Bruce Berkowitz: "Prices today are as attractive as I have seen in my career"

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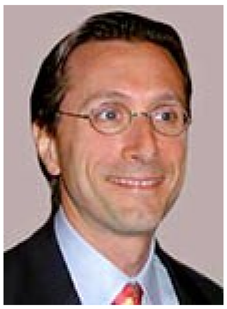

Bruce Berkowitz is the Founder and Managing Member of Fairholme Capital Management and the portfolio manager for the Fairholme Fund (FAIRX), a $6.7 billion fund that he started in 1997. The Fairholme Fund, which has consistently outperformed the S&P 500 since its inception, is one of the top 10 actively managed funds within the Most Popular Mutual Funds in the Advisor Perspectives universe.[1] One of the most respected experts on value investing, Mr. Berkowitz is the author of an introduction to a chapter in the 6th edition of Securities Analysis, a textbook on value investing by Graham and Dodd. The chapter is devoted to Graham and Dodd's concept of the dividend factor, which forms the basis for Mr. Berkowitz' reliance on free cash flow yield as his key metric for valuation.

We interviewed Mr. Berkowitz on December 24, 2008.

You were recently elected to serve on the Board of one of your portfolio companies, AmeriCredit Financial (ACF), in which you and another investor have a controlling interest. How do you value ACF in run-off mode? As a going concern? You have investments in two levels of ACF's capital structure and are now a director. How do you weigh the advantages of being an activist with the business risk of being an insider?

This is an excellent question and it goes to the key issues behind our investment. We bought ACF because we believed there was significant value in the company through its ability to generate free cash flow. Then we looked at ways in which we could "kill" the company – i.e., what kinds of mistakes or misfortunes could impair our investment. In the case of ACF, we believe that in some of those scenarios – such as in run-off mode – we could get significantly higher value. The tangible book value should start to approximate the liquidation value. But then we look for what is not included in the tangible value, such as the time value of money (e.g., the present value of

[1] Advisor Perspectives provides the most popular mutual funds based on assets under management within a universe of approximately $50 billion of assets managed by registered investment advisors. This list includes both ETFs and actively managed funds, and is updated weekly. At the time this article was written, FAIRX was the 10th most popular actively managed large cap fund, and the 26th most popular large cap fund including ETFs.

future insurance premiums) and whether the tangible values are really tangible (e.g., whether their fixed assets are fairly valued on their balance sheet).

In the worst case, we will make some pretty good money.

I look at my Board seat as a way to protect our shareholders' value. It does not affect my relationships with or ability to invest in any other companies. In fact, it expands my knowledge of related industries, from automobile lending to dealerships to insurance. When the time comes to sell our investment, I will leave the Board. I do not accept any compensation, such as fees or restricted stock grants. Only my travel expenses are reimbursed. I will only stay on the Board to help our shareholders.

Leucadia National has minimal disclosure, no Wall Street coverage, and no conference calls. Further, their free cash flow is irregular. How can you meet Ben Graham's requirement of thorough analysis or determine the margin of safety?

We can't do that analysis in this case, because we are dealing with more of a Berkshire Hathaway issue. We place a significant amount of weight on the past record of management, along with analyzing holdings on a quarterly and annual basis. Mostly, this represents the style of investing where we respect the people running the company. We have studied Leucadia and their management over a 20 year period. There are no surprises.

Their management is honest, decent, and does not have an oversized ego. They have a better track record than Berkshire Hathaway and they take their fiduciary roles very seriously. Moreover, whereas Berkshire Hathaway is built to last for a very long time horizon, Leucadia has value even over shorter time periods. When the CEO, Ian Cumming, and the president, Joseph Steinberg, retire, they'll probably give all the money to their shareholders and call it a day.

You have paired some of your stock positions with senior subordinated debt. Can you explain the investment thesis behind this?

The bond market is more dysfunctional than the equities market. When we see that we can get excess return on the higher end of the credit structure, we know we are on to something good.

We look for certain covenants on the bonds we buy. For example, we want "cross default" provisions, so that if any of the company's bonds default, then principal payment is accelerated on all the bonds. Similarly, we want change-of-control or "poison pill" provisions, which accelerate principal payments in the event of a takeover. This way, even in an unfriendly or hostile situation, we still get our "box of chocolates" from the bond markets.

Are your positions in health care predicated on the Congress and the new administration enacting some form of national health care plan? What happens if the funds to move forward with such a plan are not available?

To answer this question I must explain our investment process. First, we look at a company's free cash flow relative to its price. Ideally, we look for a free cash flow yield of 10% or better. [In a recent conference call with investors, Berkowitz said that he is now seeing opportunities with companies trading at two or three times cash flow.] Then we ask what management will do with that cash. If management has a record of investing wisely, that's great. But we also worry about what can go wrong – what I referred to earlier as "killing the company." If there are signs that value will be destroyed by actions such as over-leveraging the balance sheet or other stupid management decisions, or if there are certain questions we cannot answer, then we move on to the next investment candidate.

We did not invest in these sectors because we saw nationalized health care coming. We invested because of the value of these companies, in terms of free cash flow, relative to their prices in the market.

The Baby Boomer generation is entering retirement, and they are interested in life, liberty, and the pursuit of happiness. I know, because I am 50-and-a-half and at the edge of this generation. This is a gigantic demographic segment starting to retire and they want to be in good shape and to stay young – and it will take a lot to achieve that.

We have a great health care system, but the unintended consequences include rising costs. For example, nobody says you are too old for a hip replacement. Health care is expensive and HMOs insure the greatest number of people. The two HMOs we own handle 25% of the insured population in the US.

Obama wants everyone insured with the same degree of coverage as the members of Congress. If HMOs like UnitedHealth, WellPoint, WellCare, and others cannot provide these services, then who will? The only thing government can do is to cut a check. Those that are providing these services now will be the ones providing it in the future.

These businesses are very much like our insurance businesses. They can make a mistake in pricing a policy, but in six months they will have the opportunity to adjust those policies. They may lose some members but overall retention rates will be quite high.

Rather than meeting with management, you scrutinize earnings call transcripts and texts of speeches to understand how management has behaved in the past. Since you have also said that some of your biggest mistakes have involved overestimating management, what clues or triggers do you look for when you do this analysis?

We meet with management, but we also rely on their paper trail. The key thing is to understand how management behaved under adversity. As Warren Buffet says, when the tide goes out, you get to see who is naked.

Today's environment – right here and right now – lets us see how management will perform against significant headwinds. We are less concerned about how they performed with similar tailwinds.

As Buffet says, it pays to be greedy when others are fearful. There is a huge fear factor in the market right now. This is a necessary – but not sufficient – condition for great investing. Those that survive this environment will have many happy stories to tell.

In the past, you have said that your valuation of Sears Holdings is based, in part, on the value of their real estate. How exposed is your holding in Sears to the fragility of the commercial real estate market?

We are not looking at today's values in the real estate market. We have come to the conclusion that we cannot snap our fingers and sell. If the value from Sears comes from its real estate holdings, then it may take a while to sell those properties.

The value in Sears is in four highly valuable brands, the largest appliance retailer and servicer, and a large automobile repair operation. I am not saying that Sears cannot continue in its current business model. We are coming through the Christmas season and inventory is down, so this may be a good time for them to buy back some shares. Sears has $11 billion in inventory with $4 billion in debt, so there are many ways we can capture the value in our investment.

You are heavily weighted toward defense and health care, based at least in part on projections of future government spending. Has your thinking changed at all as a result of the projected infrastructure stimulus package?

I am more optimistic. The decisions to invest in these sectors were made before the discussion of this stimulus package. The stimulus package is icing on the cake and it also makes me more comfortable in some of our rental businesses, which were originally aided by the Bush's fiscal policies.

Now we are seeing the Mother of All Stimulus Packages. When we invested in our companies, we assumed nothing more than the value that was there at the time of our purchase. The government will be building roads, tunnels, and bridges. We are located in southern Florida, and there are man-made islands that were built during the Great Depression. Great things like these can happen as a result of adversity, although we may not know at the time. We have a way of forgetting what adverse conditions are like.

Based on your metric of free cash flow yield, how cheap or expensive is the overall market on a historical basis?

The last tough environment was in 1987, but that was a sudden shock and not a big event. Within a year the markets had recovered. In the Dot Com era the markets were caught in a mania, but the current crisis is much worse than what occurred at the end of that bubble, which was contained in the tech sector.

You would have to go back to 1974, when even the smartest investors were down 50% or 60%. I cannot say whether the market is as under-valued today as it was then, but certainly we are seeing valuations for companies in our portfolio that are comparable to those of 1974.

What are the lessons of the Madoff affair? Do you expect hedge fund liquidations to further reduce valuations in the first quarter?

Anyone who wanted to be liquid was already headed in that direction. If not, as investors withdraw funds, they will put pressure on the remaining hedge fund limited partners, unless the fund closes and does not allow redemptions.

I was extremely surprised that anyone would invest simply on a level of trust. I believe in "trust but verify." Even businesses that might seem to operate simply on trust really employ a level of verification. For example, in the Diamond District in New York, millions of dollars may appear to change hands simply on the basis of a handshake. But, behind the scenes, there is a careful evaluation of the diamonds that were just sold. Those transactions take place at a single point in time and, if something goes wrong, the participants will never do another transaction. In Madoff's case, investors continued to put money in over many years, without any verification.

There was a tremendous amount of social pressure to invest with someone who was perceived as brilliant and charitable. It was a social phenomenon.

You must have an independent source of verification. We have a large bank as a custodian, along with independent auditors and law firms. Our shareholders get statements provided by a secure independent third party. My money is in the fund too. We must avoid any possibility of collusion, which is why we rely on independent auditors.

What should investors expect from the market in 2009?

I don't mind tough questions but this is an impossible question. There are two ways to invest – either predicting or reacting. I admit I have no skill at predicting. To predict would be foolish, so we react. We invest based on free cash flow relative to the price of a stock.

We could be bouncing around the bottom of the market. But I don't know whether the true bottom will come in 31 days or 31 months. Prices today are as attractive as I have seen in my career and it will be worth the wait for the market to deliver the true value of these companies.