it makes the most sense to me. My first job was at a little corner grocery store, and it seemed pretty simple. Cash goes into the register; cash comes out of the register to pay for supplies, payroll and taxes—enough to maintain the business at a steady state. What was left over was the owner's earnings, or free cash flow. That was really what the business made.

Your cash position has averaged about 20%—much higher than most mutual funds'. Why?

No. 1, we don't have to sell that which is cheap [in order] to buy that which is cheaper, especially companies that we have gotten to know and love. And No. 2, where there are special situations, we can act quickly.

How about an example?

One is **WellCare Health Plans** [WCG], a managed-care company focusing on Medicare and Medicaid. Last October, some 200 federal and state agents raided its headquarters in Tampa. That's when we started to look at the company, especially because Fairholme is now based in Miami. WellCare, which serves only Medicare and Medicaid, offers its members a better service then they would get just on Medicare, something called Medicare Advantage. It saves the government and taxpayers money, so they are trying to reduce the growth of health-care costs. By using Medicare Advantage, members have a wonderful prescription plan that they didn't have with Medicare.

What else caught your eye about WellCare?

If you study the history of health-care companies or hospitals that get into trouble—and provided they have a reasonable balance sheet—it's the same scenario, usually taking place over a one-year period. Step A: After, or during, the investigation, senior executives are replaced. Step B: The institution pays some type of fine, which really ends up just being a delay of game, and

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the company moves on. Top management at WellCare has been replaced. If you look at the data, you'll see that the company continues to grow and continues to get enrollment in more and more counties in the U.S.

The stock fell off a cliff late last October, presumably after the headquarters was raided. At around 37 last week, it was fetching less than 10 times 2008 profit estimates of $5 a share. When did you start buying the shares?

We came in after it fell off the cliff, when it was trading in the 30s late last year. As for the investigation, the only thing we know was that there were 200 agents that raided their campus. But, to this day, we don't know exactly what is involved, except that these kinds of investigations usually involve billing practices. Still, it's growing nicely and its valuation is significantly less than those of a UnitedHealth Group, WellPoint or Humana. The government needs all of these companies to implement its health plans.

How did you develop this particular idea?

Sometimes, it's by accident and being in the right place at the right time. In January, Fairholme hired a new chief operating officer, Charles Fernandez, who used to work at IVAX, which was acquired by Teva Pharmaceuticals in 2006. He was the audit committee chairman and he had intimate knowledge of [health-maintenance organizations]. Then we [went] back to other situations like this, including Tenet Healthcare and Health South. Then we dug into the quality of WellCare. Based on Medicare and Medicaid data, we see the growth. And there are certain indicators you can't ignore, among them how WellCare has been building up cash. Also, the independent directors acted quickly and wisely. It was only a matter of months before they named a new executive chairman, Charles Berg, formerly the CEO of Oxford Health Plans, which he turned around and sold to UnitedHealth.

Where do you see the investigation going?

WellCare will pay a fine. I'm sure the company, like all other companies in this situation, wants to resolve the issue as fast as possible. But this company generates $5 a share of free cash flow; it's too cheap.

Let's move on to another holding.

Mohawk Industries [MHK] is a carpet, flooring and tile company that, together with Shaw/Berkshire Hathaway, is one of the two big national companies in that industry.

It looks pretty cheap, trading at roughly 12 times 2008 profit estimates.

The CEO, Jeffrey Lorberbaum, has done a wonderful job of cutting costs, making some acquisitions and growing the business. They are still doing very well in a difficult environment. The stock gets pushed down, based on the residential real- estate situation. But we still believe the company has the ability to earn about $7 of free cash flow a share this year, even in a difficult time, and into the future. They can earn much more than that if things get better, and they are expanding in Europe.

Berkowitz' Picks

Company	Ticker	Recent Price
Berkshire Hathaway	BRK/A	$131,300.00
WellCare Health Plus	WCG	37.25
Sears Holdings	SHLD	94.58
Mohawk Industries	MHK	69.91

Source: Bloomberg

Another of your holdings is Berkshire Hathaway, whose A shares [BRK-A] currently trade around $131,000.

In the past, the market has made some mistakes in valuing this company. But in general, right now the market is within an intrinsic value range of anywhere from $125,000 to $175,000 per A share.

What gets the stock higher?

Just a-little-bit-different assumptions in growth rates make a huge difference over time. Having said that, Berkshire isn't going to be able to do what it's done in the past, owing partly to the law of large numbers and because Warren Buffett is getting older.

The company still has the ability to outperform the index. But it's not going to produce the 27%-per-annum return he has achieved for the past 42 years. Buffett is the first one to tell you that's pie in the sky. But at this price, the company is unbelievably well-positioned to have one more good growth spurt from this environment. You can sleep extremely well at night holding this stock.

Sometimes a good bit of the trick to investing is not losing. If you can focus on not losing, the winning takes care of itself. For Berkshire Hathaway, the worse the environment gets, the better it's going to do.

Because of what?

Buffett wants a tougher environment. When you have $40 billion to $60 billion in cash on your balance sheet, you need a tough environment, as that's the only way you are going to be able to put that money to work. Berkshire isn't what I would call a back-up-the- truck bargain value, but it's reasonably priced.

Tell us quickly about St. Joe [JOE], which is based in your neck of the woods.

A major real-estate developer and forestry operation, they have over 700,000 acres in the panhandle of Florida, most of it within a reasonable ride to the Gulf of Mexico. Living here in Miami, you start to understand the state and its business climate, partly by reading the state's master plan of development. And you will see that an international airport is being built now, right in the middle of St. Joe's land. And even though St. Joe has made some mistakes in the past, specifically trying to do too many things, they have at least made the wise choice of raising some equity [by issuing more stock] so that they are pretty much debt-free.

The stock's now around 40, down from the mid-80s in 2005.

Under the right management, this is a very, very valuable company, but it is tough to see because of the long-term nature of the product and the lack of understanding that people outside the panhandle have of the panhandle. But we are talking about what everybody wants: oceans, rivers, lakes, sand and a nice climate.

Let's talk about a few stocks that haven't worked out. Would you put Sears Holdings [SHLD] in that category?

It's too soon to tell. I think Sears is going to work out. Some of our greatest victories have come from very difficult beginnings, and they have allowed us to buy more of what we like at lower prices.

At 94 and change recently, the stock was down about 50% from its peak nearly a year ago. What gives you confidence in Eddie Lampert, the hedge-fund manager who took over Sears in 2005 and serves as the retailer's chairman? They just went through another top-management shakeup recently.

Look at Lampert's overall performance. He has done a good job with retail holdings in the past, and he understands Sears' assets. We've looked at a lot of the tax assessments and location maps on many of their properties, which have a lot of value and provide downside protection. We're in the middle of a very difficult environment, so Sears is being priced for a very, very difficult outcome. Meanwhile, it's making money, and has significant assets, so I'm not concerned. We've had a position since September. One error for us was Household International, a credit-card finance company that HSBC acquired in 2003.

What did you take away from that?

You have to be very, very careful about investing in companies that are captive to the capital markets. We saw the same situation recently with **Thornburg Mortgage** [TMA] and others. The capital markets decide to call in their loans and these companies don't have good long-term financing–it doesn't matter how good they are. Well, they aren't that good because they didn't take care of the balance sheet. If your short-term financing is pulled, you're dead.

That's for sure. Thanks, Bruce. ■