Hunting for bargain-bin value stocks

Fairholme Fund manager Bruce Berkowitz is going on the offensive and buying up value stocks that he says are ready to bounce back.

By Mina Kimes, writer-reporter
Last Updated: September 29, 2009: 12:50 PM ET

NEW YORK (Fortune) -- **Fairholme Fund: (FAIRX)**
Manager: Bruce Berkowitz
Return since 12/01/08: 53%

When Fortune spoke with Bruce Berkowitz last December, Fairholme's manager was salivating over the bargains he saw in the market.

The manager used his sizable cash stake to go value hunting, and Fairholme, which has $10 billion in assets, has returned a hefty 28% on the fund so far this year, compared with the S&P 500's (SPX) 18%.

Berkowitz, whose fund has beaten the index by nearly 15 points a year since its 1999 inception, attributes this year's gains to well-timed investments in beaten-down financial stocks like American Express (AXP, Fortune 500) and AmeriCredit (ACF).

"We look for stress in the system, then count the company's cash and try to determine whether or not they'll perform well in the future," he says.

Fairholme's holdings speak to that forward-looking approach: Analysts expect the average stock in the fund to grow profits by 10.8% annually over the next 5-7 years, compared with the S&P's 9.7% projected long-term growth rate.

Over the last year, Berkowitz has "completely remade his portfolio," says Dan Culloton, an analyst at Morningstar. After reaping large gains from his energy stocks, the manager shifted assets to the stable health care and defense sectors.

Berkowitz has begun trimming his sizable health care position this year, but he still favors the sector, which composes 41% of the portfolio. His top holding, which makes up 14% of his fund, is Pfizer (PFE, Fortune 500).

"Health care stocks were good investments, and they still are good investments, because their prices have fallen so low," he says. "They're nowhere near where they used to be."

Berkowitz admits that political reform and uncertainty over drugmakers' pipelines are holding health care stocks back, but he thinks macro trends will work in their favor. "Given an aging population and what's going on around the world, those sectors aren't going to disappear," he says. He points out that defense and health care compose two of the largest components of the federal budget.

Over the last few months, Berkowitz says he's "shifted to a more offensive posture." He has amped up Fairholme's position in rental car company Hertz (HTZ, Fortune 500), which he calls "the canary in the economic coal mine," and bought shares of brokerage firm Jefferies (JEF). "They're the largest independent non-bank brokerage now," he says. "They're well run, and I like the CEO."

Another big purchase: "It's not obvious, but we've been buying Berkshire back," he says.

Berkowitz ditched his shares of Warren Buffett's Berkshire Hathaway (BRK.A) last year when he felt the insurer had grown too big to generate significantly higher returns than the S&P 500. He waited for a "cathartic event" to reinvest in the stock, believing that the Oracle of Omaha would take advantage of any market disruption.

That event occurred this spring when stocks hit rock bottom. "With the cracks in the market, if he has the cash, he can put it to work," Berkowitz says. Sounds like the Fairholme manager's own strategy.

--Over the course of this week, we're checking in on five funds we recommended last December: Osterweis, Fairholme, Vanguard Primecap Core, Third Avenue Value, and Longleaf Partners. All five are beating the market by big margins. ■

First Published: September 29, 2009: 11:05 AM ET