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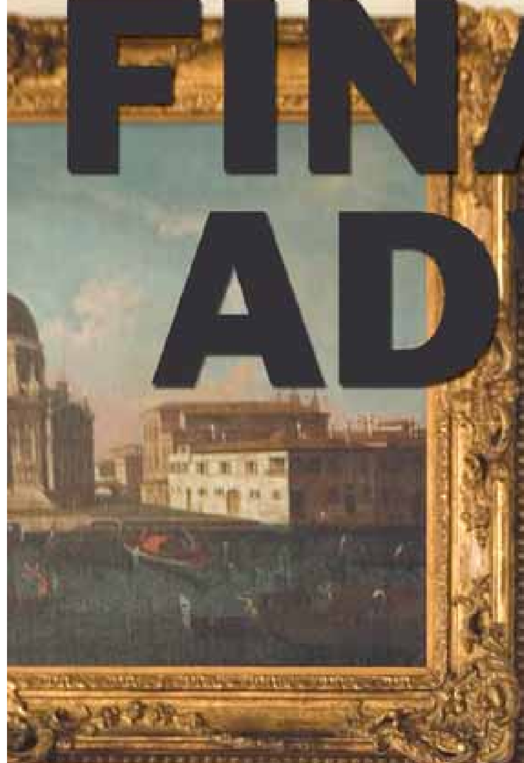

## The World According To EVEILLARD

Why disciplined value investing is so difficult.

Jean-Marie Eveillard

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# The World According To EVEILLARD

Why disciplined value investing is so difficult.

By Evan Simonoff

Ask yourself a simple question, Jean-Marie Eveillard says. "If Warren Buffett is the second-richest man in the world, why aren't there more professional value investors?"

An intriguing question indeed. "The answer is purely psychological," he argues. "If you are a value investor, every now and then you lag, or experience what consultants call tracking error. It can be very painful. To be a value investor, you have to be willing to suffer pain. Bill Ruane of Sequoia once said he thought only 5% of professional investors were value investors."

Eveillard himself was more than two years into retirement this past March and enjoying one of his frequent visits to Paris when one Wednesday he received a call from his old firm, First Eagle Funds, requesting that he report back to work the following Monday. The sudden and abrupt resignation of Eveillard's successor, Charles de Vaulx, triggered the request, so the legendary manager accepted the offer.

Until then, Eveillard had divided his time between his home in New York City and a walk-up apartment he had purchased a decade ago in Paris, from which he could make frequent visits to see his nonagenarian mother, who lives on France's Atlantic coast, and Bavaria, one of his favorite getaway spots. Teaching a course on value investing at Columbia University's Graduate School of Business enabled him to satisfy his intellectual curiosity, but Eveillard says his retirement was less active than some might think.

"I traveled and lived quietly," he explains. "People said you must be busy running your own personal portfolio, but I kept most of my investments in the funds." While Eveillard frequently dined with his old First Eagle colleagues and talked securities, he was reticent about making suggestions to research various investments for fear of creating the impression he was looking over their shoulders.

Since returning to portfolio management, Eveillard has found himself confronted with a global economic boom running on all cylinders, the likes of which has only surfaced at two junctures in the past two decades—in 1987 and during the 1999-2000 period. For an investor who has consistently looked for a margin of safety in every security he has ever purchased, neither the strong economy nor the robust level of equity markets is fazing him these days.

"I'm not worried about the global economic boom, except that it's a credit boom. What worries me is that we've had a credit boom for 15 years now, and a credit boom usually ends in a credit bust," Eveillard

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says. "Already you see problems cropping up like subprime debt. There are also indications that real estate is peaking in Ireland and Spain and England, not just America. And the appetite for risk remains high."

Three weeks after this interview, it emerged that 18 million mortgages in the United Kingdom were in arrears, indicating that his concerns about the global real estate boom may be well-founded. And financial markets that are priced for a perfect world may eventually discover that world isn't quite as perfect as it appears.

Most observers are quite sanguine about credit conditions, and believe the subprime problems are isolated. Most big banks boast strong balance sheets, they argue. Eveillard isn't convinced. "A bank today is a black box. What does an outside money manager know about their derivatives contracts and proprietary trading?" he asks. "Some banks are disguised hedge funds. Yes, they have good balance sheets because they've accumulated profits. But remember in 1990, when banks like Citicorp were too big to fail? That didn't protect equity holders."

One major change on the investment landscape Eveillard has found upon his return after 30 months in retirement is the increasingly powerful position of private equity investors and hedge funds. Both vehicles have become the darlings of pension funds and endowments, and the ever-skeptical global fund manager believes they will live to regret it. "What is private equity? It is the use of leverage in a bull market," he says. "What's a hedge fund? It's not an asset class, it's a compensation scheme. If you bought a good mutual fund and leveraged it four- or five-to-one, you'd have private equity or hedge fund-like returns."

Yet Eveillard's own style of investing, which uses gold as an insurance policy and sometimes seeks out arbitrages between complex securities like convertible or junk bonds, bears similarities to both global macro and absolute return investing, two popular styles in the hedge fund universe. Following his superlative performance in 2002, when hedge funds and First Eagle funds were about the only vehicles with positive returns, hedge fund marketers were eager to talk to him. "They could see pretty quickly it wouldn't work because their investors are often very short-term-oriented; they are almost like day traders," he says. "We don't want to use leverage because we are long-term investors and it takes away your staying power. And when you short a security, you cannot take market psychology out of the picture."

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Psychology is a subject as near to Eveillard's total investing philosophy as it is to his heart. Born in France in 1940, he spent his formative post-war years moving from city to city, watching the glacial pace of that country's reconstruction as his father was constantly transferred as an official with the national railroad.

Even though he has lived in America for most of his professional life, he remains more risk-averse than most U.S. money managers. After graduating from Ecoles des Hautes Etudes Commerciales in 1962, he started his career at Societe Generale, moving to the United States in 1968.

"Americans tend to be very optimistic about the future. Europeans tend to be more skeptical and cynical," he explains. Over the years, many U.S. money managers have told him they would love to be a value manager. But somehow they don't have the discipline or patience in America's frequently extended bull markets.

Eveillard acknowledges his approach is different and perhaps paternalistic. During his 25 years managing First Eagle Global fund, he suffered only two down years, with a combined loss of less than 2%, and posted some of the best risk-adjusted returns of any manager during that quarter century, according to Morningstar. One of them was 1998, a year in which his fund appeared on a Lemon List of funds to avoid.

Because Eveillard declined to participate in tech mania, he lost half his shareholders in the late 1990s. Today, he can laugh about it. But nine years ago when many value investors were quitting the business, it wasn't so funny. "It never pained me to watch good investors do better than me, but in the late 1990s some people I thought were idiots did much better than me," he recalls.

For a sophisticated professional investor, Eveillard shares a trait common to many retail investors. He's not just risk-averse; he's also loss-averse. "My first responsibility is to avoid losing money, at least over the long term," he says, echoing Buffett's first rule of investing. "Unlike hedge funds, mutual funds are dealing with the savings of middle-class people. If I lose money, it could make life more difficult for retirees and other people who need the money. That's more important to me than looking stupid to your boss by owning Ford and not Cisco."

The first three years of the new millennium were an extended nightmare for the vast majority of investors, but they proved to be an extended victory lap for Eveillard. From 2000 to 2002, his funds stayed in positive territory. When the last go-go investors were capitulating in the wake of the Enron-Worldcom

corporate accounting crisis in 2002, his global fund, boosted by heavy weightings in foreign stocks and gold, posted a 10.2% gain.

In 2003, First Eagle Global fund enjoyed its best year ever, returning 37.6%. Eveillard was busy loading up on depressed stocks like Tyco and Vivendi, run by "that idiot [Jean-Marie] Messier." Both Tyco and Vivendi produced big gains for First Eagle, though he remembers hearing warnings from colleagues asking if he had lost his mind or had stopped reading the newspapers, filled with headlines detailing the companies' woes.

Today's global equity markets may not be exhibiting the same degree of froth they were in other cross-continental booms in 1987 and 2000, but other factors concern Eveillard. "One thing that worries me is we, the mutual fund business, are not as well-prepared for an equity market decline, because what was required in 2000 was a lack of exposure to one group, technology," he says. "Today, every asset has gone up: stocks, bonds, gold, real estate. All sorts of hedge funds and others have an eclectic approach to trading assets. When they have a problem with one asset, they liquidate another asset class."

For most of the 25 years Eveillard ran the First Eagle funds, he held a sizeable position in gold. The dismal performance of gold during most of those years, combined with his foreign equity exposure at a time when both U.S. equity markets and the U.S. dollar often were strong, make his S&P-beating performance all the more remarkable.

These days, however, gold and gold related securities account for approximately 5% of his holdings and Eveillard is starting to question its efficacy as "an insurance policy," particularly in light of its run-up in recent years. "I'm beginning to worry that if equity markets went down, gold would go down for a few months too,' he says. "The correlation between the two is much higher."

Partly for that reason, he's holding 15% of his assets in cash these days.

Valuations for financial assets, commodities and real estate all are high, but Eveillard thinks equities, unlike real estate in several nations, haven't quite reached bubble levels. However, the increasing efficiency of most global markets is shrinking the number of investment opportunities available. "Ten or 15 years ago there were major inefficiencies in continental Europe," he says. "Today, there are far fewer."

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One major difference enhancing market efficiencies in America and Europe is the growing role played by private equity firms. Before investing in a company, Eveillard and his staff try to calculate what a knowledgeable buyer would pay for the company. "In the 1990s, you had the Greenspan put," he explains, referring to the widespread belief among investors that the Federal Reserve Board would cut interest rates in the event of a serious stock market correction. "Today, you have the Bernanke put and the private equity put."

Chuck de Lardemelle, the fund's associate portfolio manager, finds that private equity firms are becoming formidable competitors for value investors, as they are often quick to pounce on companies when their shares start trading at significant discounts. The result for the last two years is very few discounts. "When a private equity firm takes us out of an investment, very often we are not happy about the price," de Lardemelle says.

As funds that like to go where others fear to tread, it should come as little surprise that two places the First Eagle funds have been bolstering their positions are in U.S. newspaper stocks and Japanese industrial companies. Over the last year, the funds have purchased positions in both Dow Jones and The New York Times, two companies with great franchises operating in suddenly difficult environments resulting from the Internet-driven disintermediation of their basic business. Moreover, both companies are controlled by family trusts, and their managements have been criticized for mediocrity.

"If you look at what managements did before the environment became hostile, they didn't do much with franchises they had and the stocks and businesses still did well," Eveillard says. "Mediocre management was more than compensated for by the quality of business."

Many managements like First Eagle funds because of their willingness to take long-term positions in companies. Eveillard says he has sometimes opposed the sale of a business, even at a significant premium, if he believes it has the potential to sustain its growth rate for five or ten more years. In other words, he sometimes sees exactly the same business characteristics private equity firms see and doesn't want them to hog it all for themselves. It's a position more respected mutual fund companies, notably T. Rowe Price & Associates, are starting to take as the private equity train moves into the express lane.

In the case of Dow Jones, the $60 a share offer by Rupert Murdoch's News Corp. was far above what de Lardemelle estimates was its private market value of between $45 and $48 a share. But given that Murdoch sees it as a trophy asset and wants to use

Dow Jones journalists, who currently provide a major share of CNBC's content, for his soon-to-launch Fox Business channel, he may be able to justify a price that other buyers can't. As for The New York Times, de Lardemelle calls it "a high-quality franchise that will last," one with room for improvement in its operating margins.

The quest for value sometimes takes First Eagle into strange places, including some of the great American growth names of the 1990s. Two of its larger holdings are Microsoft and Johnson & Johnson. Microsoft was purchased in the low $20s when de Vaulx was still running the fund. "Value investors tend to prefer businesses that are not too difficult to understand," Eveillard says.

The U.S. pharmaceutical business has fallen on hard times, and that's the sort of development that catches Eveillard's interest. "Despite huge R&D budgets, the pipelines haven't been there and they seem to get caught up in dubious sales practices, like advertising pharmaceuticals on TV," he says.

That said, he believes Johnson & Johnson's stock is very reasonably priced. "It's a pharmaceutical business and a consumer business, and it has a very good corporate culture," he maintains. Another drug company that First Eagle holds a major position in is French giant Sanofi-Aventis, which purportedly has an excellent pipeline, even though the Food and Drug Administration recently shot down its obesity drug, Accomplia, that is approved in Europe.

But screaming values are scarce these days. Once upon a time, Europe in particular was filled with bargains galore. Another of First Eagle's major positions is a Swiss holding company called Pargesa, which typically owns substantial minority stakes in eight to 12 businesses and occasionally plays a discreet role in the management of these concerns. At the time Eveillard bought it, Pargesa was selling at a 40% discount to the sum of its parts, many of which he believed were also seriously undervalued. It seemed a rare opportunity to double down.

"I didn't see the point of the discounts, so I talked to a European analyst who told me, 'Two years ago it was at a 20% discount, now it's a 40% discount and next year it will be at a 50%.'" That was music to his ears. Today the First Eagle funds own more than 7% of Pargesa.

There's only one area left in the developed world where the classic Benjamin Graham-style values that Eveillard loves still exist. That's in Japan, possibly 2007's worst stock market, and South Korea. "The largest discounts we see are in Japan and South Korea, two nations where private equity is not a presence," de Lardemelle says.

> "I think investors everywhere in the world tend to be impatient."

China's economy may be growing at a 10% annual rate for more than two decades without a recession, an achievement many economists say has never been reached in history, but Eveillard doesn't trust their accounting. So markets like Japan, Korea and Singapore remain his favorite way of playing the Chinese boom, as does an eclectic holding like Remy-Cointreau, which is benefiting from China's love affair with Remy Martin brandy.

One Japanese diamond in the rough is Keyence, which makes sensors for factory automation. Since 1995, it has grown revenues at a 14% annual clip and compounded revenues at a 17% rate, while boasting 50% operating margins. Keyence sells at 26,000 yen a share and has 6,000 yen a share in cash. "Net out the cash and it has a 50% return on equity," Eveillard says. "We believe the business is worth about 34,000 yen."

Another recent Japanese discovery is SMC, the world's largest producer of pneumatic equipment, or complex valves. SMC, which does $3 billion in revenues, competes against Parker-Hannifin, which has several other major business lines, in the U.S. It sells at 15,000 yen a share, and its cash is about 5,000 yen a share. While the stock is cheap, Eveillard acknowledges it may be near the cyclical peak.

But then these are times to keep one's powder dry and let some cash build. Eveillard and de Lardemelle don't see equity valuations as absurd, just full and maybe a little more generous than fair. Eveillard thinks most investors' memories of the 2000-2002 bear market are still present, albeit fading. "But give this bull market another six to 12 months" and he suggests they may fade into dust.

That, of course, raises the issue of one key to successful value investing—that most un-American of virtues, patience. "I think investors everywhere in the world tend to be impatient," he says. "At the end of every day, I look at my stocks that went up and wish I had more and look at the ones that went down and wish I had less. It's human nature. But you have to learn to wait for the fat pitch."

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| Average Annual Returns as of 6/30/2007: | Year to Date | 1 Year | 5 Years | 10 Years |
|---|---|---|---|---|
| First Eagle Global Fund Class A (Without Sales Load) | 6.97% | 18.06% | 19.33% | 14.23% |
| First Eagle Global Fund Class A (With Sales Load) | 1.67% | 12.16% | 18.11% | 13.80% |

*The performance data quoted herein represents past performance and does not guarantee future results. Market volatility can dramatically impact the funds' short term performance. Current performance may be lower or higher than figures shown. The investment return and principal value will fluctuate so that an investor's shares, when redeemed may be worth more or less than their original cost. Past performance data through the most recent month end is available at www.firsteaglefunds.com or by calling (800) 334-2143. The average annual returns are historical and reflect changes in share price, reinvested dividends, are net of expenses and "with sales load" performance reflects the maximum sales load of 5%. Performance reflects a total fund operating expense ratio of 1.15%.*

First Eagle Global Fund, Overseas and Gold Funds are currently closed to new accounts.

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