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All in the Mix

Two value specialists use it all: from stocks, to bonds, to gold-related securities and cash

An Interview With Jean-Marie Eveillard and Charles de Vaulx -- These two value specialists, with about $3.5 billion entrusted to their care, like to mix it up. That's evident in the course of our conversation in the Berlin Room at the Manhattan offices of Arnhold & S. Bleichroeder as Eveillard and de Vaulx freely question each other's assumptions and assertions. It's also apparent in the portfolios they manage together: **First Eagle SoGen Overseas Fund** and **First Eagle SoGen Global Fund** are constructed to serve the client's best interests rather than the stilted style box of some consultant. So it isn't uncommon to see stocks of all sizes, corporate bonds, gold-related securities and cash stashed in the portfolios in an effort to protect capital while delivering solid returns.

Tom Iannuzzi

Jean-Marie Eveillard, left, and Charles de Vaulx say Japan is looking attractive, but their portfolios' heaviest exposure is to Europe.

Giving Eveillard and de Vaulx a free hand has resulted in first-rate performance. The Global fund is up 2.2% this year and 9.3% a year on average the past three years and about 14.5% a year on average since it started under Eveillard in 1979. The Overseas fund is up 3.6% this year and has delivered gains of 7.3% a year on average the past three years. A third fund, the **First Eagle SoGen Gold fund** is up 66% this year and about 21% a year on average the past three years. Lately, the two have focused on beaten-up big caps and mispriced European stocks. The whys and wherefores follow.

--Sandra Ward

Barron's: *Where are you seeing the best values around the world?*

Eveillard: Many securities in Japan, after a 13-year bear market, are attractively priced. But though we are bottom-up stock pickers, we can't ignore the big picture and we must exercise some restraint. Japan still has major problems: a ballooning public deficit, a banking system in tatters and a government that seems paralyzed.

De Vaulx: Our individual stock ideas in Japan share some characteristics. They are companies that are overcapitalized and generating excess cash, so that in many instances net cash -- cash minus all financial liabilities -- is in excess of market cap. Also, their businesses are profitable or breaking even. They also tend to be buyers of their own stock. We are also finding good-yielding stocks in Japan. It's nice to get paid while waiting.

Eveillard: In essence, we are getting these businesses for less than nothing. The only genuine risk is if the companies have a string of losses and the cash is dissipated. But we are very patient.

Q: *How about some names?*
De Vaulx: Aida Engineering has a 3.2% yield and cash in excess of its market cap. Okumura, a construction company, has net cash, is breaking even and is yielding 2.4%. Ono Pharmaceutical and Daiichi Pharmaceutical

both have a fair amount of cash on the balance sheet for which the market is giving them no credit. The pharmaceuticals are newer names to the portfolio. Many Japanese pharmaceutical companies have been accused in the past of copying European or American drugs, yet these two companies have discovered their own drugs and market those drugs in the U.S. and Europe. Yet the local investors in Japan seem to focus only on price-earnings ratios and the market doesn't give the companies any credit for their cash piles. With interest rates so low, the cash is yielding no interest income. But in terms of enterprise value, or market cap adjusted for net cash, it's clear the businesses are trading at very low multiples of operating income.

Q: *Do U.S. stocks look reasonably priced now?*
Eveillard: If we look at the Standard & Poor's 500, and if we use S&P's own standard for gauging "core" earnings, which puts true profits at about $35 a share, then the S&P 500 at 900 isn't exactly cheap.

De Vaulx: We've gone through a major bubble, but if you look back at 1973-74 and 1981-82, those markets troughed in single-digit price-earnings ratios. We aren't close to those levels yet. And markets can overshoot not only on the way up, but on the way down.

Eveillard: Still, as global equity markets decline, automatically the number of investment opportunities increases. In the past six to nine months in the U.S., we've picked up a few attractively priced stocks, including some controversial ones such as **Tyco International**.

Q: *Were you one of the ones who got in too early?*
Eveillard: Yes, we started at 20 and we bought all the way down to 10 and below. Our average cost is $14 to $15. So we're breaking even, basically. We had always been impressed by the kind of businesses that Kozlowski had acquired over the years. They were exactly the kind of businesses which we like to own ourselves, assuming that the price is right. The electronics-security business and the electronic-connector business, in particular, are mature somewhat-cyclical companies that generate a lot of cash. We couldn't understand how Kozlowski could pretend some of these businesses were increasing earnings by 20% a year because those businesses were mature. But when the stock declined to $20, we looked at it from the standpoint of what corporate buyers might pay for some of these businesses. We came up with an intrinsic value of about $25 a share. In hindsight it was not smart of us to start buying at $20 because it was a small discount to the $25 intrinsic value and there was still the risk of a major accounting fraud.

Table: Eveillard and de Vaulx's Picks[1]

Q: *What is the future of Tyco? Is it one of breaking up the company or does it survive intact?*
Eveillard: Its future is probably as a conglomerate. Initially, the debt will be cut, which they can do through free cash flow, and then they'll start acquiring again. Maybe they'll decide against making acquisitions and distribute a large dividend or buy back stock. Who knows?

De Vaulx: We have had to look at industry sectors that aren't customary for us. We've been buying stocks that are bigger than what we typically have bought in the past six to seven years. **Liberty Media** is one large-cap we've bought. And we've been nibbling at **Schering-Plough** and **McDonald's**.

Q: *Why the larger-cap names?*
De Vaulx: There's been a major bear market for three years, but the kinds of stocks we favor, small and midcap stocks, are up over the past three years. The Russell 2000 is up 10% from where it was in April of 2000.

Q: *The drug companies and McDonald's are facing serious problems with their businesses. Why are you interested?*
Eveillard: McDonald's mostly has a problem in the U.S., where they are accused of slow service and poor-quality food and so on. It's a problem that can be fixed, and one McDonald's restaurants don't have in Europe and Asia.

De Vaulx: Outside the U.S., McDonald's is the only game in town; its position is very strong. **Wendy's** and Burger King have never penetrated.

Eveillard: It's our contention, too, that if the problems that have lingered in the U.S. aren't fixed within a year or 18 months, top management is in trouble.

Q: *What about the drug companies?*
De Vaulx: We have only started buying Schering-Plough in the U.S. There are some long-term structural problems for the drug companies. It's getting harder and harder for scientists to come up with new drugs. The cost of research and development is increasing. Drug prices are very high.

Eveillard: It's a little bit of what has been said of newspapers. The newspaper business used to be a great business. Now it's simply a good business. Maybe the same is true of the prescription-drug business.

Q: *Among your portfolios, where are you more heavily exposed?*
De Vaulx: Europe by far. Throughout the boom times and the telecommunications, media and technology mania that occurred in the late 'Nineties, large-cap growth stocks did very well in Europe, as they did in the U.S. But since the spring of 2000, when the market peaked, small and midcap value stocks haven't gone up in Europe the way they have in the U.S. In fact, they have been flat and sometimes down. So the kinds of stocks we look for are much cheaper in Europe than in the U.S. Besides a few telecom companies that are saddled with debt, by and large European corporations have pretty good balance sheets. So do households, for that matter. Stocks trade at very modest multiples. And dividend payout ratios are higher because they've avoided the double taxation we have in the U.S. Many of the European stocks we own support dividend yields in excess of the 4% yield on the 10-year bond.

Eveillard: In Europe, Continental Europe in particular, there have always been very few value investors among the local institutions, which means there is much less competition for ideas. Unfortunately, it also means investors have to be even more patient.

Q: *Are you concerned about the European economy?*
Eveillard: It is discouraging. The economy is flat. The Germans are talking about raising taxes. There is still the matter of a very expensive, very extensive welfare system, which in the case of Germany goes back to Bismarck and in the case of France goes back to the French kings. It's part of the culture of Europe, and so far it hasn't made Europe uncompetitive, but it's a burden.

Q: *So what portion of your portfolio is in European stocks?*
De Vaulx: In the Overseas fund, more than 80% is in equities, of which half is in Europe, and a quarter in Japan. In the Global fund, the Europe weighting is almost 25%.

Eveillard: The figure is somewhat misleading in the global fund because we also have a number of corporate bonds. The average high-yield bond has a spread of 10 points over Treasuries. Corporate bonds have yields between 7% and 25%, and we decided we should look at them. American Standard, where the default risk is trivial, offers a nearly 7% yield on its six-year bonds, which is a lot better than earning barely more than 3% on a Treasury note of the same maturity.

De Vaulx: We also own the bonds of **Level 3 Communications** and **Lucent Technologies**.

Eveillard: We looked at the stocks; we declined to buy them because there was too much confusion about the state of their business. We didn't know how long demand for equipment would be lagging or who would survive. So we moved to the bonds. We bought the Lucent and Level 3 bonds with the idea that they had enough cash to last them until the demand for their equipment came back.

Q: *Did you buy Level 3 bonds before or after Warren Buffett bought them?*
De Vaulx: Before.

Eveillard: But Buffett's involvement helped raise the price of the bonds. We're underwater on Lucent.

Q: *Have you been buying any tech stocks?*
De Vaulx: Anytime we see a country or sector in turmoil, we look into it and, hopefully, find a few gems. In the case of tech, we haven't come up with many ideas over the past two or three years. Earlier this year, we bought shares of French holding company Wendel Investissement, which owns a stake in the information-technology service provider Cap Gemini. Owning Wendel, which trades at a 40% to 45% discount to its intrinsic value, is a way for us to be partially exposed to information technology at a big discount.

Q: *What else do you like in Europe?*
De Vaulx: One area where we've been quite active has been in owning the holding companies that trade there. In the past year or so, we've been accumulating shares of Pargesa, one of Belgian financier Albert Frere's holding companies. Pargesa has three major assets, two of which are listed. They have a stake in the oil company **TotalFinaElf**, in the French water company **Suez**, and their third, unlisted holding is in the German media giant Bertelsmann, which is supposed to be listed two or three years from now. When we do a sum of the parts for those three major assets, we come up with an intrinsic value of Pargesa that is almost twice the current share price. To top it off, Pargesa pays a dividend that yields 3.4% in Swiss francs, which isn't bad.

Q: *Is that your attraction to Liberty Media, the sum of its parts?*

Eveillard: It's particularly attractive because we get a double discount. In other words, Liberty Media has a stake in **AOL Time Warner**, a stake in **News Corp.** and a stake in **Vivendi Universal**, and not only are those parts trading at depressed levels, but the holding company is trading at a discount, and so we get the combination at a discount.

De Vaulx: The key to these, too, is that these holding companies have been run by very astute people, who have proven to be good at capital allocation, for a very long time. Whether it's John Malone or Albert Frere of Pargesa, or the people behind Corporación Financiera Alba, a holding company in Spain with a 3.3% stake in French retailer Carrefour, they have made sure the intrinsic value of the holding company has grown quite a bit over time.

Q: *Are you interested in financial-service companies?*
Eveillard: Except for property-casualty stocks in Japan, we have practically zip.

De Vaulx: And the property-casualty companies in Japan are so overcapitalized we look at them as closed-end funds that trade at a discount rather than as true insurance companies.

Q: *Why shy away from financial services?*
Eveillard: We look at banks, and to some extent insurance companies, as black boxes. Banks are no longer making money by lending to you or me or to **General Motors**. They have their derivatives books and their trading. In many cases, it's unclear whether top management of these banks are fully aware of the risks they have taken. People say derivatives reduce risk. They don't. They just spread the risk. One of the problems with the insurance companies is the banks have shifted some of the risk to them.

De Vaulx: Some of the regional banks look cheap based on their P/E ratios, but we worry earnings might be at their peak.

Q: *Are you that worried about the consumer at this point? Does that play into your stock picking?*
Eveillard: Yes. My attitude is that [Federal Reserve Chairman Alan] Greenspan financed the stock-market bubble, because there can be no bubble unless it's financed by the central bank. Now he's financed a real-estate bubble. The first bubble has burst. If the second, the real-estate bubble, bursts, then what does he do? Within the next year or two, either Greenspan will maintain his status, or he will be seen as the worst Fed chief since 1913, when the Fed was created.

Q: *Are there any other sectors in Europe you are partial to?*
De Vaulx: We are always intrigued by companies that have voting and nonvoting shares outstanding, especially when we see the nonvoting shares trading at a big discount to the voting shares. One we've been buying in the past six to nine months is an Italian company called Italcementi. They have a stake in Cement Français and they have their own cement operations, mostly in Italy. The discount to intrinsic value is at least 50%, but the nice thing about the nonvoting, or savings, shares is that they pay a dividend with a yield of 5.7%.

Q: *Why the discount?*
De Vaulx: It's nonvoting stock, and the large institutional investors only care about the biggest stocks, especially those in the benchmarks, and neglect the savings shares.

Q: *Any other picks?*
Eveillard: In recent months we started buying the stock of a champagne company, Laurent-Perrier. The champagne business is one in which private transactions happen fairly often. A few of them change hands every year. There is no indication Laurent Perrier will be sold, but when we add up the value of the assets -- that is, the vineyards, the inventories and the brand -- we come up with almost euro50 and the stock is trading at euro30.

De Vaulx: Even in Britain we've been able to find some values. In manufacturing, we like Spirax-Sarco Engineering, which makes valves and pumps, and **IMI**, a big manufacturer of fluid controls and drink-dispensing systems. Also, British companies typically pay big dividends. In the case of a Spirax, the dividend yield is around 4.8%, and IMI's is around 6.2%.

Q: *What about your gold positions?*
Eveillard: One thing that worries me, particularly after Sept. 11, is that Greenspan has reduced short-term rates repeatedly and yet the stock market goes down. This is the first time this has happened in the post-World War II period. If we are going to have, for whatever reason, a collapse in the U.S. dollar and lingering difficulties from the bubble bursting, then the intrinsic values we have assigned to the securities we own could be too high, at least temporarily. To protect against that risk we have about 5% of the assets in gold-related securities, with

gold as the ultimate hedge and with the idea that maybe it would provide a partial offset to the hit we would take on equities if things turned really bad for a year or two.

Q: *Thank you, gentlemen.*

E-mail comments to editors@barrons.com[2]

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