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A Portfolio of Great Companies at Cheap Prices

The manager of Longleaf Partners says his fund holds stocks with the potential for big returns.

By Andrew Tanzer

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The market may finally be starting to cooperate with Mason Hawkins, one of the managers of **Longleaf Partners**. The fund, a member of the Kiplinger 25, was up 2% this year through March 27, a return 10 percentage points better than Standard & Poor's 500-stock index. Last year, Longleaf (symbol **LLPFX**) shed 51% of its value -- 14 points worse than the index.

Of course, Hawkins, a crusty legend in the mutual fund industry, couldn't care less about short-term results. Operating from Memphis, Tenn., he's run Longleaf since its inception in April 1987 (Staley Cates became a co-manager in 1994), adhering strictly to a bottom-up, value-oriented discipline with an eye toward the long term.

When we caught up with Hawkins before the market's recent turnaround began, he could barely contain his enthusiasm. Why? He was confident that he had filled his portfolio with wonderful businesses selling at cheap prices. "Even if you assume that it takes a while for the economic picture to improve," he says, "there are certain great companies with very, very discounted share prices" that offer the potential for significant future returns.

One of Hawkins's favorite measures is to compare a stock's free-cash-flow yields to the yield of Treasuries. (Hawkins defines free cash flow -- "owner's profit"-- as cash flow minus capital spending and working capital. To figure free-cash-flow yield, you divide free cash flow per share by the share price.) By this yardstick, and with Treasuries currently yielding just 3%, he says, "stocks have never been cheaper" during his 35-year investment career.

Hawkins notes that many of the holdings in his concentrated portfolio, such as **Dell** (**DELL**), **Disney** (**DIS**), **eBay** (**EBAY**) and **DirecTV** (**DTV**), are paying free-cash-flow "coupons" well into the teens. And, unlike the fixed-interest payments of Treasury bonds, these "coupons" will grow over time, assuming the businesses generate ever-higher amounts of free cash flow. "The market is voting fearfully today because no one knows when the economic world will stabilize," says Hawkins.

He seeks to own highly competitive, entrenched businesses managed by "honorable and capable people." Longleaf appraises a business and buys the stock when the fund managers reckon it's selling at a 40% or larger discount from the underlying company's intrinsic value. Hawkins believes that, on average, his holdings today sell for less than half of the value of the underlying businesses. Says Hawkins: "We believe that great businesses like **Walgreen** (**WAG**), **Yum Brands** (**YUM**) and DirecTV will not only grow significantly over the next decade but also have few competitive threats. The strong will get stronger in this credit-starved environment, and eventually investor psychology will shift from fear to greed."

Longleaf, which reopened to new investors in January 2008, levies no sales fee and carries an annual expense ratio of 0.90%. It requires an initial minimum investment of $10,000.
