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By Robert Barker

"You Only Need a Few Ideas to Be Fabulously Wealthy"

Bruce Berkowitz, manager of the 10-month-old Fairholme Fund, explains his focused approach to investing -- and offers some surprising favorites

What's great -- and often overlooked -- about new, small mutual funds is that they can build a big position in a stock quickly, they aren't stuffed with unrealized capital gains, and their managers often have a ton of their own money on the line. The trick is finding new, small funds with well-experienced managers.

Fairholme Fund (**FAIRX**) may be one such fund that's worth your attention. The $11.5 million, no-load portfolio opened last Dec. 30. It's run by Fairholme Capital Management, a group of risk-averse, research-intensive value investors based in the same Short Hills, N.J., building where the legendary Michael Price keeps his office. And through Oct. 18 this year, this extremely picky fund had gained 19.8%, a promising contrast to the S&P 500's 8.7% loss.

Led by 42-year-old former Wall Streeter Bruce Berkowitz, Fairholme is focusing on financial stocks, particularly insurers. When I reached Berkowitz by phone the other day, he told me why he sees the underwriters' pricing cycle turning up. He also told me what other stocks Fairholme thinks hold big potential. I bet some of his picks will surprise you. Here are edited excerpts of our conversation:

Q: Who are you guys?
A: There are eight of us. Fairholme is a continuation and further development of the work that I did as a managing director of Salomon Smith Barney in the asset-management division. Right now, we manage over $600 million in separate accounts. We have a partnership, Fairholme Partners. And at the beginning of the year, we started the Fairholme Fund, a mutual fund. We have no marketing people. We sort of have a philosophy of "perform and they will come."

Q: So you have, what, $600 million under management?
A: $650 million. The fund has $11.5 million in it. And we're happy with the way that's going.

Q: Very nice, but that's only over about 10 months. Other than that good record over a short time, why should anyone give you money?
A: One, I think our philosophy makes a lot of sense. We're doing nothing more than what the wealthiest individuals in the world have done. We act like owners. We focus on very few companies. We try and know what you can know. We try and only buy a few companies which we believe have been built to last in all environments. We recognize that you only need a few good ideas in a lifetime to be fabulously wealthy.... We're always trying to wonder what can go wrong. We're very focused on the downside.

Q: Certainly you must have made some mistakes. What do you figure your biggest was?
A: I've never had a big mistake. I've had some tiny ones, but, no, we've never had a big mistake.

Q: What was the one that had you kicking yourself the most?
A: The big kicks have been the errors of omission.

Q: Such as?
A: In the mid-1980s, I was one of the largest owners of a company, well, it's called White Mountains Insurance (**WTM**) now. It used to be Fireman's Fund. And the guy running it is Jack Byrne and he is just everything you'd want. The guy is an owner-manager. He puts his money where his mouth is. Most of his family's net worth is invested in the company. He's made close to 30% per annum in various companies he has run. He was the one who resuscitated GEICO and then he went on to resuscitate

Fireman's Fund. He did a great job, and then, in the mid-'90s, I sold the position after making a lot of money. But it was a huge mistake on my part. I sold it in the 80s after buying it in the 30s, and today it's 250.

Q: Ouch.
A: That was a huge mistake that cost clients of Fairholme a lot of money. But there has been no position that cost clients. You have to understand, there were some years when we only had two positions.

Q: How many do you hold now?
A: We hold 15 in the mutual fund. By law, we're a concentrated mutual fund.

Q: This is the best approach, you think?
A: It doesn't guarantee success. But I'm a very big believer that if it's good enough for my clients, it's good enough for me. So our ultimate filter is, "Would I be willing to put a significant chunk of my own money into an idea that I'm recommending to a client?" The answer has to be yes. So in the case of the mutual fund, it's my goal to be the largest shareholder of the mutual fund.... We view it as a separate business. That is, we have a business of advising people and we also have a business of making money from our investments.

Q: Why isn't that attitude more widespread on Wall Street?
A: My only guess...is that instead of feeling that they're doubling their reward, some people believe they're doubling their risk.

Q: You see it differently.
A: Most people correlate risk to volatility, where we believe risk is permanent loss. We understand that there is volatility and we try to take advantage of it, but we don't correlate the up and down movement of prices with business risk. It doesn't make any sense to us.

Q: Tell me this: Your portfolio shows more than 20% in property and casualty insurers. Why?
A: We're always looking at these sort of unloved industries. And in the case of the property and casualty insurers, the industry has been under stress. It's consolidating and we believe that it's a misunderstood industry. And there are a few great companies in that industry that welcome stress and in fact find it necessary to grow, and they position themselves as buyers of last resort.

Q: I see White Mountains is one of the names you hold now. What's another example?
A: Well, you asked about mistakes earlier. One of my big mistakes of the past was [that] in the mid-'80s, I didn't put everyone's money into Berkshire Hathaway (**BRK.a**) and then learn how to play golf or come up with some kind of hobby and call it a day.

Q: In that, you have plenty of fellow sinners. Berkshire is your biggest position: Are you satisfied that CEO Warren Buffett has a good succession plan in place?
A: People underestimate [them], but there are dozens of very good people at Berkshire Hathaway and there are a good handful of people who could take over. Will it be as good without Warren? No. Will it still be a very good company? Yes. And what we like today about Berkshire is that it's basically Fort Knox, with over $30 billion of cash and liquid bonds.

Q: How about Leucadia National (LUK)? That has been a very interesting company over the years.
A: You're right. Great paper trail. Twenty percent-plus per annum for 20 years. They've been what I call vultures in terms of real estate. They dove into real estate during the demise in the early '90s. They were the only bidder, the buyer of last resort, for Colonial Penn Insurance, from Florida Power & Light (FPL) in the early '90s. The two guys there, Ian [Cumming] and Joe [Steinberg], are just genetically engineered for bad environments.

Q: Hah!
A: Presently, they're holding a huge amount of liquidity on their balance sheet. They're putting their cash to work in unloved areas, such as high-yield bonds.

Q: As you get new cash into the fund, where will you deploy it?
A: We're staying with a highly focused approach in property and casualty because of the stress in the industry. It's consolidating. We believe that we have an edge and that we understand these companies better than most people. [After talking with] hundreds of agents and executives at different companies and underwriters, customers, and competitors, we believe that the cycle is turning in a way that we haven't seen in 15 years.

Q: What do you mean?
A: These are companies that did the right thing and are seeing 10%, 15% rate increases now.... For seven or eight years, they've just seen rate decreases.... The smart companies over the last three, four, five years have held back and basically told their people to go play golf...and wait for the stupidity to end. And then, companies that have blown up, by [under]writing at too low a price, are now forced to pull back or are going bust.... So that's going to open it up now for the Berkshire Hathaways. It's going to open it up for Mercury General (**MCY**) in car insurance. It's going to open it up for White Mountains, it's opening it up for a little company like RLI (**RLI**)....

Q: ...Which is what?
A: RLI used to stand for the Replacement Lens Insurance Co. They came up with insurance policies when contact lenses first came out. Now, they're a specialty underwriter and another great example of a company that will only write to an underwriting profit. It has sat on its hands for a few years, working very hard just to tread water. And now their business is up 20%, 30% top line. Good rate increases and the next few years are going to look very good for them. It's another company selling close to book value with a potential for 20%-plus returns on equity.

Q: Another?
A: Same situation with Markel (**MKL**). Very disciplined approach. They're in the process of integrating [an acquisition]. And their existing businesses are now growing very nicely. Look, the key concept for insurance companies is to take a look at the investments per share. And you can find companies where the investments per share are significantly higher than the stock price. Markel has roughly $400 per share of investments. If they can break even on their underwriting and only make a 5% after-tax investment return, that's $20 per share. Not bad for a company at $140 per share.

So the trick is to have that investment leverage and at the same time break even or make an underwriting profit. And it's hard for people to see it. These are not easy companies to understand.

Q: As your firm gets bigger, do you need to develop other areas of specialty?
A: It's a question of what will be as cheap or get cheaper than the property and casualty companies or the other financial-services companies that we're involved in. We have a major position in Household International (**HI**). And Household, since Bill Aldinger came from Wells Fargo (**WFC**) six years ago, has 20% profitability, the lowest overhead, and less competition today than at any time I know of. [They have the] best performance statistics, and they're the last one on the dance floor when it comes to being a pure home-equity lender. If you looked at Household compared to Citigroup (**C**), American Express (**AXP**), and all the top financial-services names, you'd be surprised to see that Household has the best numbers, and it's only at 12 times next year's earnings.

Q: A nonfinancial stock?
A: We're currently looking at the manufactured-housing market. That's another industry in turmoil. We haven't made any major decisions there yet, but everyone's wiped out in that business and it's a business that handles 30% of the new housing market.

Q: So what are some of the names there? Fleetwood (FLE)?
A: No. To be honest with you, I'd rather hold back on that one.

Q: You don't want Business Week Online readers to profit along with you?
A: I'd like that but I don't want them to profit before we do! Here's another idea: Washington Post (**WPO**). We'd like to be large owners of Washington Post at the right price. Right now, we think the people [running it] are very intelligent in the way that they're entering the 21st century. You can look at it as a closed-end media fund run by what we would consider to be the 1927 Yankees of media.

Q: What else?
A: Ethan Allen (**ETH**) [in] the furniture manufacturing and retail area. We really like the CEO, Farooq Kathwari. He has done a great job positioning the company as a profitable, dominant force in another consolidating industry and an industry that's in distress. We believe that Ethan will do well in difficult environments.... Again, at the right price, low 20s, we would be there.

Q: One more.
A: We do like International Speedway (**ISCA**). We have tremendous respect for the France family.

Q: Nascar is big in Short Hills?
A: Not yet, but we're waiting for something to get going in the Meadowlands.... We're excited about how the new television contracts are going to exponentially increase the earnings for International Speedway. We've already seen some of the Fox advertisements, and they're really going to bring people further into the sport. We recognize that it's national now. So at the right price, we would be large owners of International Speedway. The only thing stopping us there is price.

Q: What's the right price?
A: Mid-20s we would get very jazzed up about. We'd get really excited. We'd start jumping on tables and the greed would start to get us around there.

Barker covers personal finance in his **Barker Portfolio** column for Business Week from Melbourne Beach, Fla. His **barker.online** column appears every Friday on BW Online

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