



Let's Talk Stocks: Berkowitz, Marsico and Weitz

By Robert Huebscher

June 9, 2009

Three of the industry's most accomplished value investors – Bruce Berkowitz of the Fairholme Fund, Tom Marsico of Marsico Capital Management and Wally Weitz of Weitz Funds – spoke at a panel discussion at the Morningstar Investor Conference on May 28. Pat Dorsey, Morningstar's Director of Equity Research, moderated the discussion.



Bruce Berkowitz



Tom Marsico



Wally Weitz

Below are some excerpts of their thoughts on key questions raised during the panel.

Are valuations low?

Marsico: Valuations are not as compelling as in 1981-2, when interest rates were high and P/E ratios contracted. The opportunities are great, especially with the financial stocks. Valuations in certain areas are better than in 1981.

Berkowitz: In September and October every day was a knife fight. This was the definition of a difficult bear market. It was the cheapest period I have seen in general, although some sectors may have been cheaper at other times. Most stunning was the cheapness of companies' senior credit, which were giving excess equity returns. This was the first time I have seen this in my career. We could be creditors and end up with 20% annual returns.

Is it different this time?

Weitz: A lot of financial institutions will have to follow their capital requirements more closely, and if this lasts another year or two and people get really discouraged we could see the fear of stocks that we had coming out of the 1930s. There will be bad news for a year or two, but consumers will be out spending and overall it won't be so bad.



Marsico: The regulators were not on their watch. The regulations in place need to be enforced and we need transparency, especially in the hedge fund community and among other financial intermediaries. We must get rid of naked short selling and the unregulated CDS market. We've created a situation where small price movements can create large market moves. Our banking system is responsible for a much smaller share of overall lending. We need to shift lending back to financial institutions, because it is easier to see what is on their balance sheets.

Berkowitz: This time is different because of the role of derivatives, but every time there is a difference. It was impossible to know what banks owned and owed. There were many similarities to past crises. If you stay focused and ignore the crowd, invest based on what you pay and not on what you get, you will be okay. My question is: What happens when we get to a more normal environment and everything seems more expensive? We are getting used to extremely juicy returns and I hope we don't revert to the norm too quickly.

Weitz: Investors have been rewarded for hitting the bar. If it takes two to three years of dragged out recovery, then maybe that reflex will be changed. We won't know that until it happens.

Marsico: There are \$4 trillion in money market funds earning zero return. As the pendulum swings from fear to greed, we are seeing stabilization in the economy. There have not been any failures in several months. People are panicked that interest rates will rise. Money market funds represent 50% of the equity market's value, which has not been the case since the 1980s or early 1970s. When banks pay back their TARP loans, investors will reengage in the market.

What were your mistakes of omission during the past year?

Berkowitz: We got so caught up in the world as the market was going down. We recognized value in certain areas, and bought American Express, some rental companies and automobile lenders. We could have done more. We spent too much time on defense to be able to focus on offense.

Weitz: We were guilty of the failure to sell a lot of things, going back a year or a year and half, when we recognized a recession was looming. This was true not just of the financials but of cyclical stocks.

Marsico: All asset classes went down the same amount – about 40% – bonds, stocks and commodities. We are supposed to be invested. The real issue was our cash position and how far out to go on the spectrum. We avoided the health care group because in 1992, when the Democrats came in, they went down. Now their valuations are even cheaper, as this segment is getting punished again.



What is your outlook for the health care industry?

Berkowitz: We went into health care, which we view as an essential, recession-proof industry with huge free cash flow, although the companies are horrible capital allocators. The cash is there and it flows in even when they make mistakes. Health insurers are our healthcare system – that is not going to change quickly, no matter what the rhetoric may be.

Weitz: We agree that health care companies are the health care system. The government can try to squeeze their margins but they are the players.

Marsico: Regulation in health care will require different decisions. As a society, we can't afford health care at the level it is provided now. A lot of countries are doing a better job. The US will have a much more regimented, evidenced-based mentality for medicine – an intellectual way to approach the problem. There will be fewer services and fewer drugs. Innovation needs to happen at the drug companies through a change in their culture. The existing large drug companies have lost their culture.

Berkowitz: If you eliminate fraud and excess commissions, we are halfway to solving the problem. Malpractice is still a big problem. The demographics in the US make health care expensive, and someone has to pay for it. Until we all start exercising and stop demanding hip or knee replacements because we are overweight, problems will remain. Health care companies are not making that much but they are bargains because their stock prices have fallen off a cliff relative to their intrinsic values.

Are health care companies efficient capital allocators?

Berkowitz: Health care is going to the auto insurance model. Big pharma companies are becoming administrators, like merchant bankers. They need to joint venture with the companies that are coming up with the next big find.

Weitz: There are 47 million uninsured people getting health care in the emergency room, but they are not getting preventative medicine. If you rearrange that you get more productivity.

Are there values in the railroads?

Marsico: Railroads have looked great for many years, and we have invested in them for last few years. There are now four major railroads, so there are antitrust concerns. The industry requires huge capital investments. The industry is governed by the Staggers Act, which sets a ceiling on the rate-of-return for these assets. Some companies are hitting that ceiling. The Union Pacific is not one of them, and I like their operating characteristics – a fixed-cost business where they have taken out costs, with pricing



flexibility due to contracts that are 15 or more years old that will be renewed at prices that are multiples of current rates. The Norfolk Southern is the best US railroad (but not as good as the Canadian National), with a solid business carrying coal and grain. It is a stable cash flow business at cheap multiples.

Weitz: We avoid the railroads because they are capital-intensive. Nonetheless, we like that they are beginning to gain pricing power and energy costs are giving them an advantage over trucking.

How do you value the capital allocators like Berkshire Hathaway?

Berkowitz: For companies like Berkshire, Leucadia, and Sears we use look-through analysis – valuing the assets, income statement and capital structure. Is it cheap? Can you get the future for free with a manager who has a good track record?

Weitz: The “sum of the parts” analysis is seductive, but we have had a poor experience with it. The extra ingredient is management that you really trust to use assets well, to be opportunistic, appropriately cautious and not over-leveraged. Very few managers are that way. Buffett is the only who I would buy a black box from. John Malone is very different – complex and conservative – and good things have happened with his media assets. There are only a few managers over the last 35 years who I would trust.

Marsico: One company that understands cheap assets is Goldman Sachs. They have insights into how to make money without high leverage from seeing capital flows.

Weitz: As for Sears, we don't know Eddie Lampert. When you delegate decision-making to people you have known for a long time, you want to know how they are likely to decide at a fork in the road.

Berkowitz: We want owner/managers who put themselves in the shoes of outside shareholders. We believe you die only with your reputation.

Were there any management teams you mis-appraised?

Berkowitz: We overestimated a lot of management teams. We now believe the business beats the manager. That view has changed over the last five years. You want a company where your idiot nephew can make money. It's the business, but management is crucial, especially in capital-allocation decisions. You don't know a manager until you see them in the most difficult of times.

Weitz: We have been disappointed either because managers we trusted to know what they didn't know stepped outside and got in trouble, or were too willing to take a “Hail Mary” risk. We always ask what it takes to kill a company. Especially in financial services, there is a way to kill every company.



Marsico: We owned a retailer we thought was insulated from financial conditions, but they advertised luxury goods when they should have been selling value in the crisis. We had a credit card business that we did not have our hands around, and were disappointed in execution.

Berkowitz: Management typically gets into trouble and then tries to extricate themselves. Sadly, this is the majority of situations.

Weitz: There have been fewer cases lately of companies doing poorly and management getting stock to start over.

What problems and questions occupy your time?

Marsico: We have been focusing on the global nature of the markets, to understand how they affect our market and how to invest internationally. Which will be the fastest growing markets? We have sent people to Asia, including China and India, to understand their stimulus programs. We are looking at the balance sheets of countries to see how the dollar is valued. Interest rates are rising but only to a certain level, because then we will attract capital (relative to other countries). We spend a lot of time on policy to understand where regulation is going.

Weitz: We are as micro as possible. We make sure we are focused in right place in case inflation shows up. We want pricing power, and we expect a choppy, mixed bag of news over the next year or two. We are looking forward to a lot of volatility. We don't want to follow old patterns.

Berkowitz: We are at our 10th anniversary and have averaged returns of 11.5% per year after a very poor year. We are now looking at the senior bonds of companies with yields of 18% – with some approaching 30%. What can be bad about that? These returns are better than our performance record, with less risk, and we are higher in the credit structure. Stocks are the most junior of bonds. Bonds are the most senior of stocks. We have a chance to make a lot of money. I hope this doesn't change.

www.advisorperspectives.com

For a free subscription to the Advisor Perspectives newsletter, visit:
<http://www.advisorperspectives.com/subscribers/subscribe.php>