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Outstanding Investor Digest

WITH THE COMPLIMENTS OF:
FAIRHOLME CAPITAL MANAGEMENT
(305) 358-3000

PERSPECTIVES AND ACTIVITIES OF THE NATION'S MOST SUCCESSFUL MONEY MANAGERS.

Volume XXII Numbers 1 & 2 March 17, 2009

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BAUPOST GROUP'S SETH KLARMAN
"IT'S A GREAT TIME TO BE A VALUE INVESTOR. THE COMPETITION SEEMS TO HAVE GONE AWAY."

Re-reading Seth Klarman's annual letter from a year ago, it's remarkable just how many of his warnings turned out to be tomorrow's headlines. Among those warnings were that the subprime mortgage debacle and housing contraction were likely to be "the first failure in a broader reckoning," that increased risk aversion would lead to tighter lending

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FAIRHOLME FUND'S BRUCE BERKOWITZ & CHARLIE FERNANDEZ
"I THINK ALMOST OUR ENTIRE PORTFOLIO IS SELLING AT A BACK-UP-THE-TRUCK PRICE."

Bruce Berkowitz knocked the cover off the ball for his clients return-wise while he was with Lehman Brothers — and then proceeded to do the same within the pages of *OID* in his early '90s features. So it was no surprise to us at all when he picked up right where he left off after founding Fairholme Capital in 1997. For example, since its inception on 12/29/99, his Fairholme Fund shareholders have enjoyed compound returns an incredible 13.5% per year better than

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GRANTHAM, MAYO, VAN OTTERLOO'S JEREMY GRANTHAM
"THIS CRASH SHOULD HAVE SURPRISED NO ONE. GREAT CRASHES *ALWAYS* FOLLOW ASSET BUBBLES."

We can think of few observers who provide more insight into the big picture than Jeremy Grantham and his team at Grantham, Mayo, Van Otterloo, and few times where a rigorous assessment of the big picture — in terms of how we got here, how deep the hole is, and what it may take to dig ourselves out — could be more timely and relevant.

So when we heard that Grantham was going to speak

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WINTERGREEN FUND'S DAVID WINTERS
"I'VE NEVER SEEN SO MANY TRIFECTAS IN MY LIFE — GOOD BUSINESSES WITH GOOD MGM'T AT LOW PRICES."

David Winters has described his decision to leave his position as chief investment officer at Franklin Mutual Advisers in 2005 and hang out his own shingle as an "epiphany", namely how he wanted to found a firm that emphasized investing, with maximum flexibility, over marketing and asset gathering — a firm where associates, using Buffett's phrase, would want to "tap dance to work".

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FAIRHOLME FUND'S
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that of the S&P 500 — 7.9% per year after all fees and expenses versus -5.6% per year for the S&P 500 through February 28th. (Performance figures provided by Fairholme Capital Management.)

Those returns have been remarkably consistent, too. During the three and five-year periods ending March 13th, *Morningstar* ranked the fund in the top 5% and 1%, respectively, amongst funds in the large blend category.

And while we have long admired the tremendous success that he's achieved for his clients, try as we might, we haven't been able to find the right opportunity for a good, old-fashioned *OID* brain picking.

For that, we place the blame squarely on Berkowitz. Periods of poor short-term performance are often a signal that contributors and their portfolios are particularly ripe for conversation. However, the last time that there was a broad-based sell-off, back in 2002, his Fairholme Fund lost a measly 1.6% — versus a loss of 22.1% for the S&P.

So it took a year during which there was truly nowhere to hide for the stars to align. Even then, Fairholme Fund held up far better than most of its peers — ranking in the 6th percentile of *Morningstar*'s large blend category for calendar year 2008. However, Berkowitz is finding little comfort in that relative distinction. Instead, he tells us that he and his new partner, Charlie Fernandez, have been burning the midnight oil and, in the process, finding some extraordinary bargains — which, we're delighted to inform you, they agreed to share with us.

As befits Berkowitz's return to the pages of *OID* after such a long absence, we're particularly pleased to bring you the following 25-page interview, which we culled from a series of conversations with Berkowitz and his partner that began shortly before year end and continued until shortly before we went to press. (The interview begins on page 20.)

However, first, to provide you with added perspective, we're pleased to bring you the following excerpts from his prepared remarks and answers to shareholder questions during his most recent conference call, held February 11th — along with a few excerpts from his prior call, held on November 25th.

As you may have gathered, we found what Berkowitz and Fernandez had to say regarding the bargains that they've been finding recently to be particularly interesting — and we believe that you will, too.

WHILE STILL ABOVE WATER, WE'VE GIVEN BACK A *LOT*. BUT I'M MORE OPTIMISTIC NOW THAN I'VE EVER BEEN.

We *did* predict rain, but our ark wasn't strong enough....

Bruce Berkowitz: ...Last year we predicted rain — and boy, we got an awful lot of it — but I'm sorry to say that we did not build a strong enough ark. The Fairholme Fund was down 30%, versus the S&P which was down 37%. Since the inception of the fund about 9 years ago, we're up about 150% versus the S&P being down 28%. So we're still above water — we're still ahead of the pack — but we've given an *awful* lot of it back.

The S&P has had the worst 10-year return in its history — it's been down now about 23% for a decade, or with inflation, down about 40%. So we're not going to fool ourselves, because the relative performance doesn't matter that much. After all, you can't spend relative performance.

And we may go lower. But there are reasons for optimism.

Berkowitz: But I must admit, going forward, I am more optimistic now than at any time. I can't tell you whether it's going to be 31 days or 31 months or longer before our portfolio companies begin to rise from the ashes. However, I do believe they will rise.

In fact, it's very interesting — in the most recent issue of *Fortune*, there's an article titled, "Buffett's Metric Says It's Time To Buy," which compares the total market value of U.S. stocks to the GNP of the country. And in the past, going back about 80 years, it was an awfully good time to buy equities when the value of all markets in the U.S. equalled 70%-80% of gross national product.

[Editor's note: The late, great John Templeton used to talk about this metric, too.]

Berkowitz: And, in fact, we're about there. But the chart also shows that this ratio has gone *lower*. In fact, it's gone under 50%. So there may be more pain. But I do believe we're at a point where future performance should be quite good over time.

At these prices, our co's are worth more dead than alive.

Berkowitz: Now, regarding the portfolio, as of the last report, we have over 50% of the Fairholme Fund in pharmaceuticals, health insurers, aerospace, and defense. These are profitable, growing companies generating lots and lots of cash in relationship to the prices we paid and in relationship to their present market cap. And Uncle Sam is by far their biggest customer — and a customer that pays. And after all, what is really more important than the health and safety of our families? These companies provide essential services to our families.

And it's amazing to me that many of our companies appear to be worth more dead than alive when assessing their liquidating and runoff values today.

With that, let's take your questions.

WE'RE BUYING COMPANIES ESSENTIAL TO THE COUNTRY AT PRICES MOST PEOPLE WOULD THINK IMPOSSIBLE.

I've always suffered from premature accumulation....

Shareholder: Could you please speak to your decision to put a lot of money to work since October? You always state that you are not making market timing calls, but in an environment where most asset classes have correlated near one — and there are major concerns that this time *is* different — deciding to invest or not invest can weigh heavily on your returns.

Berkowitz: Well, first let me say that I have always suffered from premature accumulation — and I have not been able to fix that. My ability to *predict* is still near zero. I've always acted based upon the free cash flow of companies relative to their price in the marketplace. And

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FAIRHOLME FUND'S
BRUCE BERKOWITZ
(cont'd from preceding page)

we've invested in companies that I believe still have significant misperceptions regarding their safety and their level of free cash flow.

We are not without sin, and we have made mistakes. But I think we've done a good job overall on understanding the free cash flows of our companies. And we own them today at prices that most, on a historical basis, would not think possible. While anything's possible, we have bought companies with significant free cash flows relative to price — and most have businesses that are essential to the country.

It's difficult to believe these multiples even *exist*....

Berkowitz: In the new edition of *Security Analysis* that's come out, I'm honored to have done the introduction to one of the sections, entitled, "Go With The Flow". And it talks about the theory of common stock investments — and the dividend factor.

Frankly, what Ben Graham and David Dodd called "the dividend factor", we call "the free cash flow factor" — owner earnings which a company could give to its owners without degrading the business. And it's very difficult to believe that some of the numbers I'm seeing today exist — but they do....

We've bought up the credit chain to protect against thieves.

Berkowitz: So we have been selling cheap to buy cheaper. And we have been buying up the credit chain. We have been buying senior bonds at better-than-average equity returns in order to prevent what I would call "thievery" — because as soon as the credit markets open up, there are going to be takeovers. There are companies that are generating so much cash that are selling for so little that there are going to be people going after them.

So by buying senior bonds with proper agreements such that they must pay off upon a change in control, it actually gives us better performance characteristics including increased safety.

We're looking for that balance between safety and return.

Berkowitz: But if I had to guess, I would say we're only about 5% to 7% in debt that gives us a great yield and has *very* good features built into the indentures regarding takeovers and cross defaults and so on.

And I think we bought the bonds and the notes and the securitizations at yields that are significantly above average equity yields. My only worry is that if we buy a whole bunch of fixed-income paper that's going to end up averaging 20% per annum for a period of time, I ask myself, what does that mean for the common? Equities could go up 5 to 10 times in 5 to 10 years.

So we're trying to achieve that balance between safety

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and return. And right now, we have really used that balance to enhance our equity positions. In other words, we don't want anyone to take our companies away from us on the cheap. I've been there, done that before — and did not have the size or ability to do anything about it. Today, we do have the size, the ability and the liquidity to do something about it — and at the same time, make a hell of a yield.

Shareholder: What percentage do you think your exposure to high-yield debt will be in the near future?

Berkowitz: It's increasing. And it's a lot more than it was in early October. I've been told we could have up to 30% *if* we wanted to, but I don't know if I'd take it that high.

THESE AREN'T GREAT BUYS BECAUSE THEY'RE DOWN, BUT BECAUSE THEIR FREE CASH FLOWS ARE *CRAZY*.

We do consider macro issues, but not to make predictions.

Shareholder: My question had to do with the larger macroeconomic picture. I know that you are generally loathe to take that into consideration, and would rather just focus on individual securities from the bottom-up. But I'm wondering if that's still the best approach. I know that it's often been said that the four most dangerous words an investor can say are: "It's different this time." — but maybe it *is*.

Berkowitz: I understand what you're saying. We *do* think about the macro environment. We just don't make predictions based upon the macro environment.

But what I can say to you is that if you look at our portfolio, we are heavily weighted towards defense and healthcare — the two largest budget items in the U.S. — which will continue to be the two largest budget items, and which will continue to grow significantly. And we believe that the U.S. government — in the areas in which these companies deal with the government, which is a significant percentage — is a great payer and a AAA credit.

Our healthcare co's are generating huge free cash flows....

Berkowitz: So we need healthcare. We're all getting older. The baby boomers are just hitting retirement. We all want to live to 100 and be in great shape. And the U.S. is a country that does not practice health triage. So the health insurers are the only shot we have to manage the process. And they are managing the process. The government doesn't have an entity to do it.

And the drug companies are great buys today. Their stock prices have fallen off a cliff. The free cash flow that they're generating is just *crazy* in relation to their current market prices. For example, Pfizer's a AAA-quality company generating huge amounts of cash that's able to help every start-up there is that has a promising Phase III drug.

Forest is debt-free. Again, relative to the price of the stock, it's just creating a huge amount of free cash — as is the case with our health insurers: Wellpoint, UnitedHealth, [Humana], and the most mysterious, WellCare, that is still settling its legal mess about overbilling.

And we think our defense companies are dirt cheap....

Berkowitz: Going to defense, we have Boeing, Northrop Grumman, [General Dynamics,] and Spirit, which used to be part of Boeing. We've had the Boeing strike,

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FAIRHOLME FUND'S
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which is going to cost them money. But strikes are well known dances — just like bankruptcies. They usually last a couple of months — because of the loss of healthcare benefits and so on.

We believe we understand how much money these companies generate. In the case of Northrop, I think 98% of their business is with the U.S. government. In the case of Boeing, it's kind of 50% government/50% private. The Dreamliner is the only game in town if energy stays expensive. And all three companies are dirt cheap relative to their free cash flows.

And bear market prices help prevent lousy capital allocation.

Berkowitz: At the end of the day, a company is worth the cash it generates for its owners — as long, of course, as they don't piss away that money through de-worse-ification or just burning it up or over-leveraging the balance sheet. But the biggest mistake most of these companies have made has been buying their stock back at too expensive a price.

They *can't* make that mistake right now. It's impossible. If they have the cash, they should be buying their stock back. If they're over-levered to some extent, they should use the cash to reduce that leverage — and Fairholme is willing to help them reduce that leverage. It's in the interest of our shareholders for us to help. And it's in the interest of the companies if we can help….

Spending on healthcare & defense is hardly discretionary.

Shareholder: With the new Obama administration making plans to move out of Iraq in the next couple of years — and the fact that they don't seem to place as much emphasis on homeland security — can you give your rationale for such a heavy weighting in the aerospace and defense sector?

Berkowitz: Well, I must admit that after reviewing the Obama plan in the press, if I knew that he was going to do what he did, we would've had a party for him before he was elected. I think that the defense budget is now set with *dramatic* increases — and there's nothing in his plan that I see that's going to lower that. I mean, no sitting president or official, in my mind, wants to see any type of attack on the U.S. So we will spend what needs to be spent — and I think the budgets that have been passed show that.

The same is the case with healthcare. In the current proposal, there is a *huge* increase in Medicare spending. So given his desire for improved — and universal — healthcare and the fact that the baby boomers are entering Medicare at record rates, given the war on terror, and given the numbers that are coming out of Congress — and the Obama administration's selection for key slots from national security advisor to various healthcare administrators — what they've done so far has backed up our thoughts on the matter.

And we were never counting on a stimulus package helping us. We assume it's *not* going to help our companies. And we were already reasonably happy with what the companies already have before factoring in the impact of any type of stimulus package.

Boeing, Northrop and GD basically *are* the defense sector.

Shareholder: Within the defense sector, why did you pick Boeing, Northrop, and General Dynamics?

Berkowitz: Well, we picked those companies because they basically *are* the defense sector, and form an oligopoly or a duopoly in each product area. We picked them, again, because of the cash that they generate, the earnings that they're generating, the growth that they will have, and the fact that they're absolutely vital to the national interest.

Yes, the civilian backlog will diminish, but not the military.

Shareholder: Regarding Spirit Aerosystems and Boeing, to what extent do the delays on the 787 and a potential funding shortfall for new aircraft deliveries concern you? And are you concerned about General Dynamics' exposure to the corporate jet market?

Berkowitz: Yes. We're concerned about all of that. We've taken that into account in our thinking. And this continued environment will eventually diminish the quite significant backlog of our aerospace and defense companies. On the other hand, you really have to focus on the military backlogs that these companies have as a buffer to that.

But we remain confident that this economic environment shall pass. We just are not confident as to how long it's going to take.

PORTFOLIO REPORTS estimates the following were Fairholme Capital Mgm't's largest equity purchases during the 3 months ended 12/31/08:

1. HUMANA INC
2. AMERICAN EXPRESS CO
3. NORTHROP GRUMMAN CORP
4. CANADIAN NATURAL RESOURCES LTD
5. GENERAL DYNAMICS CORP
6. SPIRIT AEROSYSTEMS HLDGS CL A
7. HERTZ GLOBAL HLDGS INC
8. JEFFERIES GROUP INC
9. FOREST LABS INC
10. LEUCADIA NATIONAL CORP

HEALTHCARE CO'S WILL BE A KEY PART OF THE SOLUTION — AND THEIR PRICES HAVE JUST FALLEN OFF A CLIFF.

The health insurers are really the only game in town….

Shareholder: I enjoyed reading your chapter intro in *Security Analysis*. I thought that was well done.

My question is in regards to the health insurer positions. Specifically, in recent filings, I noticed that a couple of concentrated investors that were involved in UNH and Wellpoint — a couple of coauthors of the new edition of *Security Analysis*, Seth Klarman and Glenn Greenberg — had liquidated a good portion of their position.

I was just wondering what informs your opinion on the future of health insurers with the new administration? You've mentioned that you use outside consultants to help further your research. Have you used anyone in this regard to add a bit more data to formulate your thesis?

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Berkowitz: To answer your last question first, the answer is yes. We've tried to have enough lobbyists and experts and Washington, D.C.-type people to give us a feeling and a flavor.

But that really does not matter as much as answering this one question: If the health insurers don't do it, tell me who *is* going to do it? Who handles the health plans of Congress? It's our health insurers. Fairholme is insured by a nonprofit: Blue Cross/Blue Shield of Florida — many of whose functions are managed by Wellpoint. When the government needs to figure out what prices to pay for various products and services, who do they go to? I believe it's a division of UnitedHealth.

There are a handful of companies that have the expertise and the abilities to manage the process while not making excessive profits, help the government achieve its goals, and help us to live longer. So I keep asking the question, "How else is it going to get done?" And I haven't received the answer yet. And the companies that we have pretty much insure 30% of all Americans that are insured right now. And if we become a country that's entirely insured, they will participate to a great degree in that....

On the insurance side, they're really similar to auto insurers.

Shareholder: I certainly understand the increasing demand in healthcare. But I'm wondering if you're looking at these health insurers making money simply on the claims processing side or on the insurance side, where I actually don't see them making money right now.

Berkowitz: Our health insurers have different levels of business: doing claims processing and just the management of not-for-profits, or being the actual insurer. And on being the actual insurer, to me, it's very analogous to the auto insurance companies where you have relatively short tails, and you're going to make your money on the one hand by having an underwriting profit — or with health insurance, having a reasonable medical loss ratio — and having a reasonably tight administrative expense on a huge scale. And on the other side, you're going to make yourself a few pennies on the holding of investment premiums by earning interest income.

So I'm very interested in the health insurers because I don't believe there's an alternative to them. And I don't believe they're charging a lot for the services they offer. I also believe they're capable of making a profit on the insurance side, and that they're going to be a vital part of the healthcare solution.

And at these prices, they are compelling investments....

Berkowitz: Then, when you take into account the fact that their stock prices have just fallen off a cliff in relationship to the free cash flow that they generate, they become an appealing investment. In addition, they are actually companies that don't require a lot of capital to operate. And there are a whole bunch of other reasons we like them that I prefer to keep under my hat.

[Editor's note: We asked Berkowitz if he'd removed that hat when he spoke to us, and he assured us that not only had he removed the hat, but he'd completely spilled his guts.]

Berkowitz: But I think it's possible that they can make a reasonable living in the insurance sector in the same way that a Progressive or a Geico or others can make a reasonable living in underwriting auto insurance policies. It's quite statistical. You can make mistakes in terms of pricing — but those mistakes shouldn't last for more than six to eight months. And they have a right to make a reasonable profit. It's just that that reasonable profit, in relationship to the prices at which they're now trading, makes them compelling investments.

You have to dig, but evidence of WellCare's health is there.

Shareholder: Usually, if you see one roach in the cupboard, there are many behind the wall. Why are you so sure that there are no more shoes to drop at WellCare which would permanently impair the company?

Berkowitz: Well, at Fairholme, we count cash — and we try to kill our companies. A lot of people can't find information on WellCare. But even though they're late in filing their SEC documents, they do file with the various insurance departments in which they do business. And from those filings, we are quite confident that WellCare will put their present legal matters to bed and move on.

The company's growing, they have a significant amount of cash, their members are increasing, they're getting paid reasonable amounts to take care of those members, and their quality of care is good. And by going to regulatory departments, we've been able to dig out the details and facts that we need to tell us that we're on the right track.

TOGETHER WITH WYETH, PFIZER CAN BE AS DOMINANT IN GENERIC PRODUCTS AS THEY ARE IN PROPRIETARY.

Sterling balance sheet + huge FCF yield = top holding.

Shareholder: Does Pfizer warrant becoming such a big holding? Has the Wyeth purchase changed this at all?

Berkowitz: Pfizer is AAA quality with a AAA balance sheet. It's a huge free cash flow generator — about $17 billion a year — and probably has the largest distribution system in the world. And for me, it was very reminiscent of Philip Morris and ExxonMobil while they were bumping around the bottom before most people figured them out — in terms of its merchant banking aspects and dominant distribution channels, especially when you include generic products. They understand that established products going off patent have been given away in the past. And in my opinion, they are becoming and will become much larger in the generic world. And there are other elements that we like. We like Pfizer on a whole score of accounts.

And at today's prices and today's free cash flows, we're talking about a company generating a free cash flow yield of 14% to 17% — depending on your assessment of its ongoing free cash flow between $2.00 and $2.50 per share. And to me, that justifies a large investment — especially when you take into account its sterling balance sheet.

And the dividend cut doesn't bother us one bit....

Shareholder: How do you feel about Pfizer cutting the

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BRUCE BERKOWITZ
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dividend? Does this lower yield mean you will lower the size of the holding?

Berkowitz: No. I understand that the dividend had to be cut in order to pay for the acquisition. In fact, the cash component and the debt component of the acquisition should be paid for in about 30 months. This is a statement from the company — and that statement pretty much backs up our estimate of conservative free cash flows in this most difficult environment.

Together with Wyeth, we think Pfizer will be dominant....

Shareholder: Regarding Pfizer's drive to be the number one provider of established-brand products, I'm wondering if you're talking about Pfizer being number one in the generic versions of their own drugs like Lipitor, or if you think their brand names will compete head to head with the generics because people would prefer brand?

Berkowitz: I think the new CEO of Pfizer understands the mistakes that past CEOs have made. He's been quite diplomatic though, and you're never going to hear about it. But Pfizer and all the other large bio-pharmaceuticals gave the generic business away. And from that, companies in India and Israel and other places developed *multi*-billion dollar businesses.

And I'm also fascinated by the fact that people in the U.S. spend less time thinking about the generic pill they're taking than they think about a piece of chocolate they're putting in their mouth. So I can see a Lipitor competing against the generic versions at the correct price point — and I can see Pfizer also becoming the number one generic company in the world. Why not? They have the distribution system, they have the knowhow, they have the cash, they have the ability — and it's not such a bad business. So to just give it away makes no sense to me.

And if you look closely, I think you'll see that Pfizer is already coming up in the ranks. And, together with Wyeth, it doesn't seem to me to be that big a stretch for them to be dominant in generic products — as they are already in proprietary products — in the U.S. and Europe.

With Kindler — and Pfizer — we're ignoring the crowd....

Berkowitz: I know the company's hated right now, and that the CEO is disliked — but I think he's doing a good job. It takes a bit of time to turn around such a large company — and he's doing it. There's an awful lot of activity that's going on beneath the surface that's very difficult to see. But from our investigative work, we see it — and we're excited about what they're doing.

More than a decade ago, investors could not get enough of Pfizer at 40-50 times earnings. Today, it's the most dreaded stock at 7-8 times earnings. So our tag line is that we ignore the crowd — and we're doing exactly that on this one because we see the cash. However, only time will tell if we're right.

Shareholder: One thing I'll just mention about Lipitor: In Minnesota, the largest healthcare company has just taken that off of their formulary list and replaced it with generics or one of Lipitor's competitors. I just wanted you to be aware of that.

Berkowitz: Yeah, I thank you for that. We see it in other places, as well. We know that there are lots and lots of pushers in this area....

People are still crazy about Lipitor going off patent in two or three years time. But we think Kindler has evaluated it properly and Pfizer is heading in the right direction.

DESPITE A DECLINE IN LIQUIDATING VALUE AT SEARS, THAT VALUE IS STILL *DRAMATICALLY* ABOVE ITS PRICE.

The whole *world* is over-retailed and over-stored....

Shareholder: Just a very simple question on your thesis on Sears Holdings. How much of it is based on assets, how much on them as a retailer, and how much on Eddie Lampert as a capital allocator?

Berkowitz: It's mostly based on assets and liabilities, with the assumption that he is, and will be, a great capital allocator. But to make money right now, all you have to do is liquidate the company. That's it. It's no more difficult than that given the assets and liabilities.

I believe the man is trying to save the jobs of a lot of people. Sears and Kmart have a large number of employees. And I really, truly believe he's giving it his best shot to resuscitate the retailer. But frankly, the U.S. is over-retailed and over-stored. The whole *world* is over-retailed and over-stored.

So we went into this based upon a liquidation analysis — and thought that if he ever was able to turn around Kmart and Sears, it would be, in baseball terminology, a grand slam home run. But we weren't expecting it — nor were we depending upon it.

Eddie Lampert's overall record is still quite decent....

Shareholder: What are Eddie Lampert's top successes as a capital allocator at Sears or otherwise? And how do you get comfortable with his abilities, given that much of what he does at his hedge fund is not public?

Berkowitz: Well, Eddie Lampert's overall record is still quite decent. That paper trail is important. But what's most important to us is studying Sears' balance sheet and its liquidation values.... We've always purchased Sears based upon its liquidation values, and always thought that we were buying below liquidation values.

I still believe that Sears is quite reminiscent of Warren Buffett's days with the Berkshire textile mill and that inflection point when he decided it was time to move on and reallocate the cash to more productive uses. There's nothing I see at this point which tells me that will not happen at Sears....

Asset values *have* declined, but not by that much....

Berkowitz: Last summer, we spent a tremendous amount of time going to all the tax collectors' offices around the U.S. trying to get the tax value of Sears and Kmart properties — and we came up with numbers that ranged between $80 and $90 per share.

So, how much has it changed from last summer? And where is the stock today? And how much is the largest appliance servicer worth, or a large automotive center

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FAIRHOLME FUND'S
BRUCE BERKOWITZ
(cont'd from preceding page)

worth, or three or four brands, or Sears Canada and over $11 billion of inventories? It just doesn't take a lot these days to get to the current market price....

So there are many ways to get to heaven. I think there are many ways that we will make money in Sears. Has our estimate of liquidation value declined in this environment? Yes, it has. But it's still dramatically above where Sears is trading today.

At $40 a share, the shorts are doing us a favor....

Shareholder: So you think Sears can pay off their debt — or refinance it at reasonable terms?

Berkowitz: I think the answer to both questions is yes. And if Eddie Lampert has any difficulties, I think he should call Fairholme because we would be willing to help him at the right price.

Shareholder: If Sears retires the debt but stops or curtails stock buybacks, what happens to the stock price when Sears can't fend off the short sellers?

Berkowitz: If the short sellers are still there, it probably goes down. And I *hope* the stock does go down, because it will be to our long-term benefit. I mean, after all, when you take a look at the $500 million chunk of cash he's using to buy back stock, a half-a-billion dollars goes an awfully long way at $40 a share.

And Lampert, like Buffett, pretty much tells you the plan.

Shareholder: How will you know when Eddie Lampert reaches the point where he has to sell the underlying real estate at distressed prices in order to prop up the retail side? Wouldn't it be wise to meet with Lampert to get a sense of whether he actually has a turnaround or asset sale plan?

Berkowitz: I guess we'll know when he sells. But even when he starts to sell real estate, I think investors have to be careful to not assume that any one piece of real estate is representative of the entire portfolio. I mean, if our opinion is correct, the real estate probably very much matches up with some type of 80/20 rule, where you have 20% of the real estate that's very, very valuable, even today — and 80% that may not be nearly as valuable.

In terms of meeting Eddie Lampert, it's probably a good time. But just as with Buffett, if you read his letters and go through the 10-Qs and the news releases, I think he pretty much tells you the plan. And again, the plan does match up, in my mind, with how Warren Buffett behaved with the Berkshire textile mills.

IT'S GOOD THE HUMAN BRAIN IS WIRED FOR MOMENTUM — BUT FOR INVESTING, IT DOES A LOT THAT'S BAD.

With Sears and Leucadia, there's an element of blind trust.

Shareholder: With most of your companies, you can look at free cash flow yields. You can look at discounts to intrinsic value and other metrics to evaluate the relative merits of one name versus another. But when you're looking at names like Sears and Leucadia, I would say the bet is more predicated on the jockey. And if you're looking at them as capital allocators and measuring that ability, what do you look at with Lampert versus Steinberg and Cumming? How do you evaluate them as capital allocators?

Berkowitz: Well, you're right. In the case of Sears or Leucadia — and in some sense, Berkshire Hathaway — there's an element of blind trust. So we tend to focus more on the liquidation value and then try and capture the premium on that liquidation value.

That clearly is the case with Sears — and in the case of Leucadia, it's even more so. You know, I sat on a board with one of Leucadia's principals for a little while, and got to know him as a person and as an investor. And I've watched the company for the 20-or-so years that we've been an investor. When you know a company that long, it's almost like marriage. You get a sense of the company. It's like after 25 years of marriage, if your wife looks at you in a certain way, you know you're in trouble — and she hasn't said a word.

They're good guys. And they have a better record than Berkshire — although they've taken it on the chin lately. So we're happy to be their silent partners, especially at these prices.

St. Joe is another one where free cash flow is obscured....

Berkowitz: Other areas where the free cash flow is hard to see would be a company like St. Joe. We just recently filed again on St. Joe, and are probably their largest owner.

[Editor's note: Indeed they are. Fairholme Capital reported adding 4.4 million shares to their St. Joe holdings in January — increasing their stake to 16.9% of the common shares outstanding.]

Berkowitz: And there's a company that isn't generating free cash, but which has almost 600,000 acres of land in Florida selling, basically, for swamp land prices. But I think we do also have some insights or a type of informational arbitrage that the public or Mr. Market doesn't have in all three. Time will tell, though, whether or not we have the correct insights....

Since we can't buy more LUK, we're buying their portfolio.

Shareholder: Do you see Leucadia as having a decent cash position?

Berkowitz: Yes. And I like the positions they've taken recently. I like what they did with AmeriCredit and the Jefferies position. And I like what they did with Fortescue.

Shareholder: It looks like you've favored investing in Leucadia's investments — AmeriCredit, Jefferies, and others — rather than Leucadia. Is there a reason for this?

Berkowitz: Yes, there's a reason. In order for Leucadia not to taint its significant tax net operating losses — there are *significant* assets on their balance sheet — they are limiting any one legal entity to 5% of the company. And we can't go above that 5% limit at this point.

As for mk't prices, it's about supply, demand & psychology.

Shareholder: Leucadia still seems as though they're

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FAIRHOLME FUND'S
BRUCE BERKOWITZ
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focused on commodities — for example, they recently bought some agricultural company down in Argentina.

And with Buffett and a lot of other people being bullish on equities, it seems like there's going to be a rush out of Treasuries — and then the next thing you know, with all these trillions of dollars going into the economy, equities are going to be the place to be.

Berkowitz: Well, I don't know. You're just going to wake up one day and you're going to see these positions go up. I mean, one of our positions that's just been pounded and pounded went up 50-60% in one day. And I can't explain why. It's not based upon the business. It's based upon the supply and demand in the marketplace, and the fact that the human brain is wired for momentum. It's what allows us to drive, and what allowed us as cave people to avoid being eaten — that is, if 1,000 people were running in one direction, it was probably a good idea to be running with them.

And those shortcuts — the psychology, the biology, and the chemistry that we have within us — do a lot of good. But for investing, some of it does a lot of bad.

There are many ways to implode — but cash doesn't lie....

Shareholder: What I think people are hoping for more than anything else is to stay away from companies that are going to implode. You know, I want to be a long-term investor with a long-term horizon, and not look in fear at the *Wall Street Journal* every day.

Berkowitz: Right. We think about how companies can die and how they're killed. Here are the ways you implode: you don't generate cash, you burn cash, you're over-leveraged, you play Russian roulette, you have idiots for management, you have a bad board, you de-worsify, you buy your stock too high, you lie with GAAP accounting.... But you can't lie about how much cash you have. I think auditors are pretty good at checking out bank accounts and finding out how much cash there is.

You know, Sarbanes-Oxley has been good in some ways in terms of the reports. Reading the SEC reports, and doing all the due diligence on companies is good — but it's partly like driving your car looking through the rear view mirror. It's the past.

For the price we paid, we like our chances at Fortescue.

Shareholder: I know that Fortescue's a new addition. And I understand that Leucadia has a huge position. But one of the things that concerns me is Fortescue issuing stock to pay shipping contractors.

And do you think they have an opportunity to buy any of the assets from Rio Tinto?

Berkowitz: (1) It also concerns me, even though it's a relatively small amount. (2) I have no idea about Rio Tinto. And (3) I'm happy to see where the price of iron ore is. And even with a *significant* reduction in the price of iron ore, given the production increases at Fortescue, I'm fairly happy with the price we paid for the assets and the company after the dramatic decline in its share price. I think we'll do reasonably well. But in the short term, it's subject to the vagaries of the commodity market. So we'll just have to wait and see.

But it makes sense that a company like Fortescue should be able to capture much of the business and production that comes from South America and other higher-cost operators....

WE DID TAKE OUR CHIPS OFF THE TABLE IN ENERGY — BUT THE U.S. HASN'T CURED ITS ADDICTION TO OIL & GAS.

When we heard "$200/barrel", we felt it was time to sell....

Shareholder: Bruce, I want to give you kudos on Canadian Natural Resources, and lowering that position very substantially when energy prices went through the roof. Considering that I think we're all paying sub-$2 a gallon for gas now, are you considering reentering that position in a meaningful way?

Berkowitz: I don't really want to answer that question. But I do still believe we're running out of cheap energy. All the major fields are in decline — and it's still *very* expensive to find the remainder. And we're still far away from alternatives. It's going to take years to come up with wind and rebuild the electrical grid or nuclear. But in the end, I believe we're going to need everything — including conservation. We're going to need it all.

So do I think oil and gas are going to stay at these prices? I don't know. But I didn't think it would go this low. I knew back when oil executives were talking about how it was *impossible* for oil to go over $40 a barrel and for the economy to survive that it was a good time to take a look at oil and gas companies. And I knew that when everybody started talking about $200 a barrel, it was a good time to start to think about taking chips off the table....

But at some point, you know, oil and gas are drugs — they're as addictive as anything else. And we need them — especially natural gas. So I can see one day having a much larger energy portfolio. It's just a question of the cash that we expect the company to generate over a period of time. But yeah, we started to buy Canadian Natural back.

But CNQ has unbelievable resources in a friendly place.

Berkowitz: But the problem is having more ideas than money — and trying to do it in an efficient way. But Canadian Natural is a great company with unbelievable resources in a friendly place. They can grow their supplies over the next 20-30 years in a significant manner without having to make another acquisition. And their reserves aren't based upon the kindness of people who don't want to see us do well.

They've got tremendous, long-lasting reserves in Canada. Hopefully, the government of Alberta won't totally screw it up with royalties that don't make sense. But that's about it. It's a great company. There are other good companies there. We need oil — we're dependent upon it. And I see people are buying SUVs again.

So we shall see. I don't know if it's going to help the country to go back to these prices, but then, I don't know what's going to happen vis-a-vis taxes. But again, I am agnostic about the macroeconomic future. I just want to make sure we're in companies that can have significant free cash flows under a wide range of possibilities.

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FAIRHOLME FUND'S
BRUCE BERKOWITZ
(cont'd from preceding page)

Shareholder: I don't think the Alberta government could do any worse than we will if there's a windfall profits tax on the oil companies.

Berkowitz: I really don't know how it's going to play out. For right now, I do know we've dramatically reduced our energy position. And at the right time, I wouldn't have a problem increasing it....

ACF'S LIQUIDATION VALUE EXCEEDS TODAY'S PRICE AND URI'S NOW HEADING IN THE RIGHT DIRECTION.

ACF's liquidation value exceeds the current stock price.

Shareholder: Can you describe how you analyze AmeriCredit's securitization deals, and how you think about today's uncharted territory for consumer credit? Can AmeriCredit securitize at 18% and still create shareholder value? And do the Moody's and S&P ratings even remotely reflect the risk of the securitization deal?

Berkowitz: Well, I'm now on the board of AmeriCredit, so I can't talk about it. But I can point you to their tangible book value which, I believe, estimates the liquidation value of the company on an undiscounted basis — that is, if they were to simply close their doors and run off their portfolio. Sometimes, it's better to know what happens if you die. And if that value is significantly higher than the price, then maybe that's your worst case — and perhaps something even better happens.

URI is starting to do the right thing capital allocation-wise.

Shareholder: Please expound more on the issues you have with United Rentals' management. Can these issues derail the company? And are you convinced that the country's stimulus plan will have a positive effect on URI?

Berkowitz: Well, I'm *not* convinced that the stimulus plan will have a positive effect on URI. The issues that I'm concerned about *can* derail the company. But I'm happy to report that the company appears to now be making moves in the right direction regarding capital allocation.

This company generates a tremendous amount of cash. We just want to make sure it isn't wasted. I believe the new CEO and his operating team are heading in the correct direction. And I think the board now fully understands the importance of putting that free cash — and the significantly higher amounts of cash — to work, such as, perhaps, in the repurchase of the company's debt at significant discounts.

The auto suppliers are outside our circle of competence....

Shareholder: Given the distressed pricing of some companies in the auto industry — in particular, auto suppliers — why haven't we taken advantage of this pessimism in the market?

Berkowitz: Probably because I'm not smart enough in that area. What's interesting about this bear market — and is also the reason why prices get so cheap — is that there are more good ideas than money. That's what we're going through with the securitization markets frozen and with the degradation of individual balance sheets. And with everyone now trying to delever, the cash is just not there. And for those who have cash, it's gotten to the point where they feel that they can't participate.

So there are lots of good ideas — and many ways to get to heaven. But right now, we're not going to heaven via the auto suppliers. I wish I knew more about the industry, but I don't. So we'll just stay in our circle of competence and try to do it in areas where we feel we have an edge....

TODAY, WE'RE LIVING THROUGH THE PERFECT STORM — BUT IT'LL END & SET UP A DECADE OF GREAT RETURNS.

We know we're not smarter than Buffett, simply smaller.

Shareholder: Can you speak to your team's decision to sell your holdings in Berkshire Hathaway?

Berkowitz: We sold because Warren Buffett stated that we should not expect Berkshire to do better than 2% above the S&P. And we expect the Fairholme Fund to do better than 2% above the S&P.

Shareholder: Over the last 15 months, Buffett's made notable investments in Wrigleys, Marmon Holdings, G.E., Goldman Sachs, Constellation Energy, Harley-Davidson, and Swiss Re to name a few. Isn't this a large number of investments for Berkshire in such a short amount of time? Couldn't it positively affect their intrinsic value?

Berkowitz: Well, it's a reasonably large amount. But at Berkshire's size, it really takes an *awful* lot of $5 billion gains to move the needle. You need $5 billion gains, basically, to start to give the needle a push.

But don't get me wrong. We sold Berkshire because we thought we could do better — not because we're smarter than Warren Buffett, because we're not — but because we're much *smaller* than Berkshire, and we have the chance to make some investments that maybe he couldn't because of size and strength.

There are so *many* ways to make money from here....

Shareholder: Given the down-slide in Berkshire's price, has your outlook toward the stock changed?

Berkowitz: I'm still in the camp that there are many ways to skin a cat. Would I think about buying Berkshire at the lows it hit? Yes. Would it be a good investment? Absolutely. Is Berkshire Hathaway a great company? Yes. So maybe I should have.

But one of the definitions of a bear market is that there are more great ideas than money out there. And that's what we're facing today. There are just so *many* ways, in my opinion, to make significant money over the next decade or two.

You know, I remember reading in Buffett's biography about how he felt like an oversexed guy in a harem back in 1973-'74. *That's* where we were in late November — and where we still are. But it's going to take time. I mean, a lot of investors are just in shock. People who have leveraged their life-styles have paid the price. They are coming out of denial now. They're coming out of their anger. They've had to take action. There have been forced liquidations. And the last trades of the most desperate can set off a whole new round of problems.

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FAIRHOLME FUND'S
BRUCE BERKOWITZ
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Mueller's facing a huge headwind — as its price indicates.

Shareholder: Can you comment on Mueller Water? It's been a lousy performer.

Berkowitz: Yes, it's been a lousy performer.

Shareholder: Do you see any merit in it at this level?

Berkowitz: Well, there gets to be a bit more merit as the level goes down....

You know, they've had some good branded products, but they've been resting on their laurels. It's been tough on the whole water infrastructure business — and they're feeling the pain. And there's not much they can do about it right now except to get much more aggressive on the selling and marketing side — because there's still business out there. But they're facing a huge headwind — although I believe their stock price does more than reflect that.

Shareholder: Do you think that there's a potential take out on that one?

Berkowitz: I have no idea. My guess on that plus $2 may get you a cup of coffee at Dunkin' Donuts.

With Mohawk, we were just selling cheap to buy cheaper.

Shareholder: I'm wondering what triggered your reduction in the Mohawk position. Was that a decision based on management — or was that just selling cheap to buy even cheaper?

Berkowitz: The latter. Mohawk has great management. I think the CEO is a great guy — and he's done better than I thought he possibly could do to date. He's made some brilliant acquisitions, and he's made the cost cuts. And it just depends upon when housing comes back. There's only so much cost cutting you can do. So would I love at some time in the future to be a gigantic holder of Mohawk again? The answer is yes. But we were selling cheap to buy cheaper. And I couldn't face giving our shareholders a gigantic dividend while we had such a significant unrealized loss position.

And that's part of what's happening in the marketplace, too.... There's a lollapalooza of events going on right now that have created a perfect storm, a "Black Swan", or whatever you want to call it. And we are living through it. But we will get through it. It will end — and it will form the base for a decade of great performance, in my opinion.

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MY DEFINITION OF "RISK" ISN'T VOLATILITY —
IT'S THE CHANCE OF PERMANENT IMPAIRMENT.

The longer Mr. Market takes to weigh it, the better for us.

Shareholder: First, I understand that the companies that you're buying continue to generate strong earnings even in the current environment. But do you think that there's a possibility that the multiples that the market will pay for these earnings could remain compressed for a prolonged amount of time — say, over five years?

And secondly, what do you think about the general economic outlook given that the U.S. economy got into this mess because of leverage — and we're using leverage to get ourselves out of it as well?

Berkowitz: Well, it's possible that the valuation on earnings will stay compressed for quite a long time. I have no way of predicting that. At some point, it will change. When? I don't know. I just know, to some extent, it's like pulling back on a rubber band — the longer it takes, the more our companies will continue to grow in intrinsic value. So the gap between what a company is *really* worth and what it's trading for will widen and widen — so that when we get to the point where the markets become a bit more rational and the fear factors go down, it will just be a bigger upside movement. As Benjamin Graham once said, "In the short term, the market is a voting machine, but in the long term, it's a weighing machine." Eventually, the market will get it right. And I think the longer it takes, the more we can potentially prosper.

In terms of how we're getting out of this mess, on a macro level, I don't know if you'd call this leverage, but it just seems to me like the U.S. has the printing press going 24/7 — and they're going to keep going until we get out of this. And then we'll have to address the ramifications of having those printing presses on 24/7.

As for inflation, we'll cross that bridge when we come to it.

Shareholder: What do you think the potential outcomes are of the printing presses running so much in terms of inflation or dollar devaluation? And how do you factor that in when trying to kill companies?

Berkowitz: Well, in terms of degradation of the dollar, it seems to me that we're not the only country that's going to go through this. So on a relative basis, it's hard to know.

As for inflation, in times of cheap money, assets and companies making lots of money tend to do much better than cash. And absent the strong desire to hold gold, I think you'll eventually see real assets go up in value. Companies making lots of money should also rise in value — of course, counterbalanced by a higher discount rate.

So it's not going to be good, but we'll cross that bridge when we come to it....

Tell me the last time you saw stocks at 3X free cash flow.

Shareholder: We read a lot of macro things that talk about how this cycle can be compared to the Japanese deflation or things of that sort. Can you put this in a historical perspective so we can relate the price discount to some of the macro worries and have a feel for how much

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FAIRHOLME FUND'S
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discount is already there?

Berkowitz: Not very well. But tell me the last time you could buy companies for three times free cash flow.

Shareholder: When was the last time that happened?

Berkowitz: I don't know. Did it happen during the worst time of 1974? Did it happen during the 1930s? You know, even during the Great Depression — the worst of times — there were companies that made money, because they had the balance sheet, they had the essential services, and they had good management....

Our companies are making good money. It's not as if they are bleeding to death and they are dependent upon the government for a bailout. That is not the case. We saw that coming — and we avoided it. And up until early October, we were doing quite well.

But then I made the decision that companies had gotten so cheap that it was time to start to move into companies at price-to-free-cash-flows that I've not seen before in my lifetime — and at levels that I've only read about in *Security Analysis* during the worst of times.

We'll never get the timing right, but volatility ≠ loss....

Shareholder: Bruce, the only question I have is about your number one principle — which I've always appreciated — which is to not lose.

Berkowitz: That's correct. But just remember my definition of "risk" and "losing". It's not volatility. It's the chance of permanent impairment. And I do not believe the fund is permanently impaired — or positions within our managed accounts are permanently impaired.

I think we've been through a very unique period — for the fund and for clients recently, and for the markets over the past dozen years. And it's going to come to an end — and I believe we are positioned to do extremely well. But, as usual, we are paying the price for my inability to get it absolutely, perfectly right. And if I was perfect at timing, I don't think it would help because we wouldn't be able to buy enough of what we needed to....

In some cases, we're buying at prices never *seen* before....

Berkowitz: But I'm feeling better about the future than I have in very long time. And as you know, we've talked about the dangers in our letters and in our past semi-annual reports. We saw the money market issue coming: that's why we're in U.S. Treasuries. And we saw the derivatives and leverage issues. I feel kind of stupid, because I think we *saw* most of it. And then we bought at price ratios and levels that haven't been seen in a decade or two — or, in some industries, have *never* been seen. But despite that, the fund and our accounts still went down, and started to catch up with the S&P 500....

It's time to be aggressive. It's time to be greedy....

Berkowitz: But if it was so easy, everybody would do it — and everyone would be great at it. And I believe the price that you pay for ultimate great performance on an absolute and relative basis is to have the wherewithal to go through periods like this. Could we have done it better? Yes. Have we committed sins? Yes. But I believe we're in pretty good shape. And it's time to be aggressive. It's time to be greedy....

And I feel horrible for people who have lost their entire pensions. But we're going through a deleveraging. And it's ultimately going to be good for the country, and it's going to be good for companies, and I think it's going to be good for our investments — because, while paying the price of the declines, it's also allowed us to get into situations that I believe will allow great performance.

WE DON'T THINK WE'LL MERELY SURVIVE, BUT *THRIVE*. AND IF I'M WRONG, I DON'T DESERVE TO BE IN BUSINESS.

With public markets this cheap, a fund structure is fine....

Shareholder: Bruce, what percentage of your liquid net worth is committed to the fund? And would you consider winding down the partnerships in the near future to focus more completely on the fund?

Berkowitz: I will tell you that 50% of my entire liquid net worth is in the fund. And that amount is growing. And I'm trying as hard as I can to put every extra penny I have into the Fairholme Fund.

Regarding Fairholme's partnerships, they are going into what I would call hibernation. I see no need to have partnership structures when the public markets are so cheap. So I think we can do for a 1% flat fee what it usually takes 1-and-20 to do. Our focus will be on the fund and our clients that have individual accounts with us.

And we were already in the process of giving back as much as we possibly could in our partnerships before the year was over in order to help everyone see exactly what they have, reduce complexity, improve transparency, allow them to do a little bit of tax planning, and so on. So we took — and are taking — actions that I'd want to happen if I were an outside shareholder, no matter the consequences to Fairholme.

And we think the fund will not only survive, but thrive....

Shareholder: You've always stated that you run the fund as if investors have committed 100% of their capital. How has this environment altered that approach?

Berkowitz: Well, we have become more vigilant, and we have become more focused and committed — and we are demanding more value. The fund will more than just survive. In fact, I believe the fund will *thrive* and reach new, higher plateaus. And I am in the process of putting 100% of my liquid net worth into the fund. I mean, I can't make it any clearer than that.

So time will tell. The next year or two will tell whether I'm right or wrong — and, frankly, whether or not Fairholme deserves to be in business. If I'm wrong on those statements, I don't deserve to be in business. And although I've let down a lot of shareholders recently, I don't plan on that happening again.

—OID

(interview begins on next page)

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FAIRHOLME FUND'S
BRUCE BERKOWITZ & CHARLIE FERNANDEZ
(cont'd from preceding page)

I THINK ALMOST OUR ENTIRE PORTFOLIO IS SELLING AT A BACK-UP-THE-TRUCK PRICE.

OID: How are things going, Bruce?

Bruce Berkowitz: Oh, man. It's been crazy.

OID: What's been crazy?

Berkowitz: Life in general, the markets, everything.... It's the best of times — and the worst of times. I've been pulling all nighters like I was back in college.

OID: Let's leave your personal life out of this.

Berkowitz: *What* personal life? I'm just working on deals. In fact, we recently did a private transaction with AmeriCredit — a subprime auto finance company.

But I think the big news for us is how we've begun to focus more on free cash flow. And we've been buying companies *awfully* cheap based on their free cash flow. But we look like we're idiots so far. It looks like I pulled the trigger early in November, but we've been buying some companies down around 3 times free cash flow.

OID: So you think you have a good idea or two...

Berkowitz: What are you talking about? Almost *everything* is a good idea now. We're at the point now where anybody who hasn't been wiped out because of leverage or stupidity and has cash and/or income to live on and an investment portfolio left has a really good shot at having a very good 5 or 10 years of performance going forward. Anybody you talk to right now should have some very good stories. [He chuckles.] If they don't, they *never* will.

I don't want to say this, but I'm almost beginning to think that an index approach would work — almost.

OID: In other words, you think it's gotten to the point where it's almost like shooting fish in a barrel.

Berkowitz: Exactly. But it's been fascinating. People ask me, "Why is it so cheap?" And all you can do is tell them about the madness of crowds, remind them of the past, and hold their hand — assuming they're willing to talk to you.

The psychology, the intensity... I really feel bad for some of our newer clients who are down a half — but now is the time to plant the seeds of great performance.

OID: If there's ever going to be a time we should talk...

Berkowitz: This is it. I can't remember ever being more excited about the securities we're finding to buy.

In my first shareholder conference call back in October, I remember saying several times that it always pays to be greedy when others are fearful and to be fearful when others are greedy.

OID: A quote that Buffett is so well known for.

Berkowitz: Right. And that conference call was literally the day before Buffett's editorial piece appeared in the *New York Times* pretty much saying, "I'm buying America" and, "This is the time to be greedy".

OID: Great minds think alike.

Berkowitz: I think a lot of the stuff we're doing is really cheap. You just don't see securities trading at these prices very often. Almost our entire portfolio — whether it's bonds or stocks — is selling at what I would call a back-up-the-truck price. But you be the judge of that...

OID: Twist my arm.

I BELIEVE OUR RESEARCH GOES MUCH DEEPER. WE WORK HARD TO STAY AHEAD OF THE CURVE.

OID: Before we ask you what your most compelling ideas are, I hear you've got a new sidekick...

Berkowitz: Charlie Fernandez is our new guy. And he's really responsible for a lot of the new ideas.

OID: How did you guys meet?

Berkowitz: You won't believe this — but basically, we met because Charlie married my cousin.

OID: Well, it may look like nepotism — but at least you kept it in the family...

Berkowitz: I promise you that the one thing it *isn't* is nepotism. [He chuckles.]

OID: Then let me ask Charlie the obvious question: What made you so desperate to get associated with Bruce that you would marry his cousin?

Charlie Fernandez: I'd heard about Bruce for a while. Before that, I did a couple of restructurings for Stuart Subotnick, the CEO of the Metromedia Company. I was also involved in the Frost Group with Phil Frost. And I was involved in the mergers and acquisitions for Ivax during a time when we grew it from a small company to one with operations in 30 countries that was sold for $9.9 billion. So I've been very much involved in the healthcare and pharmaceutical area.

So I had done well, and was basically semi-retired — although I was still doing a deal here and there. And I met Bruce in that process. It basically started as a friendship and then moved on to become something more. So he took me out of semi-retirement — and I'm delighted he did.

Berkowitz: You have to understand something about me and nepotism: There's no way I'd *ever* let nepotism get in the way of this business. There's 30 years of hard work and a lot of people who've put a lot of trust in me.

And let me tell you something about Charlie: I've heard him talking in his sleep when he was dreaming about depreciation. He works as hard as I do and he's totally focused.

OID: Say no more.

So I gather Charlie's experience comes in handy with the private deals you've been doing lately.

Berkowitz: Absolutely.

Fernandez: What I like to think I bring to the party is that I'm a very good forensic person in general.

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FAIRHOLME FUND'S
BRUCE BERKOWITZ & CHARLIE FERNANDEZ
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OID: So if anybody at the firm ever gets murdered...

Fernandez: Well, when we look at a business, we always look at it not like we're buying stock, but like we're buying the whole company lock, stock, and barrel. I come from a background where I've not only dealt with analysts, but I've also dealt with lobbyists, lawyers, competitors, and really gotten down into the nitty gritty in dissecting a company. I mean, when you're buying companies outright, each business you buy has to be able to generate enough on its own to pay not only its own debt, but also any debt that you incur to buy it, etc. So you've really got to study the business carefully. And I think that's one of the things that Bruce likes.

And I believe that our research goes much deeper than what traditional asset management people and their analysts do. For example, in the pharma area, we deal with some of the top attorneys that lobby with Congress for the major pharma companies. We also hire consultants on the law and order side to make sure that we understand complicated investigations and legal issues.

Berkowitz: And that's very valuable — especially for us, because we're such a focused fund with not that many positions.

Fernandez: It's hard to feel secure in this market no matter *how* much work you do. But at least we feel satisfied that we've done very good research. So we feel like our numbers as to what our companies are going to do in a stressed situation and a normalized situation have been pretty accurate. We can't really control the stock price, but at least we feel like we have a good grasp on how our companies are going to perform in different environments.

OID: And you said you had a fair amount of experience and expertise in the pharma area.

Fernandez: In the healthcare area in general, but mostly in the pharmaceutical area. And I have some experience with the health insurers, too.

But in all fairness, it becomes a lot easier in the pharmaceutical business when you have patents with scheduled expirations so that you know that they're the only company that can offer that product and you know what it sells for. You can come up with a range of how much of that product is going to be sold in a great economy, a terrible economy, and a normal economy. So it's a lot easier to predict earnings in the pharma area because of their existing pipeline, their future pipeline, what's going off patent, and what will still be on patent, etc.

OID: Maybe it is for you...

Fernandez: On the other hand, in the health insurer business, you really have to do a lot of work. It's very important in that business to look at what each company is filing in each state. And it's all public information. So we hire consultants to look at those filings. And by doing that, we try to stay ahead of the curve.

And because we use some of the best and brightest in the health insurer industry — folks who are both lobbyists and attorneys — in one phone call or one day, they can instruct us where to go to get public information. And that can save us three weeks of going through thousands of documents to find exactly what we need.

OID: Makes sense.

Fernandez: So being able to call the right people in different regulatory agencies and have them direct us in the right direction is very helpful. It's public information — so anybody can get it. But it's stockpiled in an enormous amount of data.

OID: It can be like looking for a needle in a haystack.

Fernandez: Exactly. And by the time you get the answer to your question, it may be two weeks too late.

OID: I can relate.

Berkowitz: I do think we're far ahead of the curve on some of what we're doing right now. We may be doing work that some hedge funds have been doing. And I'm certain that Leucadia and Berkshire do the same, but they never talk about it. Many asset managers have not done this kind of investigative work before — and I think that gives us a huge competitive advantage.

OID: Well, just one more question for Charlie: Was it worth giving up your freedom to get the position?

Berkowitz: I can answer that. Yes, it was.

Fernandez: I know you're kidding. But let me tell you something: I've worked for some pretty successful, aggressive entrepreneurs who've done very, very well. And I still have a great working relationship with all of them. But I can honestly say that I've loved working the last year-and-a-half with Bruce more than any time that I can remember. It's really been a pleasure. He's smart, he's fair, and we have the same work ethic — we work 12-18 hours a day seven days a week.

THE GREATEST VALUATION DISCREPANCY TODAY? PROBABLY HERTZ AND UNITED RENTALS....

OID: As you probably know, Charlie, Bruce shared some very insightful tidbits with us about Wells Fargo in our November 25th, 1992 edition.

Fernandez: I do.

Berkowitz: I remember very clearly when we were in the wilderness with Wells Fargo.

OID: Yeah. And the widespread misperception and valuation discrepancy there were incredible. Thanks, again, for sharing it with us.

Berkowitz: The pleasure was mine.

OID: Where are you finding the greatest misperceptions and most outrageous valuation discrepancies today?

Berkowitz: What would you say, Charlie? Hertz?

Fernandez: Hertz and United Rentals.

Berkowitz: In my opinion, these companies are priced as if they're not going to make it. There's a lot of fear that

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FAIRHOLME FUND'S
BRUCE BERKOWITZ & CHARLIE FERNANDEZ
(cont'd from preceding page)

some combination of their leverage, the frozen securitization markets, and their debt covenants will prevent them from having the time necessary to wait for the economic recovery.

OID: And you don't think they're going bankrupt.

Berkowitz: Definitely not. In fact, both companies are showing the ability to generate the cash they need not only to survive, but even to begin to pay down their debt, if not actually thrive.

OID: Then we're all ears...

Berkowitz: What originally fascinated us about the equipment rental companies was President Bush's original tax stimulus package — which basically said that if you bought a certain piece of equipment, you got to write an extra 50% off for tax purposes in the first year.

But really, we went into the rental arena because their stocks got destroyed — and because during bad times, people rent more of what they need. Talking to both large and small builders, they said that it's difficult to keep track of equipment. It can be stolen, it can break — and if an important piece of equipment breaks, it can hold up five different subcontractors. So price is not necessarily the most important issue. It's more about how quickly a replacement piece of equipment can arrive — and about quality and ongoing maintenance.

So we looked at all of that and thought about how the equipment rental companies would do in an extreme recession. And we noticed that their cash flows stay strong because of higher utilization rates on their existing equipment and because they spend less money on new equipment. If anything, the time that they're going to need money is when the economy heats up and they decide to add more equipment.

OID: Gotcha.

Berkowitz: And what few people realize is that Hertz's second largest segment is an equipment rental business which is *very* profitable. We actually learned about that business in the course of researching United Rentals.

OID: Interesting. How big is the equipment rental business at Hertz?

Berkowitz: Hertz's vehicle rental business accounts for about three quarters of their income and their equipment rental business accounts for the rest. And again, the equipment rental business has done very well.

OID: So far so good. And yet, like you said, Hertz is quite a controversial holding...

Berkowitz: Hertz *is* one of our most controversial holdings — in part, because it was taken private out of Ford in 2005 by three private equity firms. We think they stole it at a little under $6 a share — and got their money back by selling half of the equity to the public less than a year later. This is a company that recently went public at $15 and had a secondary at $22.

OID: Sounds like they stole 'em, all right.

Berkowitz: But now it's down around $4.00.

OID: Then again, maybe not....

Berkowitz: And Hertz is *the* name in the car rental business and has a great global brand. They do a good job — and they've made good money. It's just that it's hard to see what they've done because the private equity companies have basically pulled out all of their initial cash investment.

OID: Tell us more...

Berkowitz: Well, let me give you the bear case on the auto rental side first. We're in touch with a former senior manager at Hertz. And let me tell you, he's very worried about the company. He thinks that they've cut their expenses *too* much. Hertz has always been the low cost, high-quality operator in the space. But he doesn't think that's true any more. He thinks that they're still low cost, but he doesn't know whether they're still best of breed. And it pains him to see that.

OID: Who does he think is best of breed — Enterprise?

Berkowitz: Yeah. I hear that Enterprise has been doing a pretty good job.

OID: Yep. That's my impression, too.

Berkowitz: Incidentally, this former senior manager thinks Avis Budget is hanging on by their fingernails. But I think Hertz is still #1. So here's a company that really is a household name and the market share leader.

OID: I definitely think of Hertz as being #1, as well. But Morningstar says Hertz is #3. What do you think that's about? Could that be because two of Hertz's major competitors have multiple brands?

Berkowitz: That's right. Based on revenue, Hertz's market share is 26%, versus 29% for Avis and Budget (which are owned by Avis Budget Group), and 28% for Vanguard — which runs National and Alamo together at 11%, and runs Enterprise separately at 17%.

OID: That sounds all well and good. But doesn't Hertz suffer from a reputation of not trying hard enough?

Berkowitz: That was the #1 problem at Hertz — how long it took from when you got there until you got your car. But they've made some major improvements in that regard. I dropped someone off at a Hertz location recently. And you just go into the lot past an electronic board that has your name and tells you where your car is. The keys are there. You just get in the car, get checked out by the security guard, and you're done.

OID: So they really are trying harder...

Berkowitz: They did have a guarantee that if they didn't get the job done for you within 15 minutes from start to finish, they'd give you $50 or something like that. And people responded to it *extremely* well. But they recently canceled that program — because of tighter inventories at some of their locations. It's now possible for someone trying to rent at the last minute to not even get a car. And in this environment, that's not all bad because you *want* high capacity utilization.

Still, about 30% of their fleet isn't being utilized at any given time. So they can achieve huge savings by reducing

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FAIRHOLME FUND'S
BRUCE BERKOWITZ & CHARLIE FERNANDEZ
(cont'd from preceding page)

that percentage by maybe a third. Basically, all they have to do — to not just survive, but be profitable — is shrink. And Hertz is doing that. They've been closing car rental locations. And in their latest conference call, Hertz's CEO talked about how they continue to reduce the size of their vehicle and equipment fleets and are only committing to buy half as many new cars this year. So their utilization per unit on the auto side is going up, as well. And their cash flow has already begun to increase as of the last quarter.

OID: Interesting…

Berkowitz: The only way to stop the degradation in the price per day of a car and start to increase it to a more normal level is when major competitors in the industry get down to the right fleet size. They have to get to the point where you won't be able to find a car at the last minute — at Hertz or at any competitor. And the industry may be approaching that point. A recent visitor to our office paid $137 for a last minute one-day rental of a mid-sized car from Hertz. And even in this terrible environment, Hertz recently *increased* prices by $5 per car per day — and it's sticking. So that's another indication that the industry's fleet inventory is approaching the right size.

Or maybe it's the beginning of an economic bottom. Hertz tends to be the canary in the coal mine — an early leading indicator of the economy's health.

OID: What's the story on management?

Berkowitz: Our research has led us to believe that the guys who run their two main divisions — their rental car business and their equipment rental business — are doing a first rate job and have been around forever.

We've heard mixed reviews on Hertz's CEO. But we've met with Mark Frissora — and he's spot on with what needs to be done, which is to improve efficiencies and utilizations. So we've concluded that he's the right man for the job.

A PRICE OF 4 TIMES FREE CASH FLOW FOR A PIECE OF AMERICANA?!

OID: What else do you think we should know?

Berkowitz: We think this company's going to generate around $1 per share of free cash flow — and the stock is trading down about 80% from its high. So if we've got the free cash flow right, we're paying 4 times free cash flow for a company that's pretty much a piece of Americana.

OID: Whoa! Did you say 4 times free cash flow?!

Berkowitz: Yep. And at $4 a share, it's selling for a *whole* lot less than what we paid for it.

OID: You say that Hertz is generating free cash flow. But as you know, a couple of the services — including Morningstar and Yahoo Finance — show Hertz having big-time negative free cash flow.

Berkowitz: And Bloomberg shows the same thing.

OID: What accounts for the apparent disconnect?

Fernandez: Acquisition accounting.

Berkowitz: You're seeing the GAAP accounting related to the private equity purchase and IPO of the company.

Fernandez: Also, according to Bloomberg, *Morningstar* and Yahoo Finance, Hertz had total negative cash flow of almost $37 billion for the last four years.

Berkowitz: Bloomberg is showing free cash flow for 2007 of negative $8.4 billion, negative $9 billion in 2006, negative $11 billion in 2005, and negative $9 billion in 2004. And if those numbers were true, Hertz would've been out of business long ago.

[Editor's note: We compared numbers and determined that the free cash flow figures from Bloomberg, *Morningstar* and Yahoo Finance were all the same.]

Berkowitz: In this business, you get huge tax credits for buying equipment. And your depreciation for tax purposes is much faster than your GAAP depreciation. So you end up deferring a huge amount of taxes. For example, they only paid about $28 million in taxes, all in their foreign operations.

Fernandez: The company uses what's called "after-tax, leveraged free cash flow". But we don't work that way. We work with a grocery store mentality — which is to think how much is left in the cash register at the end of the day for the owner. And doing it that way, we come up with free cash flow of about $1.00, assuming no change in units or price.

Berkowitz: By the way, you have to remember that as rental companies deleverage, their cash flow increases. So you've got to normalize it down. And as they're growing — like they were in 2005 and even in 2006 — in theory, their cash flow decreases because they're acquiring more equipment. And free cash flow should adjust for that. Free cash flow is defined so many different ways…

Fernandez: Absolutely.

Berkowitz: Free cash flow should take into account a steady state of the business — although that's easy to say, but difficult to calculate for future periods.

OID: So you use maintenance capex instead of the actual capex — or even necessarily what capex is likely to be — in any given year because in any year, the business may be growing or shrinking.

Berkowitz: That's right. And therefore we just try to stick to Ben Graham's owner earnings concept.

So our estimate of free cash flow for Hertz is what we think their normalized run rate should be at a steady state. And while we believe Hertz has normalized free cash flow in this difficult environment of $1.00 per share, they're currently generating much more cash than that.

Fernandez: Right — because in today's environment, they're shrinking their fleet. Therefore, their cash flow is much higher.

OID: How many shares does Hertz have outstanding?

Berkowitz: We use 322 million shares in our calculations. And we're coming up with free cash flow of something in the neighborhood of $340 million on our 2009 revenue estimate of $8.2 billion — which is lower than what sales have been historically.

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FAIRHOLME FUND'S
BRUCE BERKOWITZ & CHARLIE FERNANDEZ
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OID: And that would imply that their free cash flow as a percentage of sales would be a little over 4%. Does that seem reasonable to you?

Berkowitz: Yeah. That sounds reasonable to me. Does it seem like such a crazy number to you?

OID: I asked first.

Berkowitz: If you can't earn 4%, what's the point?

OID: Depending on the business...

Berkowitz: Depending on the business, the leverage, and the amount of equity they have in the business — because as debt goes down, that number's going to go up. So it also depends on the capital structure of the business. But believe me — our $1.00 per share of free cash flow isn't based on crazy assumptions.

OID: If you put it that way...

Berkowitz: We're taking into account that they've increased prices, reduced their vehicle and equipment fleets by about 500,000 worldwide, and reduced the number of their locations, as well as how they performed during the first nine months of 2008 and the last quarter. So we're assuming that their sales will be down in 2009 — and that their sales will decline faster than their expenses.

OID: What can you tell us about their expenses?

Berkowitz: We're assuming that they'll have about $750 million in interest expense in 2009. And we're assuming that the depreciation on their vehicles pretty much equals the maintenance capex of their vehicles. And when we add that figure to what we're coming up with for the capex on their equipment business and the rest of their business, we're basically coming up with about $2 billion of total maintenance capex.

But we haven't taken into account all of the locations that they've eliminated and employee reductions and money they spent in 2008 that would supposedly result in savings in 2009 — because we haven't seen it yet.

OID: Gotcha. So you think you're being conservative.

Berkowitz: That's right. So, roughly speaking, we come up with $2-3/4 billion for maintenance capex plus interest — which would lead to something like $340 million of free cash flow. And it wouldn't surprise us if the number for Hertz's free cash flow wound up being $1.20 or $1.50 instead of $1.00. But let's just use $1.00.

Fernandez: I have free cash flow for Hertz for the first nine months of 2008 of over $1.00. And for the year, it should be between $1.40 and $1.50. But remember that free cash flow is not a GAAP figure.

[Editor's note: Berkowitz informed us that Fairholme estimated that Hertz's 2008 free cash flow actually came in at $1.42.]

Berkowitz: Is that including the effects of the stimulus package?

Fernandez: For 2008, yes — but not for 2009.

Berkowitz: Let's just make believe that stimulus package doesn't exist. What would it be for this year then, Charlie?

Fernandez: About 21¢ less. So let's call it $1.24.

Berkowitz: And Charlie and I might disagree somewhat as to the exact number, but with the stock anywhere near $4, who cares?

OID: Bruce, please know that I'll always care.

Berkowitz: I appreciate it. So Hertz's free cash flow under *very* stressful conditions is about $1 per share. And keep in mind that we're talking about what it would be if the world remains in its current recessionary environment. Is that fair to say, Charlie?

Fernandez: Yes.

Berkowitz: And if things ever get back to normal...

OID: Wow. I think you're making my glasses fog up...

HERTZ IS BUYING BACK ITS DEBT ALREADY —
AND CAN BOOST ITS CASH FLOW ANYTIME.

OID: What would you say the biggest disconnect is between the way that you guys view Hertz and the way that the rest of the world does?

Berkowitz: Well, since we've been buying it, the senior debt at Hertz has been yielding anywhere between 18% and 30% per annum. That tells us two things: First, it's an indication of just how crazy this market is. And second, as I mentioned earlier, it suggests that people are expecting this company to go bankrupt.

But Hertz will be the last rental company standing. Their businesses aren't dying. We believe the company has the cash flow. We're comfortable with their debt payment schedule. And, again, they recently raised their rental car prices by $5 per car per day.

Why does most of the world disagree? The whole rental business is getting killed. Avis Budget is down 95%. And as I said, Hertz is down about 80%. The company's being priced as though the securitization markets are completely closed and are never going to open up again.

OID: Yeah. In fact, that's one of the negatives that Morningstar points to. They say that "the company's large reliance on short-term asset-backed financing makes it vulnerable to turbulence in credit markets".

Berkowitz: And they're right. The stock prices of all of the rental companies have been destroyed based on their leverage and their inability to tap the securitization markets or otherwise get money. So their businesses, at least to some extent, are based on the kindness of strangers — because all of them have huge secured loans on their inventories. That's also true of United Rentals.

Fernandez: That's right. But Hertz only has about $4 billion of corporate leverage. The rest is basically secured loans tied to autos and equipment.

OID: Although the rest of the world seems to think that they're basically riding down a very bumpy road with a loaded shotgun.

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FAIRHOLME FUND'S
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Berkowitz: Well, if the securitization markets stay shut for, say, another year-and-a-half, it's true that Hertz and a lot of other levered companies will face issues. And it's possible that the senior bondholders of these companies will become the new owners.

OID: Perhaps a reason to own the bonds, as well — which we see that you've done with Hertz...

Berkowitz: Yes. But the latest news we're hearing is that in order to save the U.S. automakers, we may be seeing some type of federal government program designed to loosen up the securitization markets for auto loans. That could benefit companies like Hertz by providing them with an incentive to buy U.S.-manufactured cars.

And based on scuttlebutt, we're also hearing that non-U.S. manufacturers are offering great prices in an effort to gain market share.

OID: But, obviously, you're not counting on it.

Berkowitz: That's right. However, I mention that because it would begin to address the fears people have about how they'll be able to raise the money they need in order to buy new vehicles.

OID: And if those programs don't come through...

Berkowitz: So far, the answer is that the securitization market for new automobiles is *not* closed. Securitizations *can* be done — at a price — although it's currently at a very high price. For example, Avis Budget did securitizations at 9% per annum last fall.

OID: You think 9% is "very high"?! If you only knew what we have to pay our loan shark...

Berkowitz: Well, I suppose everything's relative. That's up from 5.5% previously. And again, there does appear to be some light at the end of the tunnel in terms of the government possibly coming up with a plan designed to unfreeze securitization markets. Meanwhile, Hertz can cut the company down to its essentials, lower their expenses, lower their fleet size, etc. and not need as much money.

Fernandez: Yep. They can easily lower their fleet by another 200,000 units or more — which would effectively reduce their fleets by 20% or so and lower their cash spend and improve their utilizations. And obviously that'd generate an enormous amount of cash. We wouldn't call it free cash. However, whatever you call it, they could use it to pay down debt — even if it represents a partial self-liquidation.

Berkowitz: That's right.

OID: And the fact that they can deleverage any time they want gives you extra comfort.

Berkowitz: Exactly. And buying back their debt at huge discounts to par and very high yields to maturity is a very wise capital allocation decision. If a company can buy its debt back at a 18%-30% yield to maturity without significantly increasing financial risk or hampering its ability to function, there's no better use of capital.

OID: Are they doing that, or are you just saying that you wish they were?

Berkowitz: They're doing it — slowly and methodically — and that should continue.

AND HERTZ HAS RESIDUAL VALUE AGREEMENTS
THAT LIMIT THEIR DOWNSIDE WHEN THEY SELL.

Berkowitz: So here's a great company, selling for only about 4 times free cash flow, that does a great job, and that even does well in terrible economic times — at least it does well relative to its current valuation.

OID: And it sounds like you're making a great case — as long as they don't wind up taking too big a hit on their vehicles when it comes time to sell.

Berkowitz: I thought you'd never ask. Believe it or not, Hertz has various residual value agreements — which people don't fully understand — that help keep them from taking too big a hit on 80% or so of their U.S. OEM fleet when it comes time to retire those vehicles and sell 'em.

By the way, how long do their vehicles stay in service, Charlie?

Fernandez: The average time ranges between 11 and 18 months.

Berkowitz: The agreements are somewhat complex. They have various different types of residual value agreements. And they won't tell you the exact terms. However, in one way or another, those agreements protect Hertz's downside — at least, in some part — on 80% of their U.S. OEM fleet when it comes time to sell.

Incidentally, on their non-U.S. fleet, there's been no need for residual value agreements because they've been getting really good deals from foreign manufacturers and the residual values have been holding up just fine.

OID: So that unless the auto companies go bankrupt, one thing you don't have to worry about is Hertz taking a hit when it comes time to sell their vehicles.

Berkowitz: Exactly — at least not on 80% of their U.S. OEM fleet.

Fernandez: And that's on 63% of their total worldwide fleet (as of December 8th).

Berkowitz: However, I should probably mention that the terms of those agreements are constantly changing as a result of fluctuating market conditions.

OID: Speaking of fluctuating market conditions, I suppose that one not-so-far-fetched risk is that those residual value agreements wind up being worthless if the U.S. auto companies go bankrupt — perhaps at the same time those vehicles' values take an extra, bankruptcy-related hit.

Berkowitz: First of all, it would be up to the company in bankruptcy whether or not it wished to honor those contracts. And second, I don't see an auto manufacturer bankruptcy affecting the residual values — because the cars will be sold no matter what.

OID: You don't think worries about whether or not the auto manufacturer would even be around would

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FAIRHOLME FUND'S
BRUCE BERKOWITZ & CHARLIE FERNANDEZ
(cont'd from preceding page)

reduce demand — and values along with it?

Berkowitz: I don't know. I would feel *better* about it. I'd feel better about owning a GM car post bankruptcy — because they could wipe out all of the liabilities they want. So if you bought a GM car after bankruptcy, then any type of guarantee would be post bankruptcy.

OID: On the other hand, the existing guarantees...

Berkowitz: Could the existing guarantees wind up being ripped up by GM? Theoretically, yes. But in a bankruptcy, the players that tend to get hurt are the company's suppliers, not its customers. And of course, Hertz is not an auto manufacturer supplier.

Fernandez: Yeah. For some reason, people seem to think about Hertz the same way they do auto company suppliers — who could be hurt by them going bankrupt. But Hertz is a major auto company *customer*.

Berkowitz: Exactly. In bankruptcy, GM could squeeze its suppliers, cancel what it owes 'em, renegotiate terms, etc. With Hertz, it's going to be about buying cars.

And Hertz is one of GM's largest customers. And bankruptcy or no bankruptcy, GM is not going to want to upset one of its largest customers. So if GM were to go into bankruptcy, one result of a decision not to honor its contracts with Hertz would be Hertz buying fewer cars from GM. And I don't think anyone at GM or in the U.S. government would like to see that happen.

OID: You don't think anybody in the U.S. government owns stock in Ford or Toyota?

Fernandez: Also, with supply and demand so out of whack in today's environment, it's a buyer's market. And because Hertz is a major customer, they're paying less for new cars — and getting great terms and agreements.

Berkowitz: That's a very important point. Obviously, it's a buyer's market today. And therefore, Hertz is going to demand *very* favorable deals. In the aftermath of a bankruptcy, they might get better — even *outrageous* — deals. After all, in a bankruptcy, GM could dramatically reduce their liabilities to their retirees, to their health plan, and everyone else. So their cost basis should decline dramatically. In fact, Ford just negotiated a package that had nothing to do with bankruptcy that's supposed to lower their cost basis to make them competitive with the Japanese auto manufacturers. And supposedly, GM is about to announce a package twice as large as Ford's that's expected to do the same trick.

Incidentally, unlike Enterprise, Hertz is in the business of making money from renting cars. They don't want to speculate on residual values. And even though they're forced to do so to some extent in the normal course of their business, they're now doing it to a lesser extent than ever before. By contrast, scuttlebutt has it that Enterprise doesn't make *any* money from renting cars. Allegedly, they make all of their money, believe it or not, from profits on their vehicles when they're eventually sold.

OID: That sounds amazing — although it also sounds like a negative. I imagine that it can't be a good thing to have a competitor who prices to break-even.

Berkowitz: First of all, sooner or later, anybody who's not making money on their basic business is going to eventually hit a bump in the road.

OID: There's no need to get personal.

Berkowitz: It doesn't make sense to me that they're just breaking even on the auto rental business, but that they've somehow figured out some kind of magic formula to buy low and sell high.

And even if it were an issue over the long term, with everyone shrinking their rental inventories, it's certainly not likely to be an issue anytime soon.

Also, Enterprise is in a different niche. It competes more in the off airport, non-business travel segment. And I don't find them up to the quality of Hertz.

OID: In terms of the rental process, the cars or what?

Berkowitz: The process, the cars themselves, the quality of the cars... The only time I've used Enterprise has been when I've been having a car repaired — and the insurance company just wanted to give me the cheapest, most basic rental car they could find.

THE KEY FOR HERTZ IS TO SHRINK THEIR INVENTORIES.
BETTER UTILIZATION RATES = INCREASED CASH FLOW.

Berkowitz: Again, I believe the key to understanding both Hertz and United Rentals is that by lowering the size of their fleets — which we believe they are doing already and will continue to do for as long as the current challenging environment persists — both companies will improve their utilization rates, margins, expense ratios, etc. And their increased cash flows will enable them to purchase their deeply-discounted debt at a great price to yield a great profit.

OID: And you expect that to happen not only in the equipment rental business, but in rental cars, too.

Berkowitz: I do. And the smarter the competitor, the faster they'll do it.

Fernandez: Exactly. And that's already showing up in the results at Hertz's equipment rental business. Through a combination of management skill and luck, they were late to the party in terms of buying a lot of equipment and early to the party in terms of selling a lot of it. As a result, they are very rightly sized for today's environment. That's why their EBITDA margin — which is currently over 40% — continues to be so strong in the equipment area.

Berkowitz: Incidentally, when we do a liquidation analysis of these equipment rental businesses, we come up with net present value figures that are *significantly* higher than their current stock prices.

OID: Even in the context of lower disposition prices for their assets in the current environment.

Berkowitz: That's right. The sale prices of used equipment right through to the end of the year were declining fast. But as I recall, Hertz and United Rentals saw an uptick in disposition prices in January and February. And I'm not saying that's necessarily a trend, but it's always nice to see that prices weren't continuing to decline.

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FAIRHOLME FUND'S
BRUCE BERKOWITZ & CHARLIE FERNANDEZ
(cont'd from preceding page)

OID: Again, it sounds like you make a great case.

WHO WAS UNITED RENTALS' BOARD PROTECTING BY KEEPING US FROM BUYING MORE SHARES?

OID: What's the story with United Rentals?

Berkowitz: United Rentals is a very similar story. They're the #1 equipment rental company in the U.S.

And in this environment, you'd rather rent than own — because if something breaks down, as I mentioned, you want to make sure that you'll have a replacement on the scene pronto. And the mom and pop companies can't do that. And smaller companies can't do it themselves. So it makes sense to go to United Rentals.

OID: Remind us to send you a bill for the ad...

Berkowitz: And United Rentals is generating a tremendous amount of cash in the equipment rental business — even though their utilization rates per unit haven't been going up yet as they have been at Hertz's equipment rental business. We're talking about a company generating free cash flow of $2 per share. And the stock is selling around $4.

OID: Wow.

Berkowitz: We didn't buy it at these levels, mind you — we bought most of our shares at closer to $11.

OID: Even better.

Berkowitz: And then United Rentals' board changed the rules for investors. They had allowed investors to buy up to 25% of the outstanding shares of the company. But "in order to protect shareholders", they lowered it to 15%. So they stopped us from buying more. I don't know who they're protecting us *from*. Maybe they're trying to protect us from ourselves.

OID: I don't know about you, but I could certainly use that kind of protection sometimes...

Berkowitz: They're stopping their shareholders from

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averaging down. Directors, who don't even own 1% of the company, are making decisions for a couple of hundred thousand of my shareholders.

They must fear our large ownership stake.

OID: They don't know how warm and fuzzy you are like we do...

Berkowitz: But we're their largest shareholder — and passive to a very large extent. And management, which we like, is happy to talk with us. But the board has made its share of mistakes in the past. And we can't get an answer to a simple question — which is, "Why did you stop us from buying more stock?"

OID: If you'd like a personal reference...

Berkowitz: We understand that we can't do anything in Delaware about what they've done. However, what we can do is vote against them — if necessary.

OID: You said that the board had made its share of mistakes in the past...

Berkowitz: They made a mistake when they paid too much to buy back stock — although, to be fair, that's in hindsight.

OID: A pretty common sin.

Berkowitz: True. But United Rentals spent a fortune buying back its stock at $22 not that long ago. And to buy back that stock, they had to get rid of Apollo. So their interest expense will be higher. That wasn't so brilliant. I just don't think it was balanced...

OID: Balanced?

Berkowitz: They didn't take all shareholders into account. They obviously thought — and their bankers apparently told them — that it was okay to buy back their stock at $22. Well, at $22, we tendered every one of our shares. And the company wound up buying back a third of our shares. However, in our view, that was a poor capital allocation decision on their part.

EVEN USING VERY CONSERVATIVE ASSUMPTIONS, UNITED RENTALS' CURRENT MULTIPLE IS RIDICULOUS.

OID: So much for their past. What about their present and their future?

Berkowitz: For 2009, we expect United Rentals to have revenues of a little over $3 billion — down from around $3.3 billion in 2008. Their operating expenses should be around $2.1 billion. And we expect them to have interest of about $272 million. Maintenance capex is the tough one. It could be anywhere between $330 and $430 million per year — because their fleet's aging a bit. Theirs is not nearly as young as Hertz's. The average age of United Rentals' fleet is 7-odd years. The average age of Hertz's fleet is 4-odd years.

But the only reason why Hertz's fleet is younger is that they started in the game later. Hertz may want their fleet to end up down the road where United Rentals is right now — with their 7-odd year average age. The average life of their equipment, by the way, is 17 years.

Fernandez: That's one of the challenges with these

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FAIRHOLME FUND'S
BRUCE BERKOWITZ & CHARLIE FERNANDEZ
(cont'd from preceding page)

equipment rental companies — figuring out just how much they're going to need to spend on equipment. United Rentals only has about 59 million shares outstanding. So if there's a big change in residual values or the cost of new equipment, it can change the cash flow by over $1.00 per share.

Berkowitz: But however we run the numbers, we come up with United Rentals generating a significant amount of earnings before tax. What we're trying to come up with is maintenance capex — which is the capital expenditures that the company would have if it just maintained the status quo — if it were neither growing nor liquidating the company. What we're looking for basically is what they would generate going forward on a conservative basis.

OID: And when you do that, you come up with $2.00.

Berkowitz: We come up with well *over* $2.00. However, we don't need to say anything more than $2.00, frankly. [He chortles.]

And in that $2.00, by the way, we're also assuming a normal tax rate. But they're not going to pay *any* tax for a few years because of current IRS tax rules. And for now, that would be another $1.00. It's actually *more* than $1.00 per share.

OID: Wow.

Berkowitz: And that's not unusual. That's just the nature of companies utilizing the tax laws governing the depreciation and sale of equipment.

But we assume that they pay tax. And we assume that they have to spend another $100 million because their equipment's a bit older. We also take their revenues down by 8% and only take their expenses down by 5%. And we don't exclude their restructuring outlays from our calculations — despite the fact that everybody else seems to.

OID: In other words, you're saying that you're even including some nonrecurring charges...

Berkowitz: That's right. It's amazing how companies constantly have recurring "nonrecurring" expenses.

OID: Absolutely true — and something the late, great Bill Ruane often pointed out.

Berkowitz: We don't want to fool ourselves by excluding recurring "nonrecurring" expenses. So anyway, despite doing all of that, we still come up with an estimate of EBITDA — earnings before interest, taxes, depreciation, and amortization — for 2009 of more than $900 million.

OID: And with only 59 million shares outstanding...

Berkowitz: That's a lot of money per share.

OID: So the company's trading for less than a third of EBITDA!?!

Berkowitz: If they make it. Again, apparently, the conventional wisdom is that they're too leveraged — and that the economy's going down the tubes. United Rentals' bonds are trading at a yields-to-maturity between 18% and 30%. So they appear to be in the same boat as Hertz.

OID: Again, they're viewed as riding down a bumpy road with a loaded shotgun.

Berkowitz: Right. But we've done a liquidation analysis — and it's much higher than the stock price.

The bottom line is that they're moving in the right direction — delevering with debt buybacks at significant discounts, cutting back their expenses, etc. — and the economy hasn't ground to zero...

OID: Yet.

Berkowitz: Again, we assume that revenues will be down 5% in 2008 and 8% in 2009 — and that they're not going to be able to cut the expenses that they say they are. And we're throwing in an extra $100 million of capex — which I think management would vehemently disagree with. And most people would probably think we're crazy to take taxes out that they're not going to pay.

We just want to reflect the underlying economics of the business without favorable tax laws and make sure that we're using conservative assumptions when we do it. And despite all those conservative assumptions, we still come up with free cash flow of over $2.00 per share.

OID: Given the current price, that sounds pretty wild.

Berkowitz: So their free cash flow should allow them to pay off debt. The only time they're going to need money, I believe, is when they decide that it's time to start to grow again. And then they'll probably look for money. But I don't think they're expecting to need to raise money here.

The markets are killing 'em anyway. And we'd like to offer them some liquidity — and help 'em out. We could offer them cash to help 'em pay off their debt, too, on better terms than they have now. But they keep coming back saying that they don't need any of that — that they're just fine, thank you very much. We'll see.

OID: Gotcha.

Berkowitz: So again, the trick in a very difficult environment is for Hertz and United Rentals to lower their rental inventories by selling their used equipment — whether you're talking about cars or other equipment — and buying less new equipment and thereby generate significant additional cash flow. The whole game plan in this kind of terrible environment — which I don't think people appreciate — is to shrink. To shrink is to survive. Again, higher utilization rates increase cash flow.

And one way or another, smart operators will find ways to dramatically increase their utilization rates.

MANY FINANCIALS ARE IMPOSSIBLE TO ANALYZE — BECAUSE OF WHAT YOU CAN'T KNOW.

OID: I find it interesting that you're not more heavily invested in financial companies...

Berkowitz: We've bought a couple of 'em, but that's it. You can't figure out what their liabilities are. You can't really analyze their derivatives portfolios. You don't know who the counterparties are. You don't know who the ultimate counterparty is. And today, it's even becoming hard to tell who *owns* 'em.

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FAIRHOLME FUND'S
BRUCE BERKOWITZ & CHARLIE FERNANDEZ
(cont'd from preceding page)

OID: And here I was thinking that most of it had to do with mark-to-market accounting...

Berkowitz: No. That's just optics. I can handle optics. I didn't buy AIG six or seven years ago because they had little disclosure on derivatives and everybody assumed they were just simple, plain vanilla derivatives — whatever the hell that means. And then I looked at the company a few years later and saw that they had a few pages on it. Today, I don't know *how* many pages they have on it.

Here's the situation in a nutshell: How can I assess you if you've done deals with a bunch of other people who may or may not be creditworthy? If I do a deal with you, but you've done a deal with B, who's done a deal with C, and C gets wiped out and kills B, so B can't settle with you and you can't settle with me, then *I'm* done.

What about all those derivatives Lehman did? Who's going to settle them? Lehman's going to owe money to people, and people are going to owe money to Lehman. And I read a bankruptcy report that states Lehman's already trying to pick and choose which contracts they want to keep.

OID: So?

Berkowitz: Common sense would dictate a netting out of favorable and unfavorable contracts in bankruptcy. You can't just look at one side in the absence of the other — although I'm not a lawyer or a bankruptcy expert.

Why did J.P. Morgan buy Bear Stearns? Was it a bargain? Or did they do it because Bear Stearns would have taken down J.P. Morgan with it? Why did the U.S. government have to bail out Citigroup and AIG?

OID: Something to do with campaign contributions?

Berkowitz: I don't have the answer, unless it's that they believed that if those companies were to fail, many of their big counterparties would fall like dominos. Mark-to-market isn't helping. However, if the problem were primarily mark-to-market, that would put a smile on your face — because it would mean that financials are really cheap.

OID: Exactly. And that's what I was hoping the story was. I didn't realize how much of it was derivatives.

Berkowitz: The only real question now is, "Do they have lots of derivatives?" If they have derivatives with a trillion dollars of notional value, how can you possibly know the values and whether there will ultimately be life or death for the institution?

OID: Exactly what Buffett and Munger have been saying for quite a while now.

Berkowitz: Yes, they have. And that's one reason why I find it so fascinating that Buffett would invest in companies with significant derivatives portfolios.

OID: Could it have had to do with the fact that he's been taking preferred positions?

Berkowitz: If there's a blowup, I don't think the fact that it's a preferred position is going to help him.

OID: So what do you think the answer is?

Berkowitz: I don't *know*. He's smarter than I am — so there's probably more to it. Maybe he thinks their company-specific problems are over. I honestly don't know. But I do know Buffett only buys the very best of any class — and he appears to have bought the best.

OID: Before we leave the topic of financial companies, let me give you some well deserved kudos. Color me impressed as hell that you — who have historically been so focused on financial companies — managed to mostly sidestep the debacle.

Berkowitz: Maybe I was lucky that life in the past used to be much simpler...

OID: But instead of behaving like one of Pavlov's dogs and going back to where you'd been very richly rewarded in the past, you realized that things had changed and avoided most of the pain.

Berkowitz: To some extent, the information that you glean from going through the filings is a bit like driving a car while you're looking through the rearview mirror. The past is a very helpful indicator — especially when it comes to evaluating a long-term management track record. But in terms of the potential ways in which a business can die — and in terms of how a business may have changed — it doesn't work.

And that may be one of the main reasons why some investors who were known for making money in the financial services companies went back and others didn't. In other words, if you relied on the historical records and assumed some kind of return to normalcy, it cost you dearly. In fact, some very smart people did wind up getting seduced by busted financials. And I think you're right — that it was a Pavlovian reaction.

ONE FINANCIAL COMPANY WE *HAVE* BOUGHT
THAT'S STILL BELOW 50% OF TANGIBLE BOOK.

Berkowitz: But we have *one* financial company. We've bought debt and stock of AmeriCredit — although we went in too early. By the way, before I go any further, I should tell you that I'll soon be a director. So I'd like to only discuss that which is public and common to the industry.

Anyway, we're going to wind up owning close to 30% of AmeriCredit, and Leucadia's going to wind up owning nearly 30%.

OID: Were those public or private transactions?

Berkowitz: Both. We made public purchases up to the limit, and then we did a deal with AmeriCredit where we control one senior class of bonds. So to help them with the securitization, we did two things: First, by selling them back some of their senior bonds in return for new equity, that allowed them to delever. So they're going to issue us a significant amount of stock to get us up to 1% less than Leucadia. And second, we invested $123 million in the B and C tranches of an auto loan securitization.

And by doing the securitization that we did (which is public) we wound up getting our shareholders a secured 18% per annum — that is overcollateralized initially by 24%

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FAIRHOLME FUND'S
BRUCE BERKOWITZ & CHARLIE FERNANDEZ
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and 2% cash. And on top of that, they gave us a $50 million corporate guarantee on the $123 million of debt. So it was a good deal for our shareholders.

OID: I somehow gathered that.

Berkowitz: And it was a good deal for AmeriCredit — because the company needed to securitize its existing loans from its warehouse line of credit.

In many industries, the way that securitizations work in general is that a company starts out with a warehouse line from a bank, which is their working capital. And that money is borrowed on the basis that the loans will be packaged and sold in the marketplace. Well, the securitization market is mostly frozen. AmeriCredit is the only subprime company in that industry I know of that achieved two securitizations since the trouble began.

And if you study the general covenants in warehouse lines, you'll see that companies can't hold loans for more than a year. So a company can be making all the right decisions, but face covenant issues given the fact that the clock is ticking as to how long they can hold the loans within their warehouse line. In the case of AmeriCredit, we offered them sufficient liquidity to at least keep going without needing to access the capital markets — at least for awhile. Incidentally, I do believe credit markets are starting to open — but at a steep price to the borrowers.

[Editor's note: According to Berkowitz, AmeriCredit renegotiated their warehouse lines last week — extending maturities and greatly loosening the covenants.]

OID: How does the current stock price grab you?

Berkowitz: I can't comment on that — although, frankly, I don't even know what the stock price is today....

OID: Around $5.00.

Berkowitz: Let me answer your question this way... The Fairholme Fund bought much of its stake in AmeriCredit at $6.02 in exchange for some of its senior unsecured bonds. And again, we also own securitized bonds yielding 18% per annum where we don't think there's a chance we'll lose any money on them.

But forget about all that. The reason why we purchased AmeriCredit common stock before we got involved in this securitization for our shareholders was their tangible book value. When we started, it was $16. And AmeriCredit's tangible book value is probably a good proxy for its liquidation value over time. Incidentally, it was last reported at $15 per share.

OID: So I guess the fact that it's trading at well below 50% of tangible book answers my question.

Berkowitz: Much of what we've been buying lately is being priced today like it's worth more dead than alive. And when we do a liquidation analysis on our holdings, we come up with net present values *significantly* higher than current stock prices. And I think that's true of many companies in various industries today.

OID: Gotcha. And it sounds like you're not worried about them burning through their capital...

Berkowitz: You just have to come up with an estimate for the time value of money. But I believe the average duration of a car loan is about 30 months. Remember Household International?

OID: Sure.

Berkowitz: Well, I learned an awful lot from that one. And one of the things I learned is that when you're a leveraged company and you start to face adversity in the credit markets — or the credit markets shut you down or shut down in toto — there's one thing you've got to do. And Buffett summed it up very well: "When you find yourself in a hole, the first thing you should do is stop digging."

You stop writing loans. And when you do that, less money starts to go out the front door and the same amount of money's still coming in — at least initially. Therefore, eventually the scale will tip. So you start to get much more money coming in than going out — which pretty much takes care of that issue.

OID: Which, again, is one of the reasons why you're more comfortable with equipment rental companies than other folks — because the same thing happens when they shrink their fleets.

Berkowitz: Exactly.

SOMETHING ELSE THAT'S VERY UNUSUAL TODAY — BUFFETT-LIKE EQUITY RETURNS FROM SENIOR DEBT.

OID: What else are you finding compelling today?

Berkowitz: Well, the senior debt of some of these companies is compelling today. The prices yield some *very* high returns.

[Editor's note: We noted the following corporate bond holdings in Fairholme Fund's November 30th, 2008 annual report:

- •Sears Roebuck Acceptance Corp. 6.25%, 05/01/2009
- •The Hertz Corp. 8.875%, 01/01/2014
- •United Rentals, Inc. 7.750%, 11/15/2013.]

Berkowitz: It's unbelievable. I've not seen yields on paying senior bonds like this before. In fact, I bought some bonds today — which I think are money good — at 27% per annum. Isn't that unbelievable?

OID: I think I could learn to live with it...

Berkowitz: So today, we're looking up and down the capital structures of companies and trying to marry, if it makes sense, the senior debt and equity of the company.

OID: And by buying both the equity and the debt, presumably you get added protection...

Berkowitz: That's what we're trying to do. The idea is that while I don't think we're wrong about the equity, if we *are* wrong, as senior bondholders, we'll wind up owning the company. Similarly, if we're right that the stock is dirt cheap and our biggest worry is that they're going to be taken over by somebody too cheap, we've been able to buy bonds with good covenants — so we get par or better in a change of control.

In the case of our rental companies, we're talking

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FAIRHOLME FUND'S
BRUCE BERKOWITZ & CHARLIE FERNANDEZ
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about bonds that have 3-4 years to maturity trading in the 50s, 60s, and 70s.

OID: It sure beats Treasuries.

Berkowitz: As I mentioned earlier, you can buy Hertz's stock today for less than 4 times free cash flow — and the senior debt to yield 18% or more per annum to maturity. So, at least for now, you can replicate the returns Buffett's earned over the long term without even owning an equity. In effect, you can earn outstanding equity returns at the debt level.

I can't tell you how much longer this will last, but it's one of the more unique characteristics of the environment we're in today.

[Editor's note: As we were heading to press, Berkowitz informed us that Hertz's debt was yielding over 25%.]

OID: And you don't have to worry as much about being taken out too cheap...

Berkowitz: That's right. If you have the appropriate bond covenant, you'll get paid off in full in the event of a change in control.

When we sold debt to AmeriCredit, we had a majority of a senior class of bonds — which gives you a bit more power. And AmeriCredit was happy to deleverage. As I mentioned, we also extended their freedom from the capital markets for awhile. In effect, we gave them some sweat-free time. But in return, they had to give us a Buffett-like price.

And the securitization was the first deal we've done on our own. And we're hoping to do at least a couple more.

OUR HEALTHCARE COMPANIES ARE DIRT CHEAP — AND IT'S NOT FOR ANY GOOD REASON.

OID: I understand that you've shifted the portfolio into some areas that are new for Fairholme...

Berkowitz: We've *dramatically* shifted the portfolio. For example, we were intensely in oil and gas with a 15% weighting in the portfolio — but it's now at 5%-7%. So we're underweighted in oil and gas today.

OID: Why did you get out?

Berkowitz: Because the stock prices of our energy holdings began to reflect a very rosy scenario for the price of oil — and Charlie convinced me that it was time to whittle our exposure down.

OID: So it really may not be nepotism...

Berkowitz: Again, I can *guarantee* you that it's not. And speaking of energy, it may even be time to rebuild our positions. Oil and gas stocks are starting to look *very* cheap again. But I do worry about increased royalty rates around the world — which, after all, is easily done with the stroke of a pen.

Do you remember, though, how we went heavily into telecommunications stocks for the first time ever — before we invested in oil and gas stocks?

OID: Of course. And I recall how your big positions there worked out beautifully.

Berkowitz: Well, we've now gone into three sectors that we've never been in before in any meaningful way.

OID: And do these sectors have names?

Berkowitz: Life, liberty and the pursuit of happiness. And under life, we've begun to buy health insurers and drug companies. Second, under liberty, we've begun to buy defense companies.

OID: And in the pursuit of happiness category?

Berkowitz: Try pursuing happiness if you don't have your health or you're not safe.

OID: Good point.

Berkowitz: So if you want to talk about sectors where we've backed up the truck, we should probably talk about healthcare and defense. Today, those account for the two largest pieces of our portfolio — and of the U.S. economy.

OID: And they're cheap?

Berkowitz: You bet. I can tell you about a few things at 6 times free cash flow.

OID: A 16% free cash flow yield doesn't sound like the worst thing in the world — other things being equal. Fire away...

Berkowitz: In healthcare, we have four companies — UnitedHealth, Wellpoint, Humana, and WellCare (which is more of a special situation.) And those four together have about 34% of the insured market on the government side.

OID: And you still think they're bargains.

Berkowitz: Definitely. Traditionally, anything under 10 times free cash flow has been in our buy range. The question of how much of a company to buy is dependent on the discount to that 10% free cash flow rate, the confidence we have in our assessment, and the liquidity of the security. We can't be in a lot of illiquid positions given that the Fairholme Fund, which comprises about $7 billion of the $10 billion we have under management, is a non-diversified mutual fund constrained by the Investment Company Act of 1940.

And the only other consideration is to what extent we'd rather have a package play of companies in a sector as opposed to being entirely in one company. Of course, we must compare each security to all others we own.

OID: Like Charlie Munger says...

Berkowitz: Exactly. But forget about what I think. You tell me if these things look like bargains to you. They're selling for something around 6 times free cash flow. And they're gaining business and raising prices.

OID: So far, so good.

Berkowitz: And their bonds are all selling at single-digit yields. So they're not viewed as having stressed-out credit structures. And they're getting ready to accommodate President Obama's desire to insure the uninsured.

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FAIRHOLME FUND'S
BRUCE BERKOWITZ & CHARLIE FERNANDEZ
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OID: If the picture's as rosy as you describe, why are they so cheap?

Berkowitz: I don't know. It's not like anybody can kill these companies.

OID: Why do you say that?

Berkowitz: Well, between these four companies and a few others, they own the lion's share of the market — with roughly a 90% share. And no one can really replace what they're doing. So it's not as if you have to worry about technological obsolescence. They're great companies and they really don't need any equity to run on.

OID: What about the risk of price controls?

Berkowitz: Well, there are times when government agencies do not agree to price increases. And when that happens, these companies just give the business back and say, "We can't do it at this price." And what I've seen happen is that a year or so later, the business just comes back at even higher pricing than they wanted.

Will there be price controls? It's possible. But I don't see it as very likely given the fact that at the end of the day, no company can be forced to do something at a loss for any length of time. The analogy is auto insurance. Health insurance is going the way of auto insurance.

OID: Where companies not infrequently leave states when the environment becomes overly hostile.

Berkowitz: That's right. And the reason why these companies' stocks are offering a 16% free cash flow yield today isn't because of excess profits. It's because the stocks have experienced severe price declines while the free cash flows have not.

AND WELLCARE'S MUCH CHEAPER STILL
— SO WE OWN EVERY SHARE THAT WE CAN.

OID: And it looks like WellCare is even cheaper — maybe down around 5 times free cash flow.

Berkowitz: What do you mean 5 times free cash flow? WellCare's trading at less than *4* times free cash flow — maybe even below *3* times free cash flow. Isn't that right, Charlie?

Fernandez: That's right — once their legal issues are behind them and they stop having to pay for all the lawyers and accountants and reserving for penalties.

OID: Why so cheap?

Berkowitz: The government investigations. They appear to have settled with Florida. They still have to settle with the U.S. government over not reporting overbillings in two of their divisions. We believe a partial settlement has been entered into the Federal court system. And usually, a judge acts within two months to accept or reject the settlement. In any case, a total settlement shouldn't be far off. And we expect it to be well within our understanding.

Of course, once WellCare concludes its legal issues — and the settlement reserves and outrageous legal and accounting bills stop — their true earnings power will become apparent. And today, the company is selling for less than half of the cash it has in the bank.

OID: Wow.

Berkowitz: Granted, a majority of that cash is going to be used over time to settle claims. But it's as simple as going to the company's website and looking at their quarterly statutory filings to see their generation of cash, their increased memberships, and their pricing. So it's all there. But there's a fear out there that since the investigation began, WellCare has not been a current filer with the SEC — so they're in default of SEC requirements in that regard. I don't think they're in default with any of the state insurance commissions. But you can see why it's easy for most people to stay away.

OID: You bet. But you're not staying away.

Berkowitz: You could say that. We own 19.9% of the company — and can't go any higher. We're constrained by the lowest exemption for ownership from each of the states — and our lowest rate is 20%. Therefore, we're hostage to the toughest state regulator. And the Fairholme Fund itself is limited to under 10% so as not to be considered an insurance company.

OID: But if you could, I gather you'd want to buy more?

Berkowitz: You bet. Really, it's just a fear of the unknown. Most people haven't done their homework.

OID: After you do all of your homework, what gives you comfort that the current price more than reflects the impact of the upcoming settlement?

Berkowitz: Well, to start with, they're making about $4 per share of free cash flow, excluding extraordinary legal and accounting expenses. They also have over $1 billion of cash in the bank — and their cash isn't being degraded. In addition, their membership numbers are up. They also recently did a deal with the state of Hawaii.

And Chuck Berg, who's running it now, is doing what he and Norm Payson did at Oxford Health during Oxford's legal difficulties. And they eventually wound up selling out at a nice premium to UnitedHealth. So we've seen this play before.

OID: And you like the way it ends.

Berkowitz: It's not different than the situation with Salomon Brothers and Warren Buffett years ago — and HealthSouth. In the history of these events, you've not seen one situation where the company was taken out or failed.

OID: Really!?

Berkowitz: Yeah. Why should the sins of a few hurt thousands of employees and millions of insureds? And the last thing the government needs right now is to take out a player in this arena when they're trying their best to move Medicare business to the health insurers. I mean, the health insurers are the only gatekeepers that can help reduce cost increases while maintaining quality of care and consumer choice. All the government really has the ability to do is to cut a check. So if you're on standard Medicare and the government writes the business directly, all the government can do is have the Treasury cut a check — and

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FAIRHOLME FUND'S
BRUCE BERKOWITZ & CHARLIE FERNANDEZ
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that's the end of it. Therefore, there's no way for them to realistically control cost inflation.

At least with the health insurers, there is some interaction with medical professionals to try and arrive at efficient solutions. So really the government is using the health insurers to rein in cost increases — the same way the companies who employ the insureds do. I mean, no large companies that I know administer their own health insurance plans. They don't have the systems, the facilities, the networks, or the economies of scale.

OID: Definitely. I mean, clearly, they wouldn't have remotely as much information or bargaining power.

Berkowitz: That's right.

OID: Plus, I'd imagine self-insuring would expose them to one public relations nightmare after another.

Berkowitz: Absolutely.

THE GOVERNMENT COULD DO SOMETHING STUPID.
BUT EVEN THEN, IT WOULD JUST BE A TIME OUT.

OID: So what you're saying is that it would take tremendous stupidity on the part of the government to hurt these companies.

Berkowitz: Well, yes. And, of course, phrasing it that way, it sounds like a highly likely event.

OID: You noticed.

Berkowitz: But Charlie tells me that President Obama has picked a significant number of people who'll be advising him on healthcare policy in his administration — and many are from the health insurance industry.

OID: Fascinating.

Berkowitz: We think so. And I don't think he would have picked all of these executives if he wasn't planning on using the health insurers as part of his solution.

OID: So you don't think it was a preemptive strike by President Obama against unemployment in the health insurer area once his healthcare policy is implemented?

Berkowitz: I don't think so.

Fernandez: Whenever you deal with anything related to government industry, it's not unusual to have the President talk about how he's going to cut this and he's going to cut that, but there's no substance. When you go back and you look at the Medicare cost reports and the CMS [Centers for Medicare and Medicaid Services] reports, it's just like the Stimulus Package — where at first blush, you think, "Oh, it's going to create or prevent 3-1/2 million jobs from being lost." But how do you quantify that?

It's the same with this Medicare bill that's up for debate. And when you analyze all of the details of it, half of the $300 billion of savings he's looking for over 10 years is coming from new taxes on the rich and the other half is basically about taking some of the programs into competitive bidding and reducing fraud.

OID: So what could turn these into a mistake?

Berkowitz: The big mistake for us will always be a bad assessment of the future free cash flows of our companies.

OID: And what could cause that?

Berkowitz: Some kind of extreme event that puts a freeze on prices while costs continue to rise or eliminates the insurers. And in that case, it would probably take a year for the government to figure out that it was a mistake. So there could be a one-year time out.

But beyond that, I can't think of any event — at least not over the next few years. And our independent analysts can't either when we ask them the question.

OID: Wow.

Berkowitz: And with the insureds — especially now that you have the baby boomers retiring and going over to Medicare at age 65 — you're talking about a very influential political force.

OID: And I understand almost every member votes.

Berkowitz: You bet. And when you start messing with people's healthcare when they're 65 or older, you're probably talking about the issue that's most important to them — even if health can't buy you money.

OID: Spoken like a true money manager. But isn't the political power of the insureds a double-edged sword? Isn't it likely to also drive down profitability — and keep it down?

Berkowitz: Absolutely. That is the current concern. That's a very important point. And that's the reason why these companies' stocks are being priced today as though there will be *no* profitability whatsoever in their dealings with the government. But to us, WellCare is just a layup.

By the way, here's another little tidbit that's also publicly available — we're the majority owner of WellCare's debt. In fact, we own a *super*-majority of their bank debt. They have about $150 million of bank debt — and we own more than two thirds of it.

Something else that's very interesting to us: WellCare's debt is in technical default today because they're not a current filer with the SEC — and it's coming due in May. And yet, interestingly, their debt is trading at around par.

OID: That is very interesting.

Berkowitz: So WellCare's another example of us marrying the equity of a company to its senior debt. And again, we've done that in part because one of the fears we have is that these companies are selling so cheaply that someday, a competitor may come in and steal them from us in a takeover or a private equity deal.

We look for senior debt with covenants that in the event of a change in control provide for the bonds to go into default and be repaid at par — or a cross default whereby a default of any other debt issue would cause a default of the bonds we own.

We didn't do that with UnitedHealth or Wellpoint for two reasons — both because their debt was only providing single-digit yields and because it was too big for us to control the class. When we bought a majority of WellCare's $153 million of total bank debt, it was yielding 13%. And,

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FAIRHOLME FUND'S
BRUCE BERKOWITZ & CHARLIE FERNANDEZ
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by the way, WellCare has no other debt.

OID: Very interesting.

[Editor's note: Shortly before going to press, Berkowitz informed us that WellCare now needs only to file its 2008 10-K to be current. Moreover, the company has given an estimate of the reserves set aside for the settlement, which is less than Fairholme thought it would be.]

PEOPLE ARE STILL FREAKED OUT ABOUT LIPITOR — BUT ITS SALES WON'T DISAPPEAR ENTIRELY.

OID: Within the pharma area, I see that Pfizer's your largest position by far. In fact, as of November 30th, you had nearly 19% of the Fairholme Fund in it.

Berkowitz: Yep. Pfizer's generating $17 billion a year of free cash flow and is selling at 7 times free cash flow. It has a AAA credit rating and a sterling balance sheet. And that's for the largest pharmaceutical company in the world with the #1 global distribution system.

OID; Sounds like it could have a certain appeal...

Berkowitz: We've spent a lot of time on Pfizer — and we think their CEO is misunderstood. And besides that, you're going to see something different from them.

OID: How so?

Berkowitz: They recognize that they had given away their generic business in the past. When their patents had expired, they'd pretty much given the business away to Indian or Israeli companies. And that's not going to happen anymore. We think that Pfizer's going to become the largest player in generic drugs over time.

OID: That's interesting.

Berkowitz: Generic margins are what, Charlie — 20%-25%?

Fernandez: That's right.

OID: Versus...

Fernandez: Versus 74% to 78% for the original compound.

Berkowitz: It's only a third, but what's wrong with a 20%+ profit margin — at least, after recovering the huge costs associated with developing all new drugs?

OID: Everything's relative.

Berkowitz: Everything is relative. But that's the mistake they've made in the past — just giving away that business with its 20%-25% margins, despite already having the necessary distribution channels in place.

OID: In other words, that's a lot more than nothing.

Berkowitz: Exactly. There's always a trade-off between price and volume. And in the past, price has won. They'd rather have a small chunk left at 74% or more. But the way the world is working today, I'd think that they'd be very happy to have the generic business with its 20%+ margins. And the world seems to be pricing their stock [chuckling] for much less.

OID: All of that sounds good, but another contributor walked us through what was left of Pfizer after their upcoming patent expirations — and it wasn't pretty. As I recall, their free cash flow virtually evaporated. It was almost like they were starting over.

Fernandez: I haven't seen that analysis. But I can tell you that based on our analysis — which is quite similar to a lot of other analysts' numbers — if Lipitor went to zero and wound up not being replaced with anything, it'd represent lost free cash flow for Pfizer of around 37¢ per share.

OID: Wow. That is less than we thought... But that said, presumably, they're still looking to soften the blow through their Wyeth acquisition.

Fernandez: Before the Wyeth acquisition, we were assuming that with Lipitor, Pfizer's free cash flow in 2009 would be up near $2.50 — and that if Pfizer didn't replace it with any new drugs, they would still have free cash flow of $2.00.

Berkowitz: But short-term, Pfizer's acquisition of Wyeth lowers our 2009 estimate of free cash flow per share from $2.50 down to $2.00 with Lipitor. And that's based both on the higher short-term tax rate — from Pfizer having to repatriate some cash from its non-U.S subsidiaries for the deal — as well as the initial dilution.

Fernandez: The absolute highest figure I'd seen for Lipitor is that it accounted for no more than 20% of Pfizer's free cash flow. That was a worst case scenario.

Berkowitz: And that's not including any contribution whatsoever from Lipitor, a Lipitor generic, or other Lipitor formularies, or any success whatsoever from their pre-Wyeth acquisition pipeline — which, as you know, is very large.

Fernandez: That's right. And Lipitor's sales won't go to zero. There's always some residual sales left over from a compound after it goes off patent. We're assuming that they'll keep about 10%. These companies usually wind up keeping somewhere between 25% and 30%, but we wanted our numbers to be extremely conservative.

Of course, Lipitor's a blockbuster product — representing well over $10 billion of revenues. But Pfizer is getting new approvals all the time. For example, they received five new approvals in 2008. And all of those are expected to be $50 to $200 million products. But they have hundreds of new products in their pipeline. And once you add up their impact, it starts to make a difference.

OID: And it's been suggested to us that blockbusters often come from unexpected sources.

Berkowitz: Investors are still freaked out about Lipitor and don't understand that without taking into account the Wyeth acquisition, Pfizer has 14,000 or 15,000 different drugs and something like 60,000 different variations.

And even though Lipitor is a gigantic seller for Pfizer, all of a sudden they're learning that Lipitor dramatically reduces the incidence of heart attacks. So they have a shot at repatenting Lipitor for that purpose.

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FAIRHOLME FUND'S
BRUCE BERKOWITZ & CHARLIE FERNANDEZ
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OID: Really!?!

Berkowitz: Yes.

Fernandez: If you have a compound — and let's use Lipitor as an example — and they come up with a new purpose, there's usually a new dosage and some slight variation in the formula. In that case, the company can refile the compound for a new patent.

For example, one very well known compound being repatented is Ambien and Ambien CR. The CR stands for Continuous Release.

Berkowitz: And Ambien CR is a different formula.

Fernandez: So because it's a different formula, they may get a patent extension.

[Editor's note: In Obama's budget proposal, they talk about eliminating the patent extension rules.]

OID: Wow.

Berkowitz: Every different use, every different dosage, and every different type of delivery mechanism can constitute a different formula. And one drug can have what — 10, 15, 20 different formulas?

Fernandez: Even more.

OID: But even if that's the case, if another company is producing a generic and they produce a timed release version of it, wouldn't the margins wind up really getting slashed anyway?

Fernandez: The difference is that the producers of the generic compounds wouldn't be able to sell them in the U.S. and Europe. In Asia and elsewhere, it would be a little bit more difficult to enforce the patent protection. But in those countries, the manufacturer of the generic version would not be able to legally produce that formula.

OID: Even if the original patent has expired. That's very interesting.

KINDLER'S BEEN RATED ONE OF THE *WORST* CEOS — BUT WE BELIEVE THAT HE'S ONE OF THE *BEST*.

Fernandez: Under Kindler as CEO, Pfizer created a new division about two-and-a-half years ago to handle their generic products with a separate sales force, etc. And they're running it independently, too. So they're not intermixing it — which I think is a very smart thing to do. I mean, if you were a salesperson at Pfizer, which would you rather sell — something that's easier to sell because you're the only one who has it, or something that others have, too? You really need a different sales force and a different infrastructure altogether in order to be successful in the generic world.

Berkowitz: And some of the consultants we employ tell us that some of Pfizer's manufacturing facilities are switching over to generic production and actively hiring.

Fernandez: And on the marketing side, they've apparently hired regional marketing people away from some generic companies — which we find quite impressive. And it's something that doesn't get a lot of press in a company with 80,000 employees.

Berkowitz: Did the press even pick it up, Charlie?

Fernandez: I haven't read it. I think they did cover it though in one trade magazine eight or nine months ago — a story about Pfizer hiring a vice president of sales for a U.S. region from a major generic competitor. But that's because it was a high profile hire. Otherwise, I've basically seen nothing.

OID: Yeah. In fact, the first thing I heard about them focusing on generics was from you guys. And to me, at least, that's very interesting.

Berkowitz: It's very interesting to us, too. And this is not top secret stuff. But now, with the coloring we're giving you, go back to Pfizer's website and listen to Kindler's last presentation and you'll hear every word of it. It's just that it's so foreign to the way people think about Pfizer — and that Kindler was voted one of the worst CEOs in the world, I think, last year.

We think he's one of the *best* CEOs in the country. And we have clients who worked with him when he was much younger who've given us good feedback. I can tell you that his paper trail's quite good. So he's no dummy. And Kindler's also on the board of Exxon — and I understand he gets very high marks as a board member. He's considered one of the most astute members on ExxonMobil's board.

OID: Not that either of us take CEO ratings seriously — since they're probably a better contrary indicator than anything else — but what is it that he's done exactly to be considered one of the worst CEOs?

Berkowitz: I don't know. I never pay attention to 'em either. But we've met the guy. And we were lucky. He doesn't meet a lot of people. But there are people out there who are concerned.

OID: What are they most concerned about?

Fernandez: Basically, for a very long time, the pharmaceutical industry was a gentleman's club that was run by scientists. And Kindler is not a scientist — he's an operator and a cost cutter. But a lot of people got used to the way it used to be — where it was a gentleman's game and wasn't as competitive as it has now become.

And because it had been that way for so many years, it allowed other companies to create a new industry within the industry — which is the generic industry. They always had new drugs coming on. So why mess with a product with a 20%-25% margin when you could focus on products that would make you 74%-78%. And again, the companies were being run by scientists.

So companies like Pfizer, Merck, and Bristol-Myers got fat. They weren't lean and mean.

Berkowitz: And Charlie brings up a very good point, because Kindler has done a *lot* of cost cutting — and there's more to come. We don't expect all of it will drop to the bottom line, though.

OID: So you think Kindler's generally done a good job...

Berkowitz: That's right.

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FAIRHOLME FUND'S
BRUCE BERKOWITZ & CHARLIE FERNANDEZ
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Fernandez: Distribution is so important in the pharmaceutical industry — especially in the U.S. It's *extremely* expensive. And there's a large component of cost relative to the cost of the product between the time it leaves a manufacturing plant and winds up in a plastic prescription bottle. And it varies by state and even within states. Only certain companies are allowed to distribute.

It's a very complicated process — similar to the liquor industry — from the time a drug is manufactured and comes off the line to the time it gets to the pharmacy. It's not like they're just throwing it on the back of a truck and delivering it wherever they want.

OID: And presumably, it's very heavily regulated.

Fernandez: *Very* heavily regulated. And because it's so heavily regulated, it's expensive. And when you talk about the major pharma companies in the U.S., obviously, there's no one with more distribution muscle than Pfizer. They're the clear leader.

THE WYETH DEAL IS ACCRETIVE 18-24 MONTHS OUT
— AND IT TAKES AWAY THE PATENT CLIFF IN 2012.

OID: What's your view on Pfizer's purchase of Wyeth?

Berkowitz: Just as Charlie Munger compares all capital allocation decisions to a base case, Jeff Kindler says that he compares all potential acquisitions to the alternative of acquiring more of his own company with share buybacks. So we believe his analysis must show a better future with Wyeth — or he wouldn't be doing it. And Kindler's under-promised and over-delivered thus far. So we'll take Kindler at his word for now when he says that the deal is at least a push.

Fernandez: Yeah. At the very least, it takes away the patent cliff that Pfizer would otherwise have to face in 2012 when Lipitor and a handful of other major products are set to go off patent.

Berkowitz: The way that I look at the Wyeth deal is that it can't hurt and it may help a lot. We believe Pfizer has more potential upside after the Wyeth acquisition.

(continued in next column)

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OID: Yeah. I just assumed that Pfizer had paid up for Wyeth. But I was very surprised to see that based on my back-of-the-envelope analysis, it actually appeared to be accretive a few years out.

Fernandez: Yeah. Kindler has said that he expects it to be accretive after 18-24 months. I know that in this market companies can apparently never do *anything* right. But I think it's a good deal. Needless to say, it also becomes accretive because of the cost reductions and synergies.

Berkowitz: Because a third of the acquisition price was paid in cash which Pfizer repatriated from its non-U.S. subsidiaries, the company has to pay taxes on that cash — which dramatically increases its overall tax rate for the coming year. So as I mentioned earlier, in the short run, Pfizer's acquisition of Wyeth lowers our 2009 estimate of free cash flow per share from $2.50 down to $2.00 based on the higher short-term tax rate as well as the initial dilution.

However, when we look forward to 2012, our estimate of Pfizer's free cash flow gets back to $2.50 — versus our estimate of around $2.00 before the Wyeth acquisition.

THE PHARMAS HAVE VERY DEEP POCKETS
WHICH IS GOOD — BECAUSE THEY'LL NEED 'EM.

OID: I think we could spend the entire issue on the unknowns in this industry without exhausting them — or even covering them adequately. But I guess they include illegal importation of generics, legal liabilities, unfavorable regulation, the fact that there are different patent laws in different countries, etc. Many, many issues muddy the water in this industry.

Fernandez: Yes. And when you say they "muddy the water", you're being kind — because it's a nightmare.

OID: Absolutely.

Fernandez: We're not predicting these companies won't face some extremely strong headwinds given the incredible increases in healthcare costs. Everybody's going to get nicked — including the pharmaceutical companies and the health insurers, And that's in our modeling.

OID: So you obviously feel like you're being adequately compensated for it.

Fernandez: Exactly.

OID: It's certainly harder to argue you're not being compensated for those issues at 7 times free cash flow than it is at 15 times free cash flow.

Fernandez: Bingo.

OID: So if we were to ask you what you believe could turn Pfizer into a mistake, I imagine that you'd say, "any number of things".

Fernandez: Correct — although the biggest risk in the whole pharmaceutical industry is obviously having a drug where you wind up learning it has a major adverse effect after it's already been given to millions of people. I mean, there's obviously a human and moral component. But then you have the fleet of class action lawsuits that follow. And of course, those can be extremely costly and painful — not only financially, but also in terms of taking away focus.

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BRUCE BERKOWITZ & CHARLIE FERNANDEZ
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OID: And how big a risk do you view that as being?

Fernandez: I used to know the exact percentage — because I once worked with the insurance companies that insure new products. It's well under a third of 1% of sales. But every drug that's proprietary — and generics are a little different — has a study that's attached to it in which they estimate mortality rates and so forth. Nobody can make a drug that will cause exactly the same reaction in 100 million different people. It just doesn't work that way. It can adversely affect one person and not adversely affect the other 99.999 million people.

OID: So the protection is in the profitability — plus the warning label, presumably.

Fernandez: That's right. If you see the ads and read the fine print on the next page — or you look at the brochure that comes with your medication — basically no matter what you take, you'll see that it seems like there are 500 different possible side effects.

OID: I understand that the Physicians Desk Reference has more pages devoted to warnings and side effects than everything else combined.

Fernandez: That's correct — by a *very* wide margin. But all of these companies are very careful. They really do take a lot of care. And they do plan for potential claims on each drug and price accordingly.

OID: Again, I won't try to touch on all of the negatives — because we don't have remotely enough pages. However, Semper Vic Partners' Tom Russo tells us that one of the things the pharmaceutical companies historically relied on for protection was something called the learned intermediary rule, as I recall — where the consumer was relying on a physician to determine whether they should take it.

Fernandez: That's correct.

OID: And he said that historically, that had been a reliable source of legal protection for the pharmas. But he said that once these companies began to advertise directly to the consumer, he had less confidence in that barrier — despite the disclaimer, and the fact that they always say, "Ask your doctor if such and such is right for you" and then mention a bunch of side effects.

Fernandez: When I was in the pharma business, that was always one of our defenses. But as you know, one of the advantages that these companies have is their enormously deep pockets.

OID: Like tobacco companies...

Fernandez: Yep. But one major difference is the pharmas do save lives.

OID: Could I ask the most you've paid for Pfizer?

Berkowitz: Up to $21 and down to $14 and change.

A ROCK SOLID SPECIALTY PHARMA
AT *6* TIMES FREE CASH FLOW...

OID: Is there anything else compelling in pharma?

Berkowitz: Over time, we've owned others. But as you know, we practice selling that which is cheap to buy that which is cheaper. For example, we had a very big position in Mylan, but we swapped out of all of it to buy Forest Labs. Mylan just didn't have the balance sheet of a Forest or a Pfizer.

OID: Is Forest Labs equally compelling?

Berkowitz: It is. It's a little bit of a different animal in that it's a smaller company. But it doesn't have $1 of debt — and it has a couple billion dollars of cash. And the last time we looked, they were aggressively buying back their stock — and doing it better than most.

A lot of people stay away from Forest because it has an 80-year-old chairman who is deemed to control the company, although he doesn't have a large ownership stake. If the credit markets were different, the Forests of the world would not exist.

OID: Because they'd be acquired by someone else.

Berkowitz: If a company like Forest can be bought at 8 times free cash flow, who *wouldn't* want to buy it at that price? The point is that you *couldn't* buy it at that price. Lots of players would do it in 10 seconds if they could buy it at *10* times free cash flow.

OID: And it looks to me like it may actually be selling at less than 7 times free cash flow.

Fernandez: Yeah. We're assuming free cash flow of $3.50 a share for their fiscal year ending in March.

OID: So we're talking about a free cash flow multiple of a little over 6 times...

Berkowitz: Call it 7, call it 6...

OID: Does Forest pay a dividend?

Fernandez: No, they don't. But they've continued to buy their stock back aggressively.

OID: What's the biggest difference in your mind between these two companies — aside from scale?

Fernandez: Forest is a specialty pharmaceutical company that operates in a niche within a huge industry. Pfizer is different in that it has a product line which is both very deep and very diversified.

OID: So you think your returns from Pfizer are more likely to come from it just doing smart things and being recognized for it, whereas your returns from Forest are more likely to result from it being acquired one day once the capital markets return to normal.

Fernandez: Correct. Also, 60% of Forest's people are in sales and marketing — versus about 14% for Pfizer. So you're not very likely to see Forest developing new drugs. You will see them acquire drugs from smaller companies that need distribution, though.

And getting back to the expensive and complicated distribution process, if you're one of the smaller companies, you really have to bring in a Forest Labs — because if you

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FAIRHOLME FUND'S
BRUCE BERKOWITZ & CHARLIE FERNANDEZ
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only have 10 or 15 or 20 products, even if you're operating with a 78% margin, you wouldn't be able to afford to live off of those products because of the regulation.

So that's also one of the reasons why we like Forest — because Forest takes on a lot of companies that want an exclusive. And the larger companies like Bristol or Pfizer *can't* offer them an exclusive, because they have so many products that the smaller companies' product is bound to be competitive with something they already have. And the smaller companies feel, "Hey, if you have something that's somewhat competitive with something I'm bringing you, I'm always going to be a second class citizen."

OID: A stepchild.
Fernandez: Exactly.

ANY DAMN FOOL COULD RUN THESE COMPANIES — AND THEY HAVE. THEY'RE THAT GOOD.

OID: Do you have a free cash flow multiple range in mind where you think these companies would be valued fairly?
Fernandez: Not really. But with Forest generating free cash flow of $3.50 per share and rising, I can tell you that we feel very comfortable at today's price. As you know, prior to 2008, the pharmas were trading up around 12 to 15 times free cash flow.

OID: And 20 or more times free cash flow for much of the '80s and '90s.
Fernandez: Yep. But whether or not Forest is worth 15 times free cash flow or more, I'll leave to others.

OID: But I gather that you think it's worth a hell of a lot more than the current price.
Fernandez: Absolutely.

OID: Is there anything else you want to tell us about Pfizer and Forest or the pharma industry in general?
Fernandez: Just that it's no coincidence that Pfizer and Forest have conservative balance sheets. We intentionally picked pharmas that could afford to weather much adversity without being affected.

Berkowitz: All of the free cash flow multiples we're talking about now aren't based on a return to normalcy. For example, a year ago, we made a mistake buying Mohawk and USG at good prices based on their earnings in an average economy. So we're just factoring in today's environment and assuming it's going to continue. That's why we've tried to stay with *extremely* solid balance sheets — except in the case of the rental or finance companies where we thought there were some good reasons why we could go with more leveraged balance sheets.

The drug companies are just rock solid. If anything, as I mentioned earlier, you could fault them over the years for their bloated cost structure and their poor capital allocation such as overpaying for acquisitions, paying too much in their stock buybacks, etc.

OID: Along with lots of other folks...
Berkowitz: Yeah. The health insurers are definitely guilty of very bad capital allocation decisions. They bought billions and billions of their stock back at three times the current price. And today, they're not buying back as much. So when the sun was shining, they weren't worried about anything. And now that there are some clouds, they worry about buying it back despite the fact that it's dirt cheap. So if there's anything you can justifiably criticize the health insurers for, it's the really terrible job they've done managing the unbelievable cash flows they've received over the years — because if you look at these companies' balance sheets, you see that they basically have no tangible assets. All of their assets are goodwill from the rolling up of the industry — the consolidation that's gone on. So it's all air.

But of course, if you look at the best companies, like a Coca-Cola, the less assets they have the better. The reinvestment requirement just isn't there. And therefore, the income statement provides a much truer picture of those companies' free cash flows.

OID: And that can be great — assuming that the demand and the margins are there, certainly.
Berkowitz: Right. And it's the same with the health insurers. They don't have much in the way of a tangible equity base. The only one that has a good tangible equity base now is WellCare — because of all of the cash that they have in the bank. [We all laugh.]

Also, the health insurers have gotten caught up in stock option scandals — especially UnitedHealth. But those executives are no longer there. So when we dig into the numbers, we've studied the past mistakes of these companies. And that's another reason why we haven't put all of our eggs in one basket.

But for the most part, we really think to some extent that we've gone into businesses that idiot nephews not only *could* run, but *have* run in the past.

GIVEN THE CURRENT GEOPOLITICAL REALITIES, DEFENSE SPENDING WON'T BE CUT ANY TIME SOON.

OID: You also mentioned that you've gone heavily into the defense area...
Berkowitz: That's right. The defense companies are priced pretty much like the health companies. And the defense area is another new sector for us. I'd never bought a defense company. But the largest customer in these businesses is the U.S. government. And one thing you know about the U.S. government is that they're an excellent payer. If worst comes to worst, all Uncle Sam has to do is keep our printing presses going. And if there aren't enough printing presses, we'll just add a few more.

OID: Or add a zero or two to the denomination...
Berkowitz: Exactly — which means we're likely to see a whole different environment a few years from now.

OID: Yes, indeed. But which defense companies have you focused on?

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FAIRHOLME FUND'S
BRUCE BERKOWITZ & CHARLIE FERNANDEZ
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Berkowitz: We've focused on Northrop Grumman, Boeing, Spirit AeroSystems, and General Dynamics.

OID: How cheap are those companies?

Berkowitz: Believe it or not, our defense companies are trading at something around 6 times free cash flow, too. In fact, *most* of our companies' stocks seem to be gravitating to the neighborhood of 6-8 times free cash flow — which I would never have believed even two years ago.

And when you think about it, for example, 97% of Northrop's business is with the government. So pretty much whatever you call it, it winds up being cost plus. Much of it's secret — you don't know everything that they're doing. And in the same way the health insurers constitute the healthcare system in the U.S., a half-a-dozen defense companies really constitute the country's defense. It's pretty much privatized.

And once these companies get an order and a piece of equipment becomes standard, then it's theirs to maintain and update and keep track of. Nobody else is going to get the contract. And in the commercial and defense area, for every $1 spent on purchasing the equipment, there can be as much as $7 spent on maintaining it during its lifetime. By the way, Boeing's 50% defense and Spirit's less than 10%.

Fernandez: That $7 is for ships. I know that it's a big number in aerospace, too. I just don't know exactly what it is.

Berkowitz: But clearly for every $1 spent on the equipment itself, multiples of that are spent maintaining it. It's roughly the same on average.

Fernandez: I think that's safe to say.

Berkowitz: And a non-U.S. company isn't going to get it. Look at the fight that's going on with the refueling plane. That was supposed to be between Northrop and Airbus — and that was pulled back from Airbus. In this environment with so many people losing jobs, do you really think we're going to give Airbus all of that?

OID: Sounds like a pretty safe bet right now...

Berkowitz: No one seems to appreciate that, to a large extent, it doesn't really matter what the economy is doing. Nobody wants another terrorist attack to occur in the U.S., or for the U.S. to lose the "war on terror" on their watch.

OID: On the other hand, without a "war monger" in the White House, won't there be a lot more peace and a lot less need for weapons of all types?

Berkowitz: No. There are millions of people who want to hurt us and many ways they can accomplish it. And we've got thousands of miles of borders.

Let me tell you a story: I bought a house on Key Biscayne Bay. And on the day of the transaction, the owner had to pack up and leave for Oregon. So he gets up while it's still pitch black and starts loading a small truck which then goes to a central location in Miami to get loaded onto a big 18-wheeler as part of another moving load. And he wants to finish in time for his scheduled flight. And when he arrives at the warehouse 15 minutes later, a spotlight from the sky comes down on him and the police have surrounded the place.

And it's not because it's a high crime area. I don't think our law enforcement agencies were worried about some kind of a home robbery. But someone was watching him from the sky packing up a house which happens to be on the ocean with a dock and then moving boxes to a central location.

OID: Wow.

Berkowitz: The amount of homeland security work that's being done now — underwater, above water, and overground — is absolutely amazing. And it's just going to get bigger and bigger and bigger. The more that we pull in our horns from foreign places, the more the focus is going to be on our home turf here in the U.S.

OID: Spoken like a defense company shareholder.

Berkowitz: One interesting argument about Iraq was that it kept our enemies focused on Iraq and not the U.S.

OID: In other words, our need to spend lots of money on defense isn't about to end any time soon — and we're going to need to spend more money on defense over time, not less.

Berkowitz: Exactly. And if you do some research, you'll see that the defense budget for this year has already been passed — and that it's bigger than ever.

Fernandez: Yeah, with an increase of almost 7%, including the war supplements and defense-related items in the energy department budget.

Berkowitz: And I don't think that's going to change any time soon.

DESPITE BEING OLIGOPOLISTS,
THESE COMPANIES ARE DIRT CHEAP, TOO.

OID: Can you give me the thumbnail on those three?

Berkowitz: Yeah, sure.

Fernandez: Our estimate for Northrop's free cash flow in 2009 is $6.00 per share. Their earnings per share are less — in the neighborhood of $5.00 — because of the way the accounting works.

Berkowitz: So Northrop Grumman's trading at less than 7 times free cash flow.

Fernandez: That's right.

OID: And Boeing?

Berkowitz: By revenues, Boeing's about 50% defense and 50% commercial — unlike Northrop Grumman which is almost entirely defense. Plus, Boeing has the DreamLiner0 — the new 787 — which, even with its delays, looks like it's going to be a great plane. For example, it's supposed to be between 20% and 30% more fuel efficient than today's commercial fleets.

OID: Is it more fuel efficient than the offerings of Boeing's competitors?

Berkowitz: Great question. And the answer is that

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FAIRHOLME FUND'S
BRUCE BERKOWITZ & CHARLIE FERNANDEZ
(cont'd from preceding page)

today, there *is* no competitive offering — aside from unprofitable deals on yesterday's technology from AirBus.

OID: Sounds like that could be a pretty big deal...

Berkowitz: I think it is — especially in an environment with higher oil prices. Incidentally, Boeing's DreamLiner is being built with composites and advanced aerodynamics and high-tech equipment. That's what gives the plane its fuel efficiency, its beauty, and its luxury. The competitors aren't as fuel efficient, they're not as luxurious, and they don't incorporate the latest technology.

Anyway, we're estimating free cash flow per share for Boeing of about $5.00 in 2009 — which is less than our last estimate due to pension fund asset declines. And their free cash flow is growing. So there, we're talking less than 7 times free cash flow.

OID: Even better, I gather you're saying it's less than 7 times slightly depressed free cash flow.

Fernandez: That's right.

OID: And Spirit?

Berkowitz: Spirit is a parts supplier that used to be part of Boeing. They build wings, fuselages, noses, and other components for Boeing and now Airbus. And they're in the development process to produce state-of-the-art wings for General Dynamics' Gulfstream division.

And Spirit's stock has been crushed, due to an almost 2-year delay in the 787 Dreamliner. But we're looking for Spirit to have more than $2.00 per share of free cash flow. So we're talking about a stock that's selling for something around 5 times free cash flow.

OID: Cool.

Berkowitz: And during the fourth quarter, we also began buying General Dynamics. All told, our defense and aerospace companies now have in total a backlog of around half a trillion dollars of government defense work.

SEARS IS STILL A COMPELLING BARGAIN — TRADING AT A HUGE DISCOUNT TO LIQUIDATION VALUE.

OID: Could you tell us some of your thoughts on Sears beginning with whether or not you still think it's a compelling bargain?

Berkowitz: Yeah, it's still a compelling bargain today. But I also have to confess that we thought it was a compelling bargain at twice the price. We looked at the free cash flow of the company, but we went into it based on the liquidation values of the pieces — and we factored in its liquidation value in the context of difficult times. And there are about $11.3 billion in inventories and $4.4 billion in payables. So there's about $7 billion net.

OID: And like Buffett says, you can rest assured that 100% of those payables are good.

Berkowitz: And if you mark their inventories down by a third and subtract their $4.4 billion in payables, that's a little over $3 billion. Then, divided by 122 million shares, that's about $25 per share. And that's just their inventory.

[Editor's note: According to Sears' year-end SEC filing, inventories have shrunk to $8.8 billion and payables to $3 billion.]

OID: Sounds like a good start.

Berkowitz: Plus, we also spent a lot of time trying to understand Sears' real estate. And Sears has 120 million or so square feet of real estate of which probably 20% is worth 80% of the value — whether it's near the beach in California or in city centers like Pasadena or Coral Gables. Some of Sears' real estate is located in prime locations. And it's tough because some of it's owned, whereas there are also a lot of leases at Kmart. But Kmart went through bankruptcy. So you would think that they'd have tossed all of the bad leases in bankruptcy and kept all the good stuff. But the value of their real estate alone is much more than Sears' market value — even in today's depressed real estate environment.

OID: Wow.

Berkowitz: So for every share, you're getting a square foot of real estate plus other goodies.

Fernandez: And that square foot of real estate — depending, of course, on the location — could be valued at anywhere from $10 to $1,000. And that's on a $40 stock.

Berkowitz: Then we looked at the brand. And I believe they paid over $1 billion for Lands' End a bunch of years ago — and the brand has held up. So if you take another $1 billion and divide it by 122 million shares, you get another $8 a share. And that's not including their Kenmore, Craftsman, and DieHard brands which are still legitimate brands that are part of Americana — except that Sears kind of blew it by only distributing their own brands. Needless to say, those brands would probably be worth a lot more if they were distributed by others, too.

OID: Although that presumably would have had negative implications for their retail operations...

Berkowitz: But it shouldn't have much effect on their real estate — because every single piece of property they own has been studied for a higher and better use. Just because it's currently housing a Sears or a Kmart doesn't mean it has to remain that way.

Clearly retail values have gone down — but they haven't gone to zero.

OID: How did you calculate your inventory liquidation value?

Fernandez: We spoke to a consultant who specializes in retail inventory analysis. He's retired now, but we believe that he's one of the best in the country. And he said that in his opinion, the way that Sears maintains its inventory is very, very conservative.

He tells us that other major retailers who are really focused on being retailers tend to bump up the value of their inventory — which he believes is in stark contrast to Sears which has been doing exactly the opposite. He says he thinks that Sears has been extremely conservative in

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FAIRHOLME FUND'S
BRUCE BERKOWITZ & CHARLIE FERNANDEZ
(cont'd from preceding page)

how they book their inventory.

And he's talking about liquidation value, not the balance sheet. On the balance sheet, it's cost. And that's what we're using.

OID: Gotcha.

Fernandez: And the other thing to remember is that Sears doesn't keep its inventory on hand for three years. They keep their inventory fairly fresh — especially with their big push into consumer electronics.

OID: Since you mentioned it, what have you guys come up with in terms of liquidation value per share?

Berkowitz: I think book value is a pretty conservative proxy for liquidation value. There's little or no goodwill. So I don't think there's much fluff in Sears' book value.

[Editor's note: According to their latest SEC filing, Sears' book value is $77.00 per share.]

OID: As of November 2008, it looks to me like goodwill and other intangible assets totaled about $5 billion — or about $42 per share.

Berkowitz: Sears' brands do have value. But in a liquidation analysis, you'd probably want to cut it in half.

OID: How would you assess Sears' credit?

Berkowitz: Their credit's *great*. The rating agencies don't agree...

OID: Please don't confuse me with somebody who gives a damn there.

Berkowitz: But look at the total debt — net of cash — of $3.3 billion that they have on the balance sheet today. And look at their pension fund obligations of $1+ billion. It's really not that significant compared to the total assets and revenues of the company. So Eddie Lampert's done a good job with Sears' balance sheet. It's in pretty good shape. And the price of their debt in no way reflects their ratings.

But the interesting thing to me about Sears is that they're followed by retail analysts. I don't think you have any Berkshire Hathaway-type experts making comments on Sears.

OID: So even though they're in front of the Wal-Mart and Costco steamrollers, among others, liquidation isn't such a bad thing — at least not given Sears' current stock price.

Berkowitz: Exactly. I think it's as simple as that.

AT TODAY'S PRICE, LAMPERT CAN ADD VALUE
BY SIMPLY REPURCHASING HIS OWN SHARES.

Berkowitz: I mean, we never went into Sears thinking that Lampert was going to transform Sears and Kmart into great retailers.

OID: So you're not delusional.

Berkowitz: Hopefully not. All we know is that the continued volatility in the price of Sears' stock — especially with it declining to its current level — is just hugely beneficial to all Sears' shareholders right now. I mean, all Lampert has to do is continue finding higher and better uses for the company's assets and keep buying stock back. And when you think about what a single share of Sears gets you today...

And while those free cash flows from the liquidation of assets will be diminishing — especially in a difficult time and as the company gets smaller — the diminution in value has not been anywhere near what's being implied by the current stock price. Sears is being valued as if it's some kind of leveraged financial company that's in trouble.

OID: And it's not?

Berkowitz: Sears' debt is low relative to its assets.

Then with the huge inventories that turn... I've got to tell you, I don't care what the Kmart looks like in Bridgehampton, New York — even though it's a great store. It's a nice piece of property in Bridgehampton — and it's the only game in town. And there are others like it. So as we hire more and more people to give us their views of Sears' real estate... I mean, we tried to go to tax assessors' offices around the country. And so much of that is on electronic files. For example, you can search online and find most of the Sears and Kmart stores in Florida and then go in and see what they pay in taxes. And that can provide you with a pretty conservative estimate of their value. But of course, we've cut the values more over the last eight months given what's been going on.

OID: You say that Sears isn't heavily leveraged. But the balance sheet I'm looking at shows $28 billion of assets and $18 billion of liabilities.

Berkowitz: But that still leaves $10 billion of shareholders equity — which would be something in excess of $80 per share. So it's trading down around 50% of book despite carrying its real estate at cost.

[Editor's note: As we were about to go to press, Sears came out with an updated balance sheet, which Berkowitz discussed with us:

Berkowitz: Sears' most recent balance sheet shows that its inventories and its debt have shrunk. According to their year-end SEC filing, Sears has roughly $25+ billion of assets and about $16 billion of liabilities which nets out to roughly $9 billion — which is down a half billion or so due to the severe degradation in their pension fund. The pension fund liabilities went up by $800 million and debt went down $500 million for the quarter.]

OID: You mentioned on one of your conference calls that Eddie Lampert is "testing the faithful".

Berkowitz: Everybody used to think Eddie Lampert was the smartest guy in the world. Now everybody thinks he's stupid. And he may not have been as smart as he was made out to be at the top of the market, but he's definitely not stupid. He's a smart guy — and he controls Sears.

In fact, one of the questions you have to ask yourself is whether or not he would take it private. In other words, would he steal the company from the other shareholders?

OID: And the answer?

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FAIRHOLME FUND'S
BRUCE BERKOWITZ & CHARLIE FERNANDEZ
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Berkowitz: If you take him at his word when he says that his role model is Warren Buffett — and there are a tremendous number of similarities... They both tried to turn around difficult situations early in their career, whether it was Buffett with his textile mill or his retailers or Lampert with Sears. And I think Buffett did pretty well liquidating or selling.

OID: You don't think the jury's still out with Buffett?

Berkowitz: That's all Lampert has to do. And an awful lot of people work at Sears. So I think he wants to give it as good a try as he can before he reduces headcount.

And I think his capital allocation has been fabulous in concept. If you look at other retailers, they've taken their so-called profits and reinvested them aggressively back into the business. And it's not clear to me how effective their reinvestment programs are turning out to be.

In contrast, Eddie Lampert has bought every share back that he could. Again, there's only about 122 million shares outstanding today. So every number we talk about has to be talked about in relationship to the 122 million slices of the pizza that are left. The pizza hasn't dramatically shrunk in size, but the number of slices has gone down dramatically.

OID: According to Value Line, there were 160 million shares outstanding in 2005 — so there are 25% fewer slices today.

Berkowitz: Where it's trading today, let me tell you, a half-a-billion dollar buyback goes a long way. Meanwhile, Sears keeps reauthorizing those half-a-billion dollar buybacks.

OID: Why aren't you as critical of Eddie Lampert for paying up to $160 per share — or up to 6 times Sears' recent low — as you are of the health insurers?

Berkowitz: I actually think that all of the various prices at which he was buying back stock up to $160 or so per share were at no more than Sears' liquidation value — based on both of our estimates at the time. But did he make a mistake? I think the answer probably has to be yes with hindsight. But you can make the argument that in that environment, he *was* paying liquidation value.

OID: At the $160...

Berkowitz: Yeah. Was he being pessimistic enough about potential downturns? Probably not. But it's a lot easier with hindsight. I thought *I* was being pessimistic. But again, I wasn't pessimistic enough either.

But I think you get value in Eddie Lampert as a guy who still has a pretty damn good record. But clearly investors are shaken right now — given what happened at Citigroup and elsewhere.

OID: However, the longer it stays near today's price, the more value he can create by buying stock back.

Berkowitz: Exactly. And that's all he has to do.

OID: So why the hell are you talking about it?

Berkowitz: I didn't bring it up. I'd be just as happy if you don't include it. It doesn't matter, because no one will believe me. In fact, my mother just fired me...

OID: [Laughing,] Just checking. Thanks for sharing it.

Berkowitz: And again, it's not like there are an awful lot of shares of Sears left outstanding. And there's still a huge naked short position.

OID: Really?!

Fernandez: Around 28% of its float the last time that I looked.

Berkowitz: You've got to remember that Lampert and his partnerships own over 54% of Sears' shares. And if you take into account the 10%+ that *we* own, there's well over 64% of Sears' shares that don't trade.

OID: And it looks like the stock price is down from up around $114 at the beginning of 2008.

Berkowitz: Yeah. The stock price has been *crushed*. But there's so *much* that's cheap today. One of the problems in a bear market is that there are more ideas than money. I don't know how that works exactly — I mean, which comes first — but maybe the fact that there isn't as much money around explains why the pricing is so cheap. Plus, you have the unwinding of leverage.

OID: And some brain-cell-short leaders in Washington who don't understand the damage that mark-to-market accounting is doing to the country...

Berkowitz: Is Sears the cheapest company we own? It's hard to say. *Everything* we own is very cheap. It wouldn't surprise me if our entire portfolio were to double over the next three months — although, needless to say, I'm certainly not expecting that.

By the way, you have to read Lampert's latest letter.

OID: Why do you say that?

Berkowitz: Well, he talks about how they're handling the situation and continuing to generate good cash flows. But then he talks about how the U.S. is creeping towards socialism... And he quotes Friedrich Hayek warning governments away from their move towards socialism and the devastating effects it could have. [Ed. Note: We read Lampert's letter and recommend it very highly, too.]

OID: Well, first of all, I definitely don't believe the U.S. is "creeping" towards socialism. I think galloping or lurching is more like it.

Berkowitz: That's definitely what it looks like...

OID: And secondly, I believe that it was the late, great Bill Ruane who talked about how the lessons that we've learned are lost as each generation that's learned them leaves the scene. And if you go one lifetime back, it's quite amazing how everything that we've been experiencing in recent years seems to be almost exactly one lifetime away from what we experienced during the 1920s and 1930s.

Berkowitz: It really is.

OID: And, of course, one of the things that happened

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FAIRHOLME FUND'S
BRUCE BERKOWITZ & CHARLIE FERNANDEZ
(cont'd from preceding page)

during the 1930s, following the 1929 Crash, during the Great Depression, is that business became vilified.

Berkowitz: Yep. Here we go again.

WE'VE BOUGHT EVERY SHARE OF LEUCADIA WE CAN AND PAID UP TO WELL OVER TWICE TODAY'S PRICE.

OID: Switching from the tragic to the sublime, what's the story with Leucadia?

Berkowitz: As you know, I've liked the company for a long time. But when the company was at $50 per share, we reduced our position. And the last time I looked, Leucadia was selling under $16 per share.

OID: Unless the last time you looked was 3 years ago, that's unbelievable, all right. Why is it so cheap?

Berkowitz: It's in large part because of their exposure to commodities. Leucadia had made some very astute moves in the commodities area. For example, they made a brilliant deal with Fortescue which six months ago appeared to be a grand slam. And they did a good deal with Inmet. So they have a very significant exposure to commodities. And copper and iron ore are no longer the flavors of the month. These companies have turned down quickly now that the world appears to be coming to an end. So Leucadia's stock seems to be trading based on the price of the commodities.

Plus, they took a big position in Jefferies, which is also down — and they have a big position in AmeriCredit, which is down a lot, as well.

OID: Does Leucadia have much leverage?

Berkowitz: They have about $2 billion of long-term debt against around $8 billion in total assets. And they also canceled paying a dividend this year. They normally pay a dividend of something like 25¢ once a year. [Chuckling,] And this year, they canceled it.

OID: I understand people don't like that — even though it's funny. But how should people value Leucadia?

Berkowitz: Leucadia's always been extremely difficult to value. To some extent, it's a blind trust. So all you can do is break down the pieces that you do know and try and value each of them with the knowledge it could change drastically or quickly without your knowledge — which it has recently.

To some extent, that blind-trust element is why we've reduced our position in Leucadia significantly over time. I can't remember exactly, but I think we've cut it in half. Incidentally, that was a tough decision to make because Leucadia's charter restricts any single legal entity from owning more than 5% of the company — and at one point, we owned much more.

OID: How did you manage that?

Berkowitz: Because of our stake in WilTel. When they bought the remaining shares of WilTel, they basically forced us to go over 5%. And if they force you over 5%, it's OK — because they've done all of the calculations and know you're not violating any rules that could lead them to lose their net operating losses for tax purposes.

OID: Do you mind me asking the highest price you've paid for Leucadia?

Berkowitz: We paid into the high $30s.

OID: Or well over twice the current stock price.

Berkowitz: Yep. In the high $40s and the $50s, we were cutting back. But when it started to get hit, we got more aggressive as buyers. And then it just got killed.

OID: How much of Leucadia do you still own?

Berkowitz: About 5%.

OID: Does that mean you can't buy any more?

Berkowitz: The Fairholme Fund pretty much owns what it can. Other legal entities associated with me may still be able to buy. But it gets into legal issues about who exactly controls each specific legal entity.

It's a grey area. When a company's charter says that no one person can own more than 5% of a company, it opens up a can of worms about what exactly constitutes a person. So for legal purposes, the Fairholme Fund may constitute one person. An individual client of ours who we manage money for may constitute a different person. And that different person may be able to own 5%, too.

[Editor's note: Despite bumping up against that ceiling, Fairholme recently reported buying more shares.]

OID: Might I ask what kind of valuation you guys came up with the last time you valued Leucadia?

Berkowitz: We calculate $13 per share of tangible book value — which is very close to the current stock price.

OID: Is it just me — or did you not bother to mention any rationale for buying Leucadia at today's price, much less for buying it up into the high $30s?

Berkowitz: [Chuckles.] You just put your finger on the issue with the entire market to some extent in that their investments... When I take out the intangibles of the tax benefit and when I lower the market prices of the securities that they own, I come up with a $13 per share tangible book value.

But first of all, let me tell you — it's been a long time since you could buy Leucadia at tangible book. And second, that tangible book value is based on market prices — which we don't agree with. However, the market seems to think that their investments are down for the count and that management has lost its touch.

OID: You obviously don't agree...

Berkowitz: Absolutely not.

OID: How many shares outstanding?

Berkowitz: About 230 million shares.

OID: So Leucadia has over $32 of assets per share — using their carrying values.

Berkowitz: Yep. And that's after those assets have been marked down by billions during the past few months.

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FAIRHOLME FUND'S
BRUCE BERKOWITZ & CHARLIE FERNANDEZ
(cont'd from preceding page)

YOU CAN SUFFER NOW OR SUFFER LATER — THIS IS WHEN WE EARN OUR MONEY.

Berkowitz: I've got to tell you something: a longtime client just told me, "I remember you telling me long ago, Bruce, that it's only when the tide goes out that you learn who's been swimming naked. Well, I think you're swimming naked right now."

OID: That's funny...

Berkowitz: And I said, "Well, if I'm swimming naked, I'm in awfully good company." That's no excuse, but I feel like I can stroke to the left and say hello to Warren and stroke to the right and say hi to Charlie and other investors who I respect enormously.

But clients of 20 years are calling it a day.

OID: Be still my beating heart. Isn't that the best contrary indicator in the world?

Berkowitz: I think so. Still, I can't blame 'em.

OID: Why do you say that?

Berkowitz: They're 20 years older. And they're still ahead of the game. But now that they've seen a lot of their accrued value drop, it's very hard for them to be rational. It's not hard for me to be detached. In part, I think that's because I always keep three years of cash off to the side.

OID: Yeah. I take a page from Jackie Mason. I keep enough cash set aside to last me for the rest of my life — as long as I don't live past the day after tomorrow...

Berkowitz: So my family will be fine whether it takes three years or five years, or even ten years, for a recovery in stock prices. And I understand that the longer it takes, the better it's going to be. But most people don't run their affairs that way. Few keep three years of cash around.

And all of a sudden, people have hit that point... What do you say to a client who tells you, "Look, I put money away for my kids for their education. And they'll be attending school for six years. My portfolio's down, but I still have the money. But what happens if the markets go lower and I don't have the money around when they need it?"

I say, "You're right. I can't promise you that markets will recover within a set time frame. I *believe* — and am confident — they will. But I can't guarantee it. However, don't forget that your account wouldn't be nearly as high today if we'd had a different strategy all along.

"Still, I understand what you're saying. And if you're asking me if I can guarantee the money's going to be there when you need it, the answer is, 'No.' Therefore, if that's the most important factor in your decision-making process, then you've got to do what you've got to do."

Life is short. These are clients and they're my friends. So I have a *huge* amount of empathy for them. But the other problem I have is that there are only 24 hours in a day. And let me tell you — I could easily spend 12 hours a day just holding their hands right now. Actually, I could spend 24 hours a day. But at some point, I have to practice triage.

I just have to say, "I know you're scared. I know that your heart and your brain are telling you that this bear market is going to continue forever — but it's not going to. And if you won't need this money in the next three to five years, then it's my strong belief that you should stay put.

"However, I can't guarantee it. We've had these kinds of conversations dozens of times in difficult periods before. So I get it. However, all I can do is tell you what I believe to be true and tell you what I'd do were I in your situation. Unfortunately, that's all I can do. But whatever decision you make, I'll understand. And I understand that it has nothing to do with our relationship." It's gotten to the point where they're feeling psychologically tortured.

OID: So their emotions rule.

Berkowitz: That's right. Their emotions are just screaming out to them, "Make this pain go away!" They want it to go away so desperately.

That said, if they cash out of equities now, I believe that they're going to have *another* kind of pain.

OID: Seller's remorse?

Berkowitz: You bet. When stocks start to move up, they're going to have unbelievable regret.

OID: Although they won't be lonely...

Berkowitz: Exactly. So this is the time. But it just reinforces the lesson that you learn time and time again in the investing world — which is that you need to have cash.

OID: It helps in publishing, too...

Berkowitz: Maybe every decade or two, you get a great opportunity to do a few things — and that's really all you need to do. This is when we earn our money. There's going to be plenty of time to rest and relax later.

OID: Thanks for sharing a few of those things with us.

Berkowitz: Our pleasure.

—OID

Outstanding Investor Digest is published bimonthly, more or less (usually less) by Outstanding Investor Digest, Inc.
Outstanding Investor Digest, 295 Greenwich Street, Box 282, New York, New York 10007 Telephone: (212) 925-3885

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