ADVISOR PERSPECTIVES

Au revoir Jean-Marie Eveillard: A Final Interview

By Robert Huebscher
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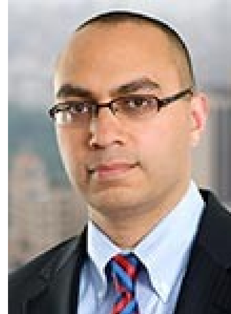
Abhay Deshpande

Jean-Marie Eveillard

Jean-Marie Eveillard was the Portfolio Manager for the First Eagle Global, Overseas, Gold, U.S. Value and Overseas Variable Funds, where he built one of the most successful long-term performance records in the investment business. On March 31, Mr. Eveillard transitioned to a Senior Advisory role at First Eagle Funds. In addition, we spoke with Abhay Deshpande, a Portfolio Manager for the First Eagle Global, Overseas, Gold and U.S. Value Funds.

We spoke with Deshpande and Eveillard on March 31, thus earning the distinction of having the final interview with Eveillard prior to his transition.

Which worries you more – a decline in the dollar, rapid inflation, or deflation? How are you positioning your portfolio to defend against these scenarios?

> We have many worries, but we are not positioned against any particular outcome. Our top-down analysis is focused on those trends that will affect the intrinsic values of the companies we own. We believe the most effective defense against these scenarios is to spread risks through diversification.

You have called your billion-dollar purchase of gold "calamity insurance." What potential events do you perceive possible that makes such a large position advisable? How do you go about determining your allocation to gold?

> Our gold position is based on our belief that gold is a universal store of value. We believe a gold position of less than 5% of our assets is irrelevant and a position of more than 15% would be too painful if we are wrong. For most of 2008, our position was between 7-8%, but it eventually grew to almost 15%. This was not because we bought more gold, but because the value of gold rose relative to the value of the rest of our holdings.
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> After World War I, during the great inflation of the Weimar Republic, the German government acted very shrewdly. They forbade German citizens from buying gold and from holding foreign currencies, and they taxed real estate very heavily. As a

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result, some rich farmers bought grand pianos. They did not want the paper currency being issued, because they knew it would be worthless the next day. Instead, they chose pianos as a hard asset that would hold its value. Today, we see gold as having these same characteristics.

The current actions of the US and UK governments, through "quantitative easing" – which is really just a code word for printing more money – will be rather good for common stocks. Initially, at least, these actions will be bad for cash and Treasury bonds. At some point, they will be good for real estate and fine art. However, these actions are very good for gold.

The path of increased money supply leads to real assets, and gold is our asset of choice. Common stocks will also benefit, as they are representative of real assets.

Remember, the opportunity cost of holding gold is near zero, because interest rates are so low. Gold investors should keep in mind the two extremes. The government has a strong incentive to keep long-term Treasury rates low, because it allows them buy Treasury bonds to increase the money supply. At the other extreme, the government dislikes high gold prices, because it reflects poorly on their policies. This is partly why FDR, during the Great Depression, made it illegal to own gold. So, to some degree, gold investors are betting against the government.

You hold currency hedges on the Yen, Euro, and British pound. How should investors think about currency risk and what if anything should they do about it?

We currently hedge about 30% of our Yen exposure and 60% of our Euro exposure. Our exposure to the UK pound is very low.

Following the collapse of the Tech bubble and 9/11, we were very concerned about the stability of the US dollar, as the government was flooding the system with liquidity. From that period until late 2007 we were mostly unhedged.

Now, we are in a completely different scenario. Countries will be tempted to engage in competitive currency devaluations. The Asian countries will likely act with mercantilist motivations, and devalue their currencies. The UK has already begun this process, and the European Union may soon follow in order to make their exports more competitive in the world markets.

In general, we prefer to be neutral with regard to currencies, unless we have a strong opinion as to a particular scenario. For us, being neutral equates to hedging 50% of our currency exposure. We are not currency or macro experts.

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We expect that the temptation of the US government will be to let the dollar decline gradually over time. As long as that decline is not too steep or sudden, the fund's hedge positions should be helpful..

Your funds have the flexibility to invest in both debt and equity. Where are you seeing the better opportunities right now – in corporate debt or the equity markets?

We are looking across the capital structure, including looking at high yield opportunities. High yield defaults typically peak 18 months after issuance peaks, and we are now approximately at that point in time.

A lot of the high yield market is truly junk, including much of the paper issued through leveraged buyout transactions that were orchestrated by the private equity industry. These transactions were done at elevated EBITDA levels, and those companies will not be able refinance their debt based on current enterprise valuations. Investors must be very careful about the quality of any high yield debt they consider.

We currently own the bonds of Boston Properties. Our approach is to avoid situations that are likely to end up in reorganization. The bankruptcy courts are clogged and the time value of these investments is very important. Interest accrual on most debt instruments stops when a company files for bankruptcy protection. We target yields to maturity of 12%-15% in our investments, not the higher returns that might be available to investors willing to purchase distressed securities and deal with restructuring.

You maintain a large position in Berkshire Hathaway. How do you feel about Buffett's latest investments – particularly his preferred stock position in GE? Are you confident that GE will be able to continue to have adequate access to the capital markets to refinance its debt as it matures?

We looked at GE ourselves. The credit arm of GE is thinly capitalized and is faced with a significant duration mismatch between its assets and its liabilities. It is highly dependent on the short-term commercial paper market, and this is very troubling to us. But, if you believe GE is a survivor, then its industrial business is worth $15-$20 per share just by itself. In this case, the market is betting that GE Capital is insolvent, or worse.

Berkshire's investment is not a bad decision, since it came with warrants. At the very least, Buffett will get his money back, plus 10% annually. His risk is a complete wipeout of common shareholders that would eat into his preferred position. A lot would have to go wrong for that to happen.

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You have been very positive on the Japanese market, yet Japanese manufacturing, imports and exports have been falling at an alarming rate in recent months. How should an investor respond to these events? What implications might this have beyond Japan? Accepting the fact that valuations are low there, based on net cash positions and valuations relative to operating profits, what do you believe will be the key drivers to increase valuations in the Japanese market?.

Japan is on the opposite side of the world, both literally and figuratively. It is an island in more ways than one. From a top-down perspective, Japan is in much better shape than the US and Germany. Its companies have massively over-capitalized balance sheets. The value of the Nikkei index is at the same level as it was in 1984. Japan has experienced 20 years of a bear market and 25 years of no returns.

Approximately 22% of Japanese companies trade for less than net-net working capital (NNWC). [Ed. Note: NNWC is current assets – current liabilities – long-term debt] Between 10% and 15% of companies trade for less than net cash value, and between 75% and 80% of non-financial companies trade for less than their book value. These companies have high quality assets – cash, receivables, and depreciated fixed assets.

The Japanese market is priced at Great Depression levels, but there are many high quality companies. For example, we own SMC, which competes with Parker Hannifin in the industrial equipment market. SMC has a better balance sheet, market position, and management team. It's not like we are buying champagne at beer prices; it's like we are getting the champagne for free.

Looking back at your investment in American Express, what is your assessment of the cause of their declining valuation?

We foresaw everything correctly when we made our investment. We suspected profitability would go to zero and than non-performing loans could rise to over 10%. We didn't realize, however, that nobody else saw this coming. The Street was expecting $3/share earnings for 2009. We made the right decision by avoiding all the other financial institutions. We have a mark-to-market loss in American Express, but our expectations for future earnings have not changed very much.

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Are there other companies in the financial sector that look attractive to you now?

Even though the financial sector is a pretty broad category, the answer is generally "no." One exception is United Overseas Bank (UOB), which is based in Singapore and is trading for less than its book value. Moreover, we can buy UOB through a "back door" – Haw Par – a Singapore company whose principal asset is its holding in UOB, and this holding is discounted 45%.

Banks in Asia, and Japan in particular, are in relatively good shape. In 2001, Japan began writing down its bad debt, which allowed it to go through a more normal credit cycle in this recession. Non-performing loans have gone up but banks have not collapsed. Ten years ago they were at the brink, but now their regulations are much stricter, and their banking system much healthier.

Is the worst behind us? Will we continue to see more surprises on the downside, or will there be unexpectedly good news?

A bit of a reprieve may be in the making, thanks to the stimulus package. One year from now, however, a wave of option ARMs begins to reset. [Ed. Note: See our article on this topic.] These loans were made at the peak of the credit cycle and the magnitude of this problem will rival that of the sub-prime problem. The housing market will need to absorb another round of foreclosures.

We are one year into the recovery process, but a full recovery will likely take longer.

We worry about the actions of the authorities, who are attempting to subvert the laws of nature. By printing more money, they are doing a rain dance in Washington, but the result could be a hurricane of inflation.

What sources of information world-wide should people in the United States seek out to become more informed and better investors?

Read the *Financial Times*. It is more international and, overall, better than the *Wall Street Journal.* We also recommend Jim Grant's Interest Rate Observer. Grant was one of the rare few people who correctly forecast the financial crisis. Nor is he a "perma-bear" – just recently he was bullish and correctly advised readers to buy long-dated call options on a basket of bank stocks.

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You will continue to serve as an advisor to First Eagle over the next several years. What will be your focus in this new role? What role will Bruce Greenwald be playing it the investment process going forward?

Bruce has been Director of Research for the past 12 months and will continue to serve in that role, in addition to his position at Columbia, where he is a professor of finance and Director of the Heilbrunn Center for Graham and Dodd Investing.

Starting in 2005, following my first attempt as a Senior Advisor, I was available for consultation. I left it to my successor at the time to call me, and it will be the same this time around. I expect to be in the office a couple of times per month, if for no other reason than to keep my desk organized, which is increasingly difficult in my apartment.

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