ValueInvestor INSIGHT
The Leading Authority on Value Investing
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Alpha from Omega

Lee Cooperman began his storied Wall Street career before many of today's hot fund managers were born … and he hasn't lost a step yet.

As a Goldman Sachs partner and CEO of its asset management business in 1991, Lee Cooperman was financially secure, highly respected on Wall Street … and itching to run his own show. "It was time," he says. "I chose the name Omega, the end of the Greek alphabet, because this would be my last venture."

The second chapter of Cooperman's career has been as impressive as the first. His Omega Advisors, launched at the start of 1992, now manages $5 billion and its flagship fund has earned net returns of 16.3% per year, vs. 10.6% for the S&P 500.

Cooperman's wide-ranging quest for value is currently uncovering many opportunities, including those in energy, healthcare, Japan and what he calls "quality-growth" companies. See page 2

INVESTOR INSIGHT

Leon Cooperman
Omega Advisors

Investment Focus: Seeks companies trading at significant discounts to their private-market values, often due to inappropriately valued growth prospects.

Compounding Interest

CEOs who truly focus on compounding shareholders' capital per share are a rare breed. Chuck Akre's success rests on betting big when he finds them.

INVESTOR INSIGHT

Chuck Akre
Akre Capital Management

Investment Focus: Seeks high-return-on-capital businesses with excellent future reinvestment opportunities that are not fully appreciated by the market.

Having first invested in Berkshire Hathaway in the mid-1970s, Chuck Akre has a simple explanation for the shares' rise from $100 to over $105,000. "They grew book value at an above-average rate – for most of that time above 20% per year," he says. "That became the holy grail for me."

Following this holy grail to identify potential investments has paid off handsomely for Akre, who now manages $1.7 billion. His flagship partnership has returned an annual 21.3% (net) since 1993, vs. 10.7% for the S&P 500.

Akre casts a wide net in his search for "compounding machines," identifying current opportunities in such varied industries as insurance, gaming, automotive supply and dollar stores. See page 11

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Investor Insight: Leon Cooperman

Omega Advisors' Leon Cooperman (along with Steven Einhorn, Mark Cooper, Michael Freedman and David Mandelbaum) describes why he always has a view on the overall market, why energy is his largest sector exposure, the worst aspect of money management and why he sees undiscovered value in Corning, 3M, Omnicare and Transocean.

Your investing strategy can be described as multi-faceted. Explain the various components.

Lee Cooperman: We basically try to make money for our investors in five different ways. First, we take a position on market direction: Do we think stocks are undervalued and likely to go up or are they overvalued and likely to go down? As good as you are at picking stocks, if you get the market wrong it can overwhelm individual selection.

Second, we spend a fair amount of time on the asset-allocation decision, making a determination on what asset class has the best prospective investment returns 12 months ahead. At the most basic level, we're looking at stocks vs. bonds vs. cash, but we also go deeper into each category, investment-grade vs. high-yield bonds, for example.

Third, our bread-and-butter business and where we've been quite successful is in finding undervalued individual stocks on the long side. Fourth, we look for overvalued stocks on the short side. Finally, we also make "macro" investments, in currencies, global fixed income and the major international indices.

Many value investors – Warren Buffett most prominently – say they spend little time thinking about the market's overall direction. Why is that an important part of your strategy?

LC: We're not a slave to our market view, but the truth of the matter is that a rising tide does lift all boats and a falling tide lowers them. I would suspect even Warren Buffett has some fairly clear and strongly held broader views when he's short dollars, for example, to the tune of $19 billion. We just apply the same type of thinking when setting our equity-market exposure.

Steven Einhorn: Virtually all studies show that about 60% of the return and volatility of the average common stock is determined by the movement in the aggregate stock market. So while we're bottom-up stock pickers, we think it's important to have a view of the economy and the overall market to help us determine which industries and sectors to emphasize.

LC: There are thousands of mutual funds that will happily manage your money for a management fee of 1% or less. If you're a hedge fund with the audacity to charge between 1% and 2% as a management fee and take 20% of the profits, your clients have the right to expect something more. What I consider "more" is that when the market's overvalued, my clients expect me to figure it out and be hedged and out of harm's way. When the market's undervalued, they want me to be leveraged to the upside. If the U.S. is uninteresting, they expect me to find something around the world that makes sense. That's why I want to have diversified capability – we have an excellent team that is also looking at fixed income, commodities and currencies. Those are areas, if we do them well, in which we can produce additive returns without necessarily correlated risks.

Do you consider today's U.S. equity market overvalued or undervalued?

SE: I'd describe our view of the U.S. market outlook as respectable. That means a market that isn't susceptible to pronounced downside risk and that should deliver a high single-digit to low double-digit total return over the next 12 months.

What are the factors driving that view?

SE: One is the economy, which we believe will grow modestly over the next 12-15

Leon Cooperman

The Forest and the Trees

In 40 years on Wall Street, Lee Cooperman has distinguished himself both by an ability to see the big picture as well as to dive into the details. He rose through the research side of Goldman Sachs, eventually chairing the firm's investment committee and running its asset management business. He was named the #1 portfolio strategist for nine straight years in *Institutional Investor*'s "All-America Research Team" survey. At the same time, the thoroughness of his research on individual companies is legendary – to this day, he's well-known for insightful and tough questioning of executives on analyst calls.

At 63, Cooperman shows no sign of letting up. As he describes it: "I grew up in the South Bronx and am a graduate of P.S. 75 and Morris High School. I went to City University of New York for $24 a semester. I then spent 16 months at Columbia University getting an M.B.A., graduating on January 31, 1967. With a six-month-old son, National Defense Education Act student loans and no money in the bank, there was no opportunity to go on the obligatory six-month tour of Europe before going to work. I started at Goldman Sachs the day after I graduated from business school and I've been working that same way ever since."

months at an annual rate of 2% to 2.5%. We think that's a sweet spot for the equity market – fast enough to deliver respectable earnings growth, but slow enough to bring about a moderation in the rate of inflation and to keep the Fed from tightening. Housing is clearly in the midst of a very significant downturn, which will take a percentage point off of GDP growth, but we think capital investment in energy and growth from foreign demand will offset that and keep the economy growing.

We also think inflation is likely to become more tame as the economy slows. The best evidence for that is that inflation expectations built into fixed-income prices have been receding in the past six months and are at a 12-month low.

The third driver of our positive market view is the strength of corporate profits, which have been terrific. It's amazing that five years into an economic expansion, 72% of companies are reporting positive earnings surprises. Next year, though growth will slow, we think earnings will grow another 7-9%.

Related to that, the condition of the corporate sector is terrific. Returns on equity and profit margins are close to record levels, balance-sheet leverage is down, dividends are growing 10-12% and share buybacks are near a peak. With all that, we consider the market to be moderately undervalued. Absolute P/Es are the lowest they've been in 15 years and relative to interest rates and inflation, the market is attractively priced.

LC: To reverse the question, we look at what would change our mind from this constructive view. Every bear market, with the exception of the one following the Cuban missile crises in 1962, has been brought on by a recession. We talk regularly to companies like GE and Federal Express and retailers and the worst you hear is a possible slowdown in growth, not a recession. Our view would also likely change with a meaningful acceleration of inflation that brought the Fed back into play. We don't see that and are operating under the assumption the Fed is done tightening for at least six months. The third big negative would be a disruption in the energy supply chain that caused oil prices to spike back up to the upper $70s – that's very difficult to predict, but we might see the beginning of demand destruction if that happened.

When the rate of inflation has been between 1% and 3%, historically the S&P 500 multiple on forward earnings has averaged over 17x. Inflation is now in that range, but the current S&P multiple is around 15x. In this type of environment, we think the idea of buying a 10-year government bond at a 4.6% yield makes no sense relative to the stock market.

ON SHORTING EQUITIES:

With all the liquidity and buyout activity out there, we haven't seen a lot of profitable opportunities on the short side.

How is that view translating into your current asset allocation?

LC: We're heavily invested, about 82% net long. Since we started Omega, our average net exposure has been closer to 70%. We don't short in order to call ourselves a hedge fund, but when we think we can make money at it. With all the liquidity and buyout activity out there, we haven't seen a lot of profitable opportunities on the short side with equities. We do think fixed income is overvalued, so we have a short position on 10-year Treasuries.

How active are you in foreign equities?

LC: We'd like to have more, but we currently have about 15% of our equity exposure outside the U.S., mostly in Western Europe and Japan. We do very little in emerging markets – after our experience with Russia abrogating its debt in 1998 – but have positions in China Shenhua Energy, the largest coal company in China, and Lukoil and Gazprom, which we think are unique Russian energy companies. Lukoil, for example, has reserves equal to Exxon's, but trades at one-sixth the market capitalization of Exxon.

The gamble in China and Russia is on rule of law. The fundamentals of the companies are outstanding – the question is whether these countries are committed to open economies and capitalistic rewards.

In individual stock selection, what signals to you that something is undervalued?

LC: Here's how we think about it: The S&P 500 companies sell at 15x next year's earnings, 3x book value, 11x cash flow, 1.5x revenues, have an ROE of 17-18% and have anticipated trend earnings growth of 8%. We're looking for companies with equal or superior growth characteristics that sell at discounts to the market valuation.

Is it always a relative view?

LC: No, for us to buy something it has to be absolutely cheap and also cheap relative to the market.

We use the typical absolute approaches to valuation – based on discounted cash flow, asset values, earnings power – to arrive at what we think a company's true business value is. Publicly traded companies have essentially two values: the auction-market value, which is the price anyone pays for 100 or 100,000 shares, and the private-market value, which is the price an informed buyer would pay for 100% control. We're looking for companies where the difference between those two values is the highest and, ideally, where we can identify a catalyst for change. We're also looking for mispriced growth, where our view of the growth potential or the value of that growth potential differs from the market's.

How do you generate ideas?

LC: We have 12 people working on the idea side. We give them responsibility for an agreed-upon universe of companies and we expect them to mine those compa-

nies for the opportunities Mr. Market presents. They go about mining those opportunities in different ways, but nothing goes into the portfolio without someone's initials by it and my approval.

When you hire people, you have to give them enough rope to prove what they can do and be willing to share in the upside with them. At the end of the year when we review performance, we look at how each analyst's return on capital compares to the opportunities presented by the group of companies he or she follows. We look at how they manage drawdowns and risk. Did they make their money broadly or in just a few names? Did they communicate effectively? Did they learn from mistakes?

Are there particular businesses or sectors that tend to attract you?

LC: For the most part, we'll look at any sector of the market. Technology isn't at the top of our lists usually, but we do own Cisco, Microsoft, Oracle and Corning. With the exception of Corning so far, which we'll speak about later, these have all been very good stocks for us.

This isn't unique to us, but we want companies with large amounts of free cash flow, good business dynamics, a proven ability to profitably reinvest that cash flow and management properly incentivized to do the right thing for shareholders. We generally focus on businesses that are "two-cycle tested," where they've been through a couple recessions and have survived intact.

You generally won't see us buy things that have been up 50-60% – we figure somebody else already made the money on those. A company like [floor-coverings maker] Mohawk Industries, which has a lot of free cash flow and a CEO, Jeff Lorberbaum, who has done a great job of reinvesting that cash flow, we'd probably own if the stock was in the mid-$60s, but not at the $75-76 at which it trades today.

Do you consider yourself an activist investor?

LC: We don't look to go into underperforming companies and try to get them to change their ways, but we have no qualms about making our views known when things are being done that we don't agree with. When [power wholesaler] Mirant [MIR] announced a tender offer at a 30% premium for NRG Energy earlier this year, we said very publicly that it makes absolutely no sense to use auction-market stock trading at a big discount to our view of its value to pay private-market value for another company. [*Note*: Mirant withdrew the acquisition proposal in June.]

ON BED BATH & BEYOND:

I have tremendous respect for them, but they're too debt-averse and should buy up to 25% of their stock.

We own Bed Bath & Beyond [BBBY], which is arguably one of the best retailers in the country, and I have tremendous respect for the way they run their business. But we think they're too debt-averse and should take on debt to buy up to 25% of their stock. They have short- and long-term cash of $1.4 billion with almost no debt, while they generate in a typical year $400-450 million of free cash flow, which is growing. We have a very open conversation with them about this, they just haven't listened to us yet.

An example of good activism – by others, I should say – is what happened with Kerr-McGee, which has been my best performer this year. I couldn't get the company to see the virtue of buying back stock, but when Jana Partners and Carl Icahn launched a proxy fight, the company responded by shedding assets and announcing a big share buyback. A year later they announced another $1 billion buyback on their own and then ended up selling the company to Andarko Petroleum for a big price, well above the price at which they bought back stock. There's no question, and they will tell you this, that a key reason they got the price they did was by shrinking their cap base at the right time.

Sometimes being an activist can take more effort than it's worth. Four years ago we gave up on Tenet Healthcare, selling our entire position at about $35, after they made a series of stupid decisions. The final straw was when they bought back $1 billion in stock and said at the same time that the company's outlook was too uncertain to provide earnings guidance. I said to them, "I can respect the fact that you're not providing guidance, but why are you buying back $1 billion worth of stock if the outlook is so uncertain." Duh! [*Note*: Tenet shares collapsed in late 2002 and currently trade at around $7.]

What other things prompt you to sell?

LC: The highest-quality reason is when something reaches our price objective. When energy got to be too much of our portfolio and some of the companies started hitting our price targets, we sold a few, like Royal Dutch Shell and [coal producer] Consol Energy. A second reason we sell, as it was with Tenet, is to cut our losses short if something's not moving in the direction we expected. I tell my people to be in touch at least every couple of weeks with all their companies, to get whatever indication possible on how they're tracking versus expectations.

The third main reason to sell is when we identify other ideas with better risk/reward characteristics. A recent example was selling Time Warner because we thought News Corp. was more attractive. Finally, as we discussed earlier, when our market view changes, we sell to make adjustments in our asset allocation.

Your equity portfolio tends to be quite diversified. Why?

LC: Diversification is an important part of our risk management. Average individual positions range from 1-2%, with the largest core positions at 4-5%. In 15 years, we've had three positions that got as high as 8%, two that worked out very well and one, Tyco, that was a disaster at the time. With Tyco, we thought the market was being irrational and were buying on the

way down before the scandal really hit.

An important percentage of Omega's total capital is our own money and we're just trying to do what we think is intelligent in a highly uncertain world. I don't know how some of these young hedge-fund guys do it, being 160% gross long and 40% net long. I'm not questioning anybody, but if you're running a lot of capital, to be that gross long you have to either have enormous positions where you give up liquidity or you have to have an incredible number of positions, too many to follow effectively. Our level of diversification reflects our unwillingness to make such giant bets or to give up liquidity. We could liquidate our portfolio in 48 hours.

Describe the opportunity you're finding in "quality-growth" companies.

LC: As I mentioned earlier, we often find opportunity when our view of the value of a company's growth prospects differs from the market's, which is the case today with some very high-quality companies.

Michael Freedman: Stocks go up for one of two reasons: growth or multiple expansion. Growth investors who are not price sensitive are playing for business growth. Value investors often play for multiple expansion and are not overly concerned with growth. We try to look for situations where you can benefit from both – that gives you two ways to win.

Good, growing businesses tend to be cheap either because they're overlooked or out-of-favor. With our asset size, we're more likely to put capital to work in high-quality growth companies that are out-of-favor and in Mr. Market's penalty box. Fortunately, short-term, momentum investors can drive down growth-company share prices, providing plenty of opportunity for those with a longer-term focus to buy on the cheap.

Let's talk about one of the specific growth companies you see as out-of-favor, Corning [GLW].

MF: Corning's biggest and highest-profile business is providing the glass used in making screens for a wide variety of consumer electronics, most importantly liquid-crystal-display monitors and TVs. Consumer adoption of LCD TVs is now hitting its acceleration zone, as prices come down. I looked up and down the industry's food chain for the best way to play this explosion in consumer adoption and landed on two areas – supplying the liquid crystal and supplying the glass for screens. In each case there are very few suppliers and the manufacturing process is very difficult, making the potential upside very interesting as demand grows 40-50% per year.

The LCD panel itself is essentially a sandwich, with two sheets of glass and all the electronics and lighting behind it. The glass – Corning's business – has to be absolutely perfect, with no deviation in thickness or any imperfections throughout the entire panel, and it has to be able to withstand high temperatures in the fabrication process.

Given how hard that is to do, there are only three main players in the market: Corning, with 60% of the market, followed by two Japanese competitors, Asahi Glass and Nippon Electric Glass. Corning has been the technology leader, which gives them a pricing advantage until the competitors catch up. They're

INVESTMENT SNAPSHOT

Corning
(NYSE: GLW)

Business: Manufacturer of glass-based products with applications primarily in consumer electronics, telecommunications, life sciences and environmental control.

Share Information
(@ 11/29/06):

Price	**21.49**
52-Week Range	17.50 – 29.61
Dividend Yield	0.0%
Market Cap	$33.62 billion

Financials (TTM):

Revenue	$5.01 billion
Operating Profit Margin	15.2%
Net Profit Margin	6.1%

Valuation Metrics
(Current Price vs. TTM):

	GLW	S&P 500
P/E	28.4	20.4
P/CF	33.7	14.4

Largest Institutional Owners
(@9/30/06):

Company	% Owned
Fidelity Mgmt & Research	7.0%
Capital Research & Mgmt	4.8%
Wellington Mgmt	3.5%
Axa	3.1%
Barclays Global Inv	3.1%

Short Interest (@ 10/9/06):

Shares Short/Float	1.1%

THE BOTTOM LINE

As the market-share and innovation leader, Corning is ideally positioned to profit from booming consumer and industrial demand for liquid-crystal-display glass, says Michael Freedman. He believes that at a more appropriate 20x multiple of estimated 2008 earnings of $1.50 per share, the shares within a year should be worth around $30.

Sources: Company reports, other publicly available information

also the most flexible and cost-efficient manufacturer and their glass runs up to 15% more efficiently through the customers' fabs. That's why they've been able to maintain market leadership and another reason they get premium prices.

What is the market concerned about?

MF: Some of it has been over the timing of seasonal orders, which I think is irrelevant. There may be variability in consumer – and therefore TV-manufacturer – demand, but it has no effect on longer-term demand for LCD glass.

The market also seems very concerned about pricing. Every year the price of LCD glass on a per-inch basis goes down, as is typical in consumer-electronics businesses. This year the price per-inch will probably be down about 15%, which is more than the market expected. I don't consider that a big deal for two reasons. One, a big part of this year's decline came from Asahi and Nippon catching up in quality in certain glass sizes, wringing out some of the premium Corning was able to command in those sizes. To the extent the premium has been wrung out in those products, it can't be wrung out again, so there's no reason to consider the 15% price drop a trend.

Second, Corning seems to get little credit for that fact that they've been reducing manufacturing costs in the mid-teens also. This highlights one of their primary competitive advantages: they spend 10% of sales on research and development, working on both inventing the next big thing as well as driving down costs of existing products. That's a lot more money on R&D than their competition can afford.

How attractive do you consider Corning's other business lines?

MF: LCD glass is the major driver today, but I consider the two other main businesses to be excellent call options for the future. The telecommunications business is basically a play on more optical fiber being employed. During the Internet bubble, a lot of long-haul fiber was laid, but it can't be taken advantage of until new short-haul connections – utilizing Corning products – are in place. As demand for Internet video increases, you're eventually going to need that fiber capacity available. This business is breakeven now, but if orders picked up it would be very profitable, very quickly.

Their other interesting business is making emissions-control products for car and truck engines. New environmental regulations in Europe and the U.S. requiring cleaner-burning diesel engines in heavy-duty trucks go into effect on January 1. The rules basically require a scrubber on the engine and Corning has the best product on the market. They're booking small revenues now, but have signed deals that will show up materially next year. Corning believes this can be a $500-600 million revenue business within the next few years, and they tend to guide conservatively.

More generally, Corning's heavy spending on R&D would suggest they may have several blockbuster products in their labs right now, from things like solar cells, green lasers or ultracapacitors.

Trading recently at around $21.50, how are you looking at valuation?

MF: The company trades at about 16x consensus 2007 earnings estimates, which I think are conservative. If you look at 20 of the best name-brand technology companies, like Cisco, Nokia and Microsoft, the median P/E on next year's earnings is 17.9x and the median expected long-term annual growth estimate is 14.6%. So Corning is trading for a lower multiple while its consensus growth estimate is higher, at 17.3%.

Looking to 2008, I think the company can earn north of $1.50 per share. At the 18-20x multiple a company with these growth characteristics should have, we have a target price for next year of around $30.

ON 3M:

That researchers can spend 15% of their time doing what interests them is a source of 3M's competitive advantage.

Another blue-chip attracting your attention is 3M [MMM]. Why?

Mark Cooper: 3M is a large industrial conglomerate whose specialty is utilizing chemistry and materials science for a wide variety of purposes, often involving applying coatings to some kind of surface. Their best-known products are Post-it notes and Scotch tape, but that division makes up only about 15% of revenues. They have six different business units, serving a wide variety of consumer, commercial and industrial markets. For example, the display and graphics business applies film over any type of screen to enhance brightness or improve the viewing angle.

It's very much a company driven by intellectual property. It generates among the highest number of patents annually and *BusinessWeek* earlier this year ranked it #3, behind Apple and Google, on their list of the world's most innovative companies. The fact that its researchers can spend approximately 15% of their time doing what interests them is an important part of the company culture and a source of its competitive advantage.

You've said the company is currently misunderstood. What do you mean?

MC: With all the different business units and industries, it's very hard to analyze 3M at a micro level. Perhaps that's why the market seems so unenthusiastic about the company. I was at an investment conference in New York a few weeks ago and George Buckley, 3M's CEO, made a presentation. It was supposed to be mostly a Q&A session, but only two people asked a question and I was one of them. Afterwards, only one other investor joined me on the stage to speak with Mr. Buckley. This is a $60 billion market-cap company and I could spend a month with them and not know half the detail I'd want to learn about their businesses, but no one had any questions.

The opinions that seem to be driving the market price don't match reality. For example, there seems to be an increasing fear that the company's growth prospects have diminished, but if we look at the last three years of sales growth, it's close to the long-term average. The most recent year sales growth wasn't great, but I don't at all consider that a permanent trend, primarily due to growth potential overseas, particularly in Asia. The company currently gets just over 60% of revenues from outside the U.S. – that should be 70% within the next five years. I'm confident they can at least hit their overall target of 8% annual organic sales growth.

There's also concern that the company will overemphasize growth at the expense of margins. I think that concern is exaggerated for a few reasons. One, they're growing incrementally faster overseas, where they've historically earned higher margins. I also believe there's considerable inefficiency in their manufacturing and logistics operations. Over 50% of the products 3M sells go through at least three of their factories, which is shocking. Attacking those inefficiencies and taking costs out will obviously benefit margins.

Despite these issues, margins are currently at all-time highs – gross margins are over 50% and EBITDA margins are close to 30%. Even if the company did sacrifice some margin to grow faster in certain areas or devote even more than the current 5-6% of revenues to R&D, that would likely be a positive from a net-present-value perspective.

How is the market's seeming lack of enthusiasm showing up in the share price, which is currently around $81?

MC: Almost every valuation metric today is at a multi-year or all-time low, which contrasts with the growth potential and the returns on tangible capital this company earns, which are consistently over 50%. The P/E is close to a 15-year low, price-to-book a 10-year low, price-to-sales a six-year low and the dividend yield, at 2.3%, is the highest it's been in eight years.

If the company does just what the market expects, which is to earn $5 per share next year, I believe they deserve a 20x P/E multiple, which is appropriate for a business that should produce consistent 15% annual growth in earnings per share while generating extraordinary returns on capital. That puts our target price next year at around $100. If 3M does what we believe it can do over time on the growth side, the upside is much more than that.

LC: One thing I'd add here is that the company has a ridiculously unleveraged balance sheet – it ought to buy back $2-4 billion of common stock immediately at current prices. One reason we own it is that we expect a very significant cap shrink.

Tell us about one of your current healthcare bets, Omnicare [OCR].

David Mandelbaum: Omnicare is the nation's leading provider of pharmacy services to the long-term-care industry, primarily nursing homes. They have centralized dispensing and packaging facilities and also provide a variety of services beyond just filling prescriptions – things like making sure people are taking their meds and aren't having any adverse drug interactions. After buying NeighborCare last year, they have approximately 50%

INVESTMENT SNAPSHOT

3M Company
(NYSE: MMM)

Business: Diversified conglomerate specializing in applying chemistry- and materials-science-based solutions to consumer, commercial and industrial needs.

Share Information (@ 11/29/06):

Price	**80.98**
52-Week Range	67.05 – 88.35
Dividend Yield	2.3%
Market Cap	$59.63 billion

Financials (TTM):

Revenue	$22.47 billion
Operating Profit Margin	22.7%
Net Profit Margin	15.7%

Valuation Metrics
(Current Price vs. TTM):

	MMM	S&P 500
P/E	17.7	20.4
P/CF	13.2	14.4

Largest Institutional Owners
(@9/30/06):

Company	% Owned
State Street Corp	7.4%
Barclays Global Inv	3.0%
Vanguard Group	2.6%
Fidelity Mgmt & Research	2.1%
Capital Research & Mgmt	2.0%

Short Interest (@ 10/9/06):

Shares Short/Float	0.7%

MMM PRICE HISTORY

THE BOTTOM LINE

Market concerns over diminished growth prospects and margin pressures are overblown, says Mark Cooper, who expects overseas growth and cost savings to fuel consistent 15% annual earnings growth. At a 20x multiple of the consensus 2007 EPS estimate of $5 per share, he believes the shares are worth at least $100.

Sources: Company reports, other publicly available information

market share, far ahead of PharMerica and Kindred Pharmacy, which now themselves are merging into a new, independent company.

This is a business that is all about scale and market share. Ominicare has cost, price and distribution advantages from being #1, which gives them superior EBITDA margins in the 11-12% range. PharMerica's are around half that.

The stock's been a bit of a disaster this year, off more than 35% to a recent $39. What are the primary reasons?

DM: Several things have been weighing on the stock. First, the industry is undergoing a dramatic transition. Omnicare had previously been largely a Medicaid provider, but this year, with the new Medicare Part D program for prescription drugs, all seniors who qualify for both Medicaid and Medicare – much of the nursing-home population – are now covered under Part D. With that, instead of being price takers of state Medicaid agencies for drugs and dispensing, Omnicare now negotiates separately with all the private Part D plans, such as HMOs or pharmacy-benefits managers that are licensed under Part D. While change causes uncertainty, I generally look at this as a long-term positive. As the only truly national provider, Omnicare has been able to get better pricing from the large private plans relative to what it had under Medicaid.

Second, there's been an overhang problem because of some investigations into Omnicare's practices. The state of Michigan went after them over billing errors it discovered and the federal government and 42 states sued them over some irregularities in documenting the substitution of generics. Both of these have recently been settled, and while the market has tended to view these as potentially indicative of a larger problem, we generally consider these to be isolated situations that are inevitable when operating in such a complicated regulatory environment.

The third thing worrying the market is a pricing dispute with UnitedHealth. United covers about one-third of the dual-eligibles now getting their prescriptions paid under Part D. Omnicare negotiated great rates with United, but then United acquired PacifiCare, with which Omnicare had a less attractive contract. United then started moving its dual-eligible members over to the PacifiCare contract, which, if it sticks, would result in a 40-cent hit to Omnicare's annual earnings per share. Omnicare has sued them over that, and while I'm not counting on it as part of my investment thesis, I think it's most likely there will be a positive resolution of this for Omnicare, which would be a great catalyst for the stock.

Fourth, the company has been hit with significant extra costs – which we clearly see as non-recurring – in the second half of this year, due to a fire that closed one of its two main repacking facilities.

Last, but not least, Democrats taking over Congress has been a negative for healthcare stocks of all kinds.

What upside do you see for the shares?

DM: In investing in any business, but particularly relevant to healthcare, you make money when you can separate the noise from the fundamentals. When the fundamentals are strong and improving, as they are with Omnicare, the noise can create an exceptional opportunity.

INVESTMENT SNAPSHOT

Omnicare
(NYSE: OCR)

Business: Provider of pharmaceuticals and pharmacy services to long-term healthcare institutions such as nursing homes, primarily in the United States and Canada.

Share Information
(@ 11/29/06):

Price	**39.11**
52-Week Range	35.30 – 62.50
Dividend Yield	0.2%
Market Cap	$4.75 billion

Financials (TTM):

Revenue	$6.51 billion
Operating Profit Margin	7.5%
Net Profit Margin	2.5%

Valuation Metrics
(Current Price vs. TTM):

	OCR	S&P 500
P/E	28.8	20.4
P/CF	16.9	14.4

Largest Institutional Owners
(@9/30/06):

Company	% Owned
Fidelity Mgmt & Research	14.6%
Glenview Capital	7.2%
T. Rowe Price	4.7%
JPMorgan Chase	3.5%
Barclays Global Inv	3.1%

Short Interest (@ 10/9/06):

Shares Short/Float	8.5%

THE BOTTOM LINE

David Mandelbaum doesn't believe the recent events weighing on Omnicare shares threaten the company's strong and improving business fundamentals. Once the market "sees through all the clouds," he expects the shares to return to their historical 17x multiple of forward earnings, which would result in a share price of at least $54.

Sources: Company reports, other publicly available information

Omnicare's earnings power is very strong. They're getting higher margins on generics, which are taking market share. Other than with UnitedHealth, better pricing is locked in for next year. We see substantial cost-saving opportunities from the NeighborCare acquisition and efficiency initiatives now underway. There are also hundreds of acquisition opportunities for them among smaller players who can't compete in an increasingly scale-driven business, and such deals have generally been extremely accretive.

We estimate on the low end they'll earn $3.20 per share next year, versus the Wall Street consensus of $2.90. They could do even better than our estimate if the United case gets settled in their favor.

So the shares are trading at just over 12x next year's earnings, vs. an historical average of around 17x. Once the market sees through all the clouds and starts focusing on how well the company is positioned and the mid-teens annual growth in earnings it can produce, we see no reason this shouldn't return to its historical multiple. At 17x, this is a $54 stock.

What are the biggest risks here?

DM: If we're going to be wrong, it's most likely to be from some market change, say Medicare cutting Part D rates or plan sponsors squeezing them on pricing. We don't believe either is going to happen.

You're still heavily invested in energy. Describe one of your favorites in the sector, Transocean [RIG].

LC: We do still like energy, which currently makes up about 15% of our portfolio. We find energy-sector valuations to be attractive and expect high free-cash-flow levels to help fund buybacks, dividend increases and the de-leveraging of balance sheets. Having come down from speculative levels of a few months ago, we think an oil price of $50-60 per barrel is fundamentally defensible and that the secular supply/demand environment is favorable, with global oil demand growing up to 2% per year, while global supply growth is 1.5% or less. Despite extremely high oil prices, you're not seeing production grow at the majors – it's actually declining.

Oil prices are at a level that's more than sufficient to generate good capital spending in the sector, which particularly benefits services firms like Transocean. They own about 35% of the world's supply of fifth-generation deep-water drilling rigs and have the most-sophisticated equipment, the best technology and the best-trained personnel to man the rigs. And, there is an acute shortage of supply in these rigs, which will not change until around 2010. That's an excellent combination: You've got the best mousetrap in town, and mousetraps are in short supply.

As we've seen recently with the large discoveries in the Gulf of Mexico, deep water, which is economic at prices as low as $40 per barrel, is where all the development prospects are. Given that we agree with Boone Pickens – who made all his money trading oil – when he says he expects to see $70 oil again before he sees $50, we think Transocean trading on 50-cent moves in the price of oil is silly.

Isn't the rig business famously prone to overcorrecting on the supply side?

LC: We're the first to acknowledge that, but given that you're not going to see new

INVESTMENT SNAPSHOT

Transocean
(NYSE: RIG)

Business: Global provider of offshore contract-drilling services for oil and gas wells, with a focus on deep-water and harsh-environment drilling.

Share Information
(@ 11/29/06):

Price	**78.51**
52-Week Range	62.62 – 90.16
Dividend Yield	0.0%
Market Cap	$22.96 billion

Financials (TTM):

Revenue	$3.47 billion
Operating Profit Margin	33.2%
Net Profit Margin	26.4%

Valuation Metrics
(Current Price vs. TTM):

	RIG	S&P 500
P/E	27.2	20.4
P/CF	16.7	14.4

Largest Institutional Owners
(@9/30/06):

Company	% Owned
Capital Research & Mgmt	5.2%
Davis Selected Advisers	3.2%
Fidelity Mgmt & Research	3.0%
State Street Corp	2.8%
Vanguard Group	2.8%

Short Interest (@ 10/9/06):

Shares Short/Float	4.9%

THE BOTTOM LINE

As the leader in deep-water drilling services, Transocean "has the best mousetrap in town, and mousetraps are in short supply," says Lee Cooperman. Just by getting credit from the market for the $12 billion in cash earnings he expects from backlog orders through 2010, he believes the shares are worth at least $100.

Sources: Company reports, other publicly available information

deep-water rigs in any volume before 2010, we think that risk is already more than in the stock.

Another risk would be if the holes start coming up dry. These rigs lease out for $500,000 per day, so if they're not finding oil, they're obviously not going to drill. We see no evidence that will be a constraining factor.

At around 78.50, the shares are off nearly 15% from their May high. What do you think they're worth?

LC: Given the backlog from now until 2010 – all from orders by triple-A and double-A companies and countries – their business is reasonably locked. They have a funded backlog of over $20 billion, which will convert into about $12 billion of cash in the next three and a half years. That $12 billion in cash is about $40 per share. Just getting credit for the cash flow that's already basically in the bank, we believe the shares are worth at least $100.

Supporting the price is the fact that they're using some of their enormous free cash flow to buy back shares. They've authorized $4 billion in buybacks and have already bought in $2.6 billion worth so far this year.

Are you making any important "macro" bets, as you described them earlier?

LC: We have a position right now in Japan's Nikkei index. The S&P 500 is up around 12% this year, Europe is up 13-14% and the Nikkei is so far down about 2%. Japan has significantly lagged major world markets, yet they have a cheap currency, which is very positive for the profit outlook, and they have a 0%-interest-rate policy, which is very positive for multiple valuations. You have a growing economy with world-class companies, while corporate profit margins are low relative to the rest of the world, so there's more room for improvement. You're coming off a 15-year bear market and common sense would tell you there's more to go on the upside than two or three decent years. Finally, given the proximity to China, I expect more to fall off China's plate into Japan than into the U.S.

You've been at this for 40 years. Do you expect to keep it up for another 40?

LC: I still enjoy the game, making bets on something other people don't see and having Mr. Market prove me right.

I've said since I started in the business that three things would get me out of it. One is a medical issue and, knock on wood, I feel fine and have a lot of energy. Second is if I stopped delivering performance that is acceptable. My investor base is very committed to me and they know me personally – I don't want anyone sticking with me unless I'm delivering highly competitive performance. Third, I'll stop if I don't still enjoy it. That's the only one that's becoming more of challenge.

Why?

LC: The people side of things can be difficult. I'm unusual in this business. I spent my career at one firm before setting out on my own and have always been interested in being long-term selfish, not short-term selfish.

I've hired people for $50,000 a year, three years later paid them a multi-million bonus and then had them quit to make more money. It's "pay me, pay me, pay me if I do well and if I lose money, I'll see you later." I can't bemoan the way things are, the system has treated me very well. But people should recognize that it's a vacuum in nature, not some God-given right, that's created the opportunity to make the money that we do.

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Investor Insight: Charles Akre

Akre Capital's Charles Akre describes why "moats" are so central to his investing style, why he's not big on diversification, why high valuation is rarely the reason he sells and why he sees undiscovered value in Penn National Gaming, Markel Corp., American Tower, O'Reilly Automotive and 99 Cents Only Stores.

Your investment philosophy has been influenced as much by Warren Buffett the CEO as by Warren Buffett the investor. Describe how that came about.

Charles Akre: I was fascinated by John Train's *The Money Masters* in the mid-1970s, the first chapter of which was on Warren Buffett. I became the best student of Buffett I could and first bought Berkshire Hathaway shares when it had a $100 million market cap. From that happy experience, it became clear to me that the best way to see if a business is adding shareholder value is by the growth in its book value per share. You have to make adjustments for different industries or for issues with GAAP accounting, but I'm looking for growth in the company's true economic value per share over time.

What surprises me today is the number of CEOs and CFOs who are focused on other things – growth in new stores or the share price or their options. When I meet with management, I don't ask about growth in book value because I want to see if they get there on their own. Few do.

I look at it this way: The average annual total return from equities over long periods of time has been around 10%. When you clean up the accounting, the real return on equity [ROE] of American business averages in the low teens. So our conclusion is that a stock's return will approximate the company's ROE over time, given a constant valuation and absent distributions. So we choose to swim in the pool of companies where the returns are a whole lot better than average, in the 20% range.

Historical returns obviously don't guarantee future returns. How do you separate the future winners from the has-beens?

CA: We focus on three things: business model, people and reinvestment capability.

In companies earning abnormal returns, there's something unique going on and we want to understand what it is, why it exists and whether it's sustainable. We're trying to find businesses that have great moats, which translates into great returns on capital. Moats are fairly rare but come from a variety of things, such as regulation, intellectual property, sustainable cost advantages and superior management. True moats give you more confidence in projecting future performance.

We next focus on management. I'm at a stage in my career where I'd say human behavior is the most important determinant of a business's long-term success. I don't care how smart an analyst you are, you can't really know what's going on inside a business. We want to invest not only in highly capable managers, but also those with clear track records of integrity and acting in shareholders' best interest. I've found that when a manager puts his hands in shareholders' pockets once, he's much more likely to do so again.

Do you ever buy a great business with a not-great management, expecting change?

CA: We generally don't invest in broken businesses that need to be straightened out or bad people that need to be thrown out. It's just not what we do.

Our third focus is related to the first two: Because of the nature of the business and the skill of management, we're looking for companies that can reinvest what we expect to be excess cash in a way that earns unusually high rates of return. This was the case with Berkshire Hathaway, which created a compounding machine.

How does valuation come into play?

CA: On top of everything we apply our sophisticated valuation methodology,

Charles Akre

Long and Winding Road

Having earned an English Literature degree from American University, Chuck Akre took a practical approach to his indecision about a career: "I took a series of vocational aptitude tests which indicated I should be a stock broker or stock analyst," he says. "I truly didn't know the difference between the two then."

Starting as a retail broker at Johnston, Lemon & Co. in 1968, Akre over 21 years there became a shareholder in the firm, director of its research department and CEO of its investment-management division. He started Akre Capital in 1989 to manage separate accounts and a hedge fund and teamed in 1997 with Friedman, Billings, Ramsey & Co. to launch the FBR Small Cap mutual fund, which he still manages and which earns a five-star rating from Morningstar.

Akre now works out of an office in rustic Middleburg, Virginia, not far from his farm at the foothills of the Blue Ridge Mountains. "I had an atypical start in this business and it's taken a long time to get to where I am now," says Akre. "Curiosity, hard work and more than a little luck goes a long way."

which is basically "We're not willing to pay very much." We typically buy companies with higher returns on capital, better growth, stronger balance sheets and lower empirical valuations than the overall market. We think it's intuitive that if we get all these right, our return should be higher than that of the market, with what we believe is a lower level of risk than the market.

The opportunity to buy usually comes down to a significant diversity of opinion in the market. It's good for us when Wall Street's opinion differs from ours, which allows us to buy at attractive valuations.

We really don't pay that much attention to why something is undervalued. If we buy companies in which shareholders' capital compounds at a 20% rate of return over a reasonable time period and we pay a below-average multiple for it, our investors will do extremely well.

How would you define your circle of competence?

CA: We focus on service businesses, in general, because the fixed assets required to produce revenue are smaller. I've done well over the years in recreation and entertainment businesses, property/casualty insurance, and banks and other financial institutions. We have larger investments today in retail than we've had in the past – they're relatively easy to understand, which is key for me.

Do you have any cap-size restrictions?

CA: It's axiomatic that when businesses are smaller, the opportunities for compounding at a high rate are greater, so we may be somewhat more likely to be in small- or mid-caps.

I would say I don't get overly concerned with how my portfolios are categorized. Our mutual fund [the FBR Small Cap fund] was originally called a value fund, then it was a "core" fund and now it shows up sometimes as a growth fund. Through all that, we haven't changed anything we do since day one – the notion that growth is a creator of value is an important part of how we invest.

Describe the distinction you make between what you call "core" and "workbench" positions.

CA: I've never been so disciplined that I hold off buying until 100% of the work is done. A workbench position gets built into a core position only when we have little or no question about the business, people and reinvestment opportunities. It takes time to learn how the business model really behaves and I've also found that it usually takes a long time to understand when management is really good. Many of the times I thought I knew right away, I was dead wrong.

ON CONCENTRATION:

A company compounding capital at way above-average rates when the valuation is modest, I want to own a lot of that.

An example of a workbench holding that has been that way for some time is AmeriCredit [ACF], a sub-prime auto lender we bought in 2002. We got into it after they had some credit problems and they changed their accounting from gain-on-sale to more cash-based, making their GAAP earnings nearly disappear. We bought originally around $7, down to as low as $3, and they've done a great job of getting the business back on track. [*Note*: AmeriCredit shares currently trade at $23.50.] But I've never upgraded it to a core holding because I'm still uncertain how their customers will behave in a more credit-restricted environment. It's a business-model issue that keeps me from fully committing to it as a core holding.

Your have 65% of your hedge fund portfolio in the top seven holdings. Why so concentrated?

CA: If I didn't have partners, the concentration would be even higher. You know how much of Warren Buffett's partnership was in American Express when he bought it after the DeAngelis salad-oil scandal? 40% or so. [*Editors' Note*: In the early 1960s, commodities trader Tino DeAngelis attempted to corner the market for soybean oil, which was used in salad dressing. His elaborate scam involved taking out loans – many from an American Express subsidiary – against what turned out to be non-existent soybean-oil inventory. When the fraud was uncovered, American Express suffered significant losses on the loans, driving down its share price.]

If you think about individual wealth creation in this country, it almost always comes from a single asset. A company compounding capital at way above-average rates, when I have great confidence that will continue and the valuation is modest, I want to own a lot of that. The rationale is that simple.

Tell us about your largest holding, Penn National Gaming [PENN].

CA: Penn National is primarily in the business of operating slot-machine venues – on land and on riverboats – in thirteen jurisdictions around the country. They're only in regional markets, with no position today in Las Vegas or Atlantic City. They also have racetrack licenses in West Virginia and Maine.

When we first got involved with the company ten years ago, it was mostly in the off-track betting business, which had very little reinvestment opportunity. That led them to get into running slot machines at racetracks and then buying more traditional casinos. They have an excellent history of acquiring casinos and making improvements in their return on assets.

What's attractive about the business?

CA: I like that they see their profits in cash, every day. Once venues are established, they benefit from barriers to entry from the strict licensing issues surrounding gaming. On the demand side, it's driven by human nature and the fact that large demographic groups see playing the slots as three or four hours of entertainment, for which they're more than willing to pay $50 to $100. There's a lot of activity,

camaraderie in going with friends, and pretty good food. That's an attractive value proposition for many people.

All of this makes it an inherently high-return business. In the ten years we've owned Penn stock, book value has compounded at more than 40% per year.

What's driving future growth?

CA: With existing assets, they continue to do a great job of expanding when they can. In Charles Town, West Virginia, they started with a racetrack and 154 slot machines and now have 4,200 slots, with approval to go to 6,000. In Lawrenceburg, Indiana, across from Cincinnati, they're adding a new riverboat and parking garage to an existing venue.

Many existing assets are relatively finite, though, so they'll have to acquire more. They continue to make selective acquisitions of individual properties and I see several public companies that would be great fits, at the right time. If the opportunities don't materialize, they'll have a tremendous amount of capital to shrink the share base.

This is a perfect example of where my confidence about reinvestment potential has a lot to do with management. I remember meeting Peter Carlino, who is still the CEO, in the 1990s in Boston. I could see a few things right away, including that he was very ambitious and had a high level of self confidence. His background was in real estate development, so I knew his ambition would likely result in his taking on a lot of debt. But one thing that stuck with me from that conversation was how in all his real-estate deals, he'd never had his wife on a note. That's almost impossible to do as a small developer – the banks want your first child. It told me he had an acute sensitivity to risk. Over time, as he made acquisitions and built the company, that sensitivity has translated into very high standards for the returns he requires for the risks he takes.

Hasn't Penn been particularly generous with stock options?

CA: They've given options at a good clip and Peter takes the most, which I don't agree with, but he and his family are the largest shareholders and that's what they've chosen to do. It doesn't take away from the fact that he's created enormous value for all shareholders over time.

With the shares currently around $37, how are you thinking about valuation?

CA: The shares trade at 11x our $3.40 estimate of 2007 free cash flow per share – that's after all maintenance capital spending as we understand it. If we're correct that the company can continue to compound book value at a high rate – 20% or greater – over the next five years and we only have to pay 11x to get it, like I said, we'll do very well. That's why this is nearly 20% of my portfolio.

What are the biggest risks you see here?

CA: Gaming revenue to various jurisdictions is like crack cocaine – they always want more – so the risk is that taxes will keep going up on casino revenue, as they have in Illinois, for example. In some cases, local and state taxes are as high as 50%.

New jurisdictions will also open up, bringing some new competition to existing venues. I just assume there will always be

INVESTMENT SNAPSHOT

Penn National Gaming
(Nasdaq: PENN)

Business: Operator of casino and horse-racing facilities, with a primary focus on slot machines. Currently in 13 jurisdictions, though not in Atlantic City or Las Vegas.

Share Information
(@ 11/29/06):

Price	**37.30**
52-Week Range	29.48 – 43.83
Dividend Yield	0.0%
Market Cap	$3.17 billion

Financials (TTM):

Revenue	$2.22 billion
Operating Profit Margin	21.8%
Net Profit Margin	7.3%

Valuation Metrics
(Current Price vs. TTM):

	PENN	S&P 500
P/E	20.4	20.4
P/CF	11.6	14.4

Largest Institutional Owners
(@9/30/06):

Company	% Owned
Fidelity Mgmt & Research	11.7%
Akre Capital	8.5%
Friedman, Billings, Ramsey	4.7%
Bamco	3.9%
Munder Capital	3.3%

Short Interest (@ 10/9/06):

Shares Short/Float	3.8%

THE BOTTOM LINE

Through organic growth and timely acquisitions, Chuck Akre expects Penn National to continue expanding its book value per share by at least 20% annually over the next five years. Trading at only 11x his $3.40 estimate of 2007 free cash flow per share, he expects the share price to compound at least as quickly as book value.

Sources: Company reports, other publicly available information

new competition, as there has been for the past 10 years. While that's a risk, it's also an opportunity for an experienced operator like Penn to open up new markets.

Why is Markel Corp. [MKL], another long-time holding, still attractive?

CA: We've actually owned Markel since 1990. They operate primarily in what's called the "E&S" (Excess & Surplus) insurance market, covering hard-to-place risks that aren't included in the standard, regulated forms that exist in every state. They have more than 90 different lines of insurance, including things like liability for summer camps, earthquake and hurricane protection and professional liability for physicians who have had drug and alcohol problems. Not surprisingly, they tend to have very strict underwriting conditions and premium pricing.

Their business is no different than mine: it comes down to people and how well they put business on the books that earns an underwriting profit. The property/casualty business has been plagued by large companies driven by volume rather than profitability, who expect to more than offset underwriting losses with investment profits. Markel only writes business for which they expect to make an underwriting profit.

In underwriting this way, it allows them to be more aggressive with their investments. They now have 75% of shareholders' capital invested in equities, with the expectation – that has been borne out by experience – that they'll have higher investment returns than those who invest more in fixed-income. [*Note*: Markel's equity portfolio is managed by Thomas Gayner, whose interview was featured in the May 26, 2006 issue of *VII*.]

What growth in annual book value are you counting on here?

CA: Because the company has a history of underwriting at a profit and earning excess investment returns, it has an unusual balance sheet. Its "gearing ratio" is around 3.6x, meaning they have 3.6 dollars in the investment portfolio for every dollar of book value. Given that, only a 5% annual after-tax return on their portfolio results in an 18% increase in book value per share. If you put underwriting profits on top of that – which they've achieved in all but three or four of the past 20 years – plus a track record of doing better than 5% after-tax on the portfolio, you can easily see them returning over 20% per year.

Will they need acquisitions to grow?

CA: They may have to acquire premiums to have the type of reinvestment returns I'd like to see. That could come from investing in people to build lines of business or from making acquisitions. You could argue that given the difficulties they've had with their last big acquisition [of Terra Nova, a European insurer acquired in 2000], there's some risk in how well they'll do with that. I think it's very unlikely you'll see them do another deal that plays out like that.

Markel's shares have been on quite a roll, up 40% in the past year to a recent $444. Do you still see great upside at this price?

CA: Underwriting profits this year will likely be anomalous, as the company got

INVESTMENT SNAPSHOT

Markel Corp.
(NYSE: MKL)

Business: Underwriter and marketer of primarily "Excess and Surplus" insurance policies, covering less-traditional risks not included in standard state insurance forms.

Share Information
(@ 11/29/06):

Price	**444.40**
52-Week Range	307.41 – 456.25
Dividend Yield	0.0%
Market Cap	$4.29 billion

Financials (TTM):

Revenue	$2.45 billion
Operating Profit Margin	24.9%
Net Profit Margin	16.1%

Valuation Metrics
(Current Price vs. TTM):

	MKL	S&P 500
P/E	21.3	20.4
P/CF	n/a	14.4

Largest Institutional Owners
(@9/30/06):

Company	% Owned
Ariel Capital	12.4%
Davis Selected Advisers	4.6%
Akre Capital	4.0%
Fidelity Mgmt & Research	4.0%
T. Rowe Price	3.5%

Short Interest (@ 10/9/06):

Shares Short/Float	2.6%

MKL PRICE HISTORY

THE BOTTOM LINE

Chuck Akre believes Markel's underwriting discipline and skill in producing excess investment returns positions it to continue compounding its book value per share in the 20% annual range. Given such growth prospects, he says, the shares are very attractive at only 11x the $40 per share increase in book value he estimates for 2006.

Sources: Company reports, other publicly available information

big price increases in hurricane areas, while hurricane losses have been almost non-existent. But if you combine those profits and the marked-to-market net investment gains, we expect to see book value increase by around $40 this year. So even the current stock price is only about 11x what we would call this year's economic earnings, which we expect to compound over several years in the 20% range. As with Penn National, we'll get wealthy putting our money to work in such a proposition.

American Tower [AMT] is also up strongly this year. Why are you still high on it?

CA: The business model here – leasing wireless-communications tower capacity to operators like Cingular and Verizon – is extraordinary. Once a tower is up and has enough tenants to already operate at a terrific operational margin, revenue from the additional fractional tenant is added at about a 90% gross margin.

As with gaming, this is a business with high regulatory barriers to entry. American Tower is building towers, but it's hard to get it done on a jurisdiction-by-jurisdiction basis and even harder for anyone new to the business. When a new tower does go up, it makes little sense for someone to come along and put one next to it, even if they could get approval.

Wireless technology is evolving beyond voice toward increased transmission of video and data. You've had the recent sale of a tremendous amount of wireless spectrum and companies like Craig McCaw's Clearwire building a nationwide wireless broadband network. All of these things currently need network ground antennae to be efficient, which significantly increases demand for tower capacity. While it's difficult to cite a single, unutilized-capacity number for American Tower, they're adding tenants at a rapid clip and capacity is not yet a constraining factor.

Another thing we like about the business is that ongoing maintenance capital spending is actually very low. Customers generally pay for most of the technology upgrades.

How is the competitive environment changing?

CA: The largest number of towers are still owned by the carriers and small private owners. It's an asset-deployment issue for the carriers and they have been net sellers of towers to the independent companies like American. That's not to say American tries to buy everything that's on the market – they've been very smart in making financial judgments on assets to buy.

Crown Castle recently agreed to buy Global Signal, another big player in the market, and will now be the largest independent, passing American. American's management points out that about 65% of Global Signal's assets were former Sprint assets which were on the market – and they thought overpriced – a year and a half ago for $1.6 billion. Now Crown Castle is paying nearly $6 billion for all of Global Signal. We think this type of thinking by competitors plays into American Tower's hands.

Are there key technology risks here?

CA: Clearly, if some way is developed that allows the wireless exchange of voice and data without the use of ground antennae, that would be a disruptive event. From

INVESTMENT SNAPSHOT

American Tower
(NYSE: AMT)

Business: Owner and operator of more than 22,000 wireless and broadcast communications towers and rooftop sites in the United States, Mexico and Brazil.

Share Information
(@ 11/29/06):

Price	**38.23**
52-Week Range	26.35 – 38.74
Dividend Yield	0.0%
Market Cap	$16.04 billion

Financials (TTM):

Revenue	$1.08 billion
Operating Profit Margin	10.0%
Net Profit Margin	(-9.5%)

Valuation Metrics
(Current Price vs. TTM):

	AMT	S&P 500
P/E	neg	20.4
P/CF	43.7	14.4

Largest Institutional Owners
(@9/30/06):

Company	% Owned
T. Rowe Price	8.4%
Fidelity Mgmt & Research	7.5%
Goldman Sachs	5.7%
Wellington Mgmt	5.2%
Chieftain Capital	3.7%

Short Interest (@ 11/8/06):

Shares Short/Float	4.9%

AMT PRICE HISTORY

THE BOTTOM LINE

High regulatory barriers and booming wireless demand help protect the 90% incremental gross margins the company earns in leasing available tower capacity, says Chuck Akre. If book value increases at the 20% annual rate he expects, paying even the current 25x multiple of 2007 free cash flow will pay off handsomely, he says.

Sources: Company reports, other publicly available information

what we can see now, there's nothing like that on the horizon.

One risk is that another shoe drops with respect to an options-backdating inquiry at the company. Here's a case where we have to make judgments about the people. Having known [CEO] Jim Taiclet and [CFO] Brad Singer for quite a few years, I take it at face value when they tell me they were not involved in the issuance and pricing of any backdated options. It will take its course, but I expect ultimately that the biggest downside for shareholders will turn out to be that they've stopped an aggressive stock-buyback program until this is sorted out.

How attractive are the shares at a recent price of just over $38?

CA: We own a lot of shares with a cost basis of around $10, so the current price isn't the deal it has been. It trades at about 25x our estimate of 2007 free cash flow, but we've kept a very large position because there's a high probability the company can compound book value at close to 20% annually for the next five years. If they compound at 20% per year and you have to pay 25x to get that, the arithmetic still works very much in your favor.

By 2010, before they're in a position to be paying taxes, I expect there to be a transforming event for this company. They'll convert to a REIT or someone will buy it for the extraordinary cash flow, long-term contracts and high-quality tenants.

What attracted you to your next pick, O'Reilly Automotive [ORLY]?

CA: We got to know O'Reilly and the auto-parts business through owning AutoZone and Advance Auto Parts. As an operator, we believe O'Reilly has the best model, with 50% of its revenues coming from selling parts and supplies to individual do-it-yourselfers and 50% from commercial garages and auto-repair shops. Because of that mix, the company has a higher concentration of distribution centers relative to their stores, giving them better in-stock positions and same-day service capability not only for the professionals – who require that kind of service – but also the DIY market. O'Reilly services stores from a distribution center at least five times a week, as opposed to other DIY competitors who can only do it once or twice a week. That gives them a competitive advantage – their products are much more likely to be in stock or delivered within 24 hours.

Is such a system much more expensive?

CA: It works well for them – their returns on equity are in the upper-teens.

Is this a growth business?

CA: The market is largely driven by the number of cars on the road and miles driven, which continue to grow. It can be affected by gas prices or a slowing economy in the short term, but the underlying growth trend is up.

The big opportunity for O'Reilly is that auto-parts supply is still a fragmented business, with a tremendous number of mom-and-pops who are willing to sell for net asset value when one of the bigger chains comes along. Even a bigger company like CSK Auto [CAO], with 1,300 stores in the West, is considered to be mismanaged and

INVESTMENT SNAPSHOT

O'Reilly Automotive
(Nasdaq: ORLY)

Business: Domestic marketer of automotive aftermarket parts, tools, supplies and accessories, targeting both do-it-yourself customers and professional installers.

Share Information
(@ 11/29/06):

Price	**31.55**
52-Week Range	27.49 – 38.30
Dividend Yield	0.0%
Market Cap	$3.59 billion

Financials (TTM):

Revenue	$2.24 billion
Operating Profit Margin	12.6%
Net Profit Margin	7.9%

Valuation Metrics
(Current Price vs. TTM):

	ORLY	S&P 500
P/E	20.5	20.4
P/CF	15.0	14.4

Largest Institutional Owners
(@9/30/06):

Company	% Owned
T. Rowe Price	8.5%
Select Equity Group	8.2%
Wasatch Advisors	6.6%
Ruane, Cunniff	3.7%
William Blair & Co	3.6%

Short Interest (@ 10/9/06):

Shares Short/Float	5.2%

THE BOTTOM LINE

As the premier operator in a consolidating auto-parts-supply business, O'Reilly is well-positioned to translate revenue and margin increases into high-teens annual earnings growth, says Chuck Akre. He believes such growth prospects are not all adequately built into the shares, which trade at 15x his estimate of 2007 free cash flow.

Sources: Company reports, other publicly available information

would make an attractive acquisition opportunity for either O'Reilly or Advance Auto. O'Reilly actually has the better balance sheet to do so and I believe they're much better, more-focused operators.

The company is opening 170 new stores this year and has been growing square footage 12-13% per year. If you combine that with mid-single-digit growth in same-store sales, growing buying power and the prospect of a large acquisition one day, it's pretty easy to see how they can get to high-teens annual earnings growth.

At $31.50, how cheap are the shares?

CA: We think they'll earn $1.75 in free cash flow per share this year and around $2.10 next year. So the shares trade at a 15x multiple, for a company growing book value at least in the high teens. Again, that's math I expect to work out well.

Your last pick, 99 Cents Only Stores [NDN], appears to be more of a turnaround play.

CA: The company was founded in the early 1980s and is one of the four major dollar-store chains in the U.S. It's also, by the way, one of only two of those that actually sells things for only $1 or less. Many of the stores you'd mistake for your local supermarket, with an astounding range of brands. When 99 Cents buys the merchandise at closeout, the big brands know the merchandise won't get back into the normal distribution channel.

The news here hasn't been great. They entered the Texas market a few years ago, didn't get it right and have been losing money there. The management transition between the founder, David Gold, and his son-in-law, Eric Schiffer, hasn't gone well. They have underinvested in systems and technology, gone through more than one CFO and changed auditing firms twice in recent years, with the result that they haven't filed audited financial reports yet this year.

The result of all that has been that the stock went from the mid-$30s three years ago to under $10 a year ago. We actually started our position around $14 and have bought more on the way down. [NDN shares currently trade around $11.25.]

Where does a competitive moat come from in this business?

CA: Against more traditional retailers, 99 Cents Only offers good value and some "treasure-hunt" excitement. Within the dollar-store market, we think it offers a more attractive product mix, with fewer knick-knacks and novelty items and more focus on food. They also have a particularly strong real-estate footprint in southern California and have proven to be more skilled in finding closeout merchandise.

Where do you see the clouds lifting?

CA: Despite all the problems, the business is modestly profitable and producing good cash flow. Same-store sales are positive, so customers are still attracted. The key problems are Texas and their back-end infrastructure, both of which are stabilized and showing signs of progress. We believe the people running the business are smart retailers and we see no reason why they can't get return on equity at least back to the 15% range, which is far less than the company earned historically. This can be a terrific business if they execute well.

INVESTMENT SNAPSHOT

99 Cents Only Stores
(NYSE: NDN)

Business: Retailer of primarily name-brand food and general merchandise priced under $1, with nearly 240 stores in California, Texas, Arizona and Nevada.

Share Information
(@ 11/29/06):

Price	**11.23**
52-Week Range	9.47 – 13.88
Dividend Yield	0.0%
Market Cap	$781.3 million

Financials (TTM):

Revenue	n/a
Operating Profit Margin	n/a
Net Profit Margin	n/a

Valuation Metrics
(Current Price vs. TTM):

	NDN	S&P 500
P/E	n/a	20.4
P/CF	n/a	14.4

Largest Institutional Owners
(@9/30/06):

Company	% Owned
Akre Capital	9.9%
Primecap Mgmt	6.8%
Dimensional Fund Adv	5.5%
Friedman, Billings, Ramsey	4.9%
Amvescap	4.7%

Short Interest (@ 10/9/06):

Shares Short/Float	12.2%

THE BOTTOM LINE

The company is poised for a turnaround after a series of operational and administrative blunders in recent years, says Chuck Akre. By better managing its balance sheet and achieving even 50% of prior operating margins, it can earn $1.50 per share – making the current $11.25 share price appear extremely cheap, he says.

Sources: Company reports, other publicly available information

How are you thinking about valuation?

CA: Hard book value is $7 per share, including a couple dollars of cash. Real estate values above stated book value – they own 35 stores and two distribution centers – add another $2-4 per share. So at a share price just over $11, we've got a book value that's 80-100% of market value. On the upside, if they use their balance sheet prudently and achieve even 50% of prior operating margins, we can see them earning $1.50 per share. At that level of earnings, we'll make a lot of money from the current price.

How patient do you expect to have to be?

CA: We've heard from a handful of private-equity types because of the size of our stake, which is around 10%. I've said we're willing to give management a chance first. If they can't get it right, there's likely to be some sort of catalyst to get it right.

In general, how do you approach the decision to sell?

CA: Valuation rarely comes into play in our sell decisions. We sell when something materially changes among the three things we focus on, the business model, the people or the reinvestment opportunities.

We recently sold Citigroup, for example, which originally came from a big stake we bought in Salomon Brothers after its Treasury-bond scandal. [Former Chairman] Sandy Weill demanded a 25% ROE from every business unit and if the management didn't produce, they were history. On one hand, that type of thing is music to my ears, but the other side of it was that it didn't exactly matter to Weill how you made your numbers. We sold, then, for a couple of reasons. First, the driver at the top demanding high rates of return from individual businesses was gone. Second, the unwinding of all the past bad behavior made it difficult for us to judge with confidence how attractive the returns would be going forward.

Another example is Willis Group [WSH], the insurance broker. We had the idea after 9/11 that the insurance-brokerage business would benefit from changes in insurance pricing and we thought Willis had an opportunity to take share from competitors like Marsh & McLennan, which were much more tarnished in the price-rigging scandal. This was a case where the upside just didn't ever arrive, so after a couple years we just gave up.

CarMax [KMX] would be an example of something we expect to own for a very long time, even though we wouldn't buy more at the current valuation. We love the business model, the people and the reinvestment opportunities. It's sold almost the entire time we've owned it for north of 20x free cash flow per share, but if they achieve their ten-year objective of growing 15% per year – which we believe they can – we'll do extremely well from here.

ON BERKSHIRE HATHAWAY:

It's a low-teens compounder of book value with a huge option – $40-plus billion of cash to make extraordinary purchases.

Have you held your Berkshire Hathaway?

CA: Yes, even though its return characteristics are now lower than what we're typically looking for. I see it as sort of a low-teens compounder of book value with a huge option – the $40-plus billion of cash that could allow them to make extraordinary purchases in an adverse time.

You mentioned the potential of activism with 99 Cents Only. How much of an activist do you tend to be?

CA: We want to have a regular and in-depth dialogue with management. I've owned shares in International Speedway [ISCA] for nearly 20 years. It's an amazing business model: the barriers to entry are high and they not only get ticket and concession sales from the motorsport venues they own, but they get the biggest portion of TV and radio revenues. For years it has been a business with little debt and ROEs from the low-teens up to 25%. But my feeling is that they're now not taking advantage of the quality of the business and have been willing to accept too-low returns. We've had several chats with them around this issue.

Are you active on the short side?

CA: If I'm successful investing in businesses which compound economic value per share at a 20% rate, then our expected annual returns are likely to be around 20%, less the costs of achieving it. For 13 years, the hedge fund has averaged around 21%, net of all fees and incentives. The incremental returns come from what we do "around the edges," as I call it. Sometimes it's from shorting, or making a short-term trade or participating in an arbitrage opportunity.

With shorts, we take a lot of little bites, rather than concentrate. We're looking for bad business models, bad accounting, bad people or bad valuations. Our short book regularly adds to overall performance, sometimes only a little and sometimes much more. In 2002, it was the reason we were up in a terrible market – our short returns were 9% and our net returns, after incentives, were 4.5%.

The market turning south was when you seem to have really hit your stride.

CA: At the end of 2000, the FBR mutual fund I manage was four years old and had $9 million in assets. We had a fine, but not spectacular record. We then had positive results across all our businesses during the 2000-2002 period, a time when the S&P 500 was down nearly 40% and Nasdaq off nearly 70%. This may be the most significant achievement of my investing career. When we then also had home-run years in 2003 and 2004, we really started to get noticed.

What I particularly enjoy is when you can help change the choices people have in their lives. I put my sister into shares of Berkshire at $200 per share and she still has them. That's the coolest experience of all. VII

Here's to You, Mr. Robertson

At the time legendary investor Julian Robertson closed his hedge fund, I described his portfolio as a "lame collection of companies." Mea culpa, Mr. Robertson. ***By Whitney Tilson***

Six and a half years ago, at what turned out to be the very peak of the Internet bubble, famed hedge-fund manager Julian Robertson closed his fund with the following prophetic words:

> **This is an irrational market, where earnings and price considerations take a back seat to mouse clicks and momentum. The current technology, Internet and telecom craze, fueled by the performance desires of investors, money managers and even financial buyers, is unwittingly creating a Ponzi pyramid scheme destined for collapse. There is no point in subjecting our investors to risk in a market which I frankly do not understand.**

A week later, I wrote a column asking whether Warren Buffett should also call it quits – the parallels with Robertson were many – but answered with an emphatic no because Buffett had not fallen into the trap of buying "companies trading at low multiples but with poor financials and weak future prospects." My argument was that Robertson appeared to have fallen into the trap of buying companies of increasingly lower quality in order to continue paying the prices to which he had become accustomed.

To support my argument, I presented the table reproduced on this page, contrasting the major U.S. public stock holdings of Buffett's Berkshire Hathaway and Robertson's Tiger Management. Every one of Buffett's picks were characterized by solid growth, high margins, great balance sheets, and returns on equity that exceeded their cost of capital. While Tiger's holdings were ostensibly much cheaper, they also had lots of debt, low margins, poor returns on equity and erratic growth. My conclusion at the time: "This is a lame collection of companies ... which deserves to trade at a low average multiple!"

As I prepared to interview Robertson recently (*see page 21*), I was curious to see how all of these stocks had performed. Did Buffett's high-quality businesses trading at not-so-cheap stock prices outperform Robertson's lower-quality, but much cheaper, businesses? I certainly would have bet on the former ... and I would have been dead wrong.

As detailed in the table on the next page, despite two bankruptcies, Tiger's portfolio did far better than Berkshire's – though both handily beat the market. In just six and a half years, an investor putting $1 million in an evenly weighted portfolio of the Tiger companies would have $823,000 more today than one who bought a comparable portfolio made up

Stretching for Value?

In a comparison of his disclosed holdings with those of Warren Buffett's Berkshire Hathaway, it appeared in early 2000 that Julian Robertson had fallen into the dangerous trap of chasing low-quality companies in order to find "value." As things turned out (see table, p.20), appearances were deceiving.

Berkshire Holdings	P/E	Cash/ All Debt	Net Margin	ROE	Average EPS Growth	Steady Revenue?	Steady EPS Growth?
American Express	28	14%	12%	23%	18%	Yes	Yes
Coca-Cola	36	35%	19%	42%	16%	No	No
Freddie Mac	15	n/a	n/a	20%	18%	Yes	Yes
Gillette	30	2%	13%	42%	13%	No	No
Washington Post	23	19%	11%	14%	15%	Yes	No
Wells Fargo	18	62%	n/a	14%	14%	Yes	Yes
Berkshire Averages:	**25**	**26%**	**13%**	**26%**			
Tiger Holdings	**P/E**	**Cash/All Debt**	**Net Margin**	**ROE**	**Average EPS Growth**	**Steady Revenue?**	**Steady EPS Growth?**
Bear Stearns	8	16%	9%	15%	14%	No	No
Bowater	38	3%	5%	5%	n/a	No	No
Federal-Mogul	4	2%	2%	5%	15%	No	No
GTECH Holdings	7	2%	10%	35%	20%	No	No
Navistar	7	25%	4%	28%	41%	No	No
Niagara Mohawk	neg	2%	-1%	-2%	neg	No	No
Pittston Brink's	10	37%	5%	17%	20%	Yes	Yes
Sealed Air	27	4%	7%	17%	26%	Yes	No
Starwood Hotels	16	3%	6%	6%	neg	No	No
Tosco	17	5%	2%	14%	19%	No	Yes
UnumProvident	6	50%	n/a	14%	5%	Yes	No
US Airways	11	60%	6%	3%	n/a	No	No
United Asset	16	17%	8%	29%	10%	No	No
XTRA	8	0%	13%	17%	7%	Yes	No
Tiger Averages:	**13**	**16%**	**6%**	**15%**			

Notes: 1) Average EPS growth is over the previous five years; 2) "Steady" revenue and EPS growth is defined as increasing every year from 1994 to 1999; 3) Data source: Value Line, 3/30/00

of the Berkshire holdings. And that's not even counting Tiger's short positions at the time. Says a former Tiger employee familiar with the firm's portfolio: "In the first quarter of 2000, Robertson was short a wide range of high-flying Internet companies such as eToys, Priceline.com and Lycos, which means he would have made another 50-60% on the short side. In fact, knowing how he acts when shorts go his way, he surely also would have added with conviction on the way down, so the gains would have probably been even larger."

So, *mea culpa*, Mr. Robertson. You were undone not by your own mistakes, as I originally thought, but primarily by a once-in-a-generation bubble that you correctly and publicly identified.

What are some of the lessons to be learned here? First, buying beaten-down, out-of-favor companies can be hairy – witness the two bankruptcies in the Tiger portfolio plus decliners of 58% and 24% – but also very profitable. The corollary is true as well: paying too high a price for even the greatest business can be an unprofitable endeavor – witness Coca-Cola over this time period.

Another lesson is that while Buffett has often cited the disadvantages of Berkshire's corporate structure, it has some huge advantages that become apparent during times of stress, such as in early 2000. While Robertson's investors could put his fund out of business, Buffett's couldn't. A handful of other great investors, such as Joseph Steinberg and Ian Cumming at Leucadia [LUK] and Michael Ashner at Winthrop Realty Trust [FUR], have learned the same lesson and chosen a corporate structure for their investing as well.

Finally, what better evidence is there for the cliché, "The market can stay irrational longer than you can stay solvent"? All investors, at some point in their careers, will be confronted with markets that appear irrational, in which nothing appears to be working. During times like these, money managers – especially highly successful ones, who can be prone to overconfidence – are inclined to press their bets which, taken to an extreme, can lead to self-destruction. Sometimes the wisest course is to play defense and live to fight another day. VII

Funds managed by Co-Editor Whitney Tilson own stock in Berkshire Hathaway and Winthrop Realty Trust.

The Weak Shall Be Strong

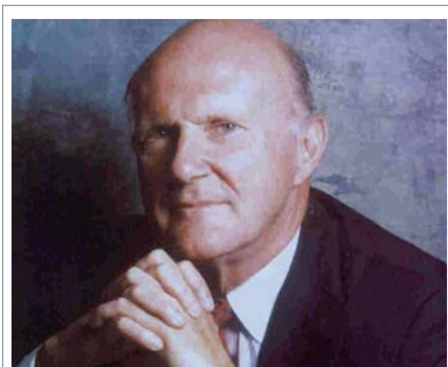
Tiger Management's motley band of disclosed portfolio holdings in 2000 have handily beaten the gilt-edged holdings in Berkshire Hathaway's portfolio from that time. Not surprisingly, both the Tiger and Berkshire portfolios have trounced the overall market.

Berkshire Holdings	Price 4/30/00	Price 11/24/06	%Change	Notes
American Express	45.37	59.90	32%	
Coca-Cola	49.31	46.92	-5%	
Freddie Mac	46.50	67.28	45%	
Gillette	39.00	60.87	56%	Acquired 1/05 by Procter & Gamble; assume PG held to present
Washington Post	532.50	735.00	38%	
Wells Fargo	21.84	35.57	63%	
Berkshire Total:			**38%**	Simple average, assuming equal holdings

Tiger Holdings	Price 4/30/00	Price 11/24/06	%Change	Notes
Bear Stearns	45.56	158.60	248%	
Bowater	52.69	22.23	-58%	
Federal-Mogul	15.88	0.43	-97%	Went bankrupt 10/01
GTECH Holdings	4.70	35.00	645%	Acquired 8/06 by Lottomatica; assume took cash
Navistar	40.44	30.81	-24%	
Niagara Mohawk	13.56	41.50	206%	Acquired 1/02 by National Grid; assume NGG held to present
Pittston Brink's	16.25	55.79	243%	
Sealed Air	55.25	60.39	9%	
Starwood Hotels	20.20	65.38	224%	
Tosco	30.50	116.10	281%	Acquired 9/01 by Phillips Petroleum, which in turn merged in 8/02 with Conoco; assume held COP to present
UnumProvident	17.31	20.48	18%	
US Airways	27.69	0.00	-100%	Went bankrupt 8/02
United Asset	16.48	25.00	52%	Acquired 6/00 by Old Mutual; assume took cash
XTRA	39.44	55.00	39%	Acquired 9/01 by Berkshire Hathaway; assume took cash
Tiger Total:			**120%**	Simple average, assuming equal holdings
S&P 500:			**-7%**	As in all above, excluding dividends

"My concept of value has changed"

Legendary investor Julian Robertson reflects on his storied career, building a great team, "retirement"and what he makes of today's market.



Julian Robertson
Tiger Management

On retiring: "I always said if a guy was long the best 50 companies he knew and short the 50 worst, if that didn't work you were in the wrong business."

Editors' Note: *Tiger Management's Julian Robertson called it quits in 2000, explaining that "There is no point in subjecting our investors to risk in a market which I frankly do not understand." It was an unhappy end to one of the most successful careers on Wall Street: At its peak, Tiger managed $23 billion, and even after big losses in 1999 and 2000, Robertson earned 25% annualized returns over 20 years for his investors. Charming as ever at 74, Robertson recently spoke with Co-Editors Whitney Tilson and John Heins at his Park Avenue office.*

Has your definition of what constitutes value in stocks changed over the years?

Julian Robertson: When I started in the business and for a long time, my concept of value was absolute value in terms of a price-earnings ratio. But I would say my concept of value has changed to a more relative sense of valuation, based on the expected growth rate applied against the price of the stock. Something at 30x earnings growing at 25% per year – where I have confidence it will grow at that rate for some time – can be much cheaper than something at 7x earnings growing at 3%. Some people call that GARP (growth at a reasonable price), I'd call it value. I think that's just semantics.

We've always had excellent analysts, and a good analyst is more adept at making judgments on growth. That's their job – based on the business and the company's position in it, how fast is the company going to grow? It's pretty hard to lose if you're right on the growth rates when the growth rates are high. In that 30x-earnings company growing 25% per year, you'll be bailed out pretty quickly because in about 2 1/2 years the earnings will double and the multiple on that is only 15x.

You were a pioneer in hedge funds before they became trendy. Is it a good thing that hedge funds have become so popular?

JR: I think it's an inevitable thing. It's the best way to pay a good manager, for one thing, so it does attract the best managers. From the point of view of the investor, he gets a partner in the manager who, in most cases, has all of his money in the same fund. That's a huge advantage. Think about that as opposed to the trust department guy who calls you up reading from a script. You want the guy working for you to have the most to lose – and the most to win – from the selections he makes. He's not going to go overboard wild, because he has the most to lose.

The fact that so many new people go into this business does makes it tougher on those already in it. For example, you used to get a rebate on credit balances when you were short – now borrowing stocks costs you money overall. That alone makes a big difference in the profitability of shorting.

How activist were you as an investor?

JR: We were never very active in the way people are today. I do remember taking a strong stance with Cleveland-Cliffs, the iron-ore company. In that instance we were doing it as much for all the shareholders as we were for ourselves. It had a board of directors that I think not only all came from the same town, Cleveland, but as I recall were also all from the same country club. We brought in a few outside directors, including an investment banker, a consultant from Booz Allen and a female professor from Yale. We thought our actions would be appreciated, but the press attacked us as brash young upstarts fighting against a long-term management. They made us the bad guys and management the good guys – just the opposite of what was intended.

Tiger was well known for the quality of its analysts, many of whom now run some of the most successful hedge funds in the business. What was the secret to your finding and developing investing superstars?

JR: : I really think that we benefited from starting with good young people, who begat more good young people. We eventually devised testing that all applicants had to take. We still give that test, which takes about three or four hours. It is part aptitude, but also psychological. It sort of emanated from our having a few people over time who just didn't have the firepower to do the job – it's tragic when that happens, because it's not their fault. So we designed these tests to better avoid that.

The test was also designed to show what kind of team player the person was and their competitiveness. I've found that most good managers are great competitors. I think that all helped us pick good people. Whether it helped as much as having great young people recommending more great young people, I don't know.

How did you organize the work to get the best out of people?

JR: I was the trigger-puller and they were the analysts. It probably wouldn't have

worked if not for the huge difference in age. When we first got most of them, they were maybe 25, and when we were peaking they weren't much over 30. They were competitive and would do fabulous work to justify their ideas, but were also smart enough to know that experience counted for something.

Looking back on your decision to close your hedge funds in 2000, do you wish you'd done anything differently?

JR: I was almost 70 years old and was starting to think about whether this was something I wanted to keep up until I croaked. I'd always had a lot of fun – I was competing with the other people doing what I was doing and I enjoyed that.

I'd always said that if a guy was long the best 50 companies he knew and short the 50 worst, if that didn't work you were in the wrong business. But that strategy was literally a recipe for bankruptcy from 1998 to 2000. I said when I closed down that it was a market I didn't understand, and I didn't. [*For more on how Robertson's investments fared after the Internet bubble burst,* *see p. 19.*]

What's keeping you busy today?

JR: We have seeded and own a piece of the action in 30 different independently managed funds, which have a total of probably $11-12 billion in assets. I'm here to help them in any way I can. These are incredibly talented managers, some of whom operate under the Tiger name. I've got 50% of my own money – I wish it was more this year – in these different funds, and there's still a group here with which I run the remainder of my money.

What's your view on today's stock market?

JR: I actually think the insanity of the late 1990s is repeating itself.

Surely you don't see the same degree of irrationality today that existed then?

JR: Oh yes sir, I do. There's a more serious bubble today than there was then.

Housing?

JR: You toss the housing debacle out as if it were nothing! The Internet bubble affected a few of us, but the vast majority of Americans were not fazed by that. Now you've got people living on the refinancing of equity in their homes and almost all of us own homes.

I'm not predicting what's going to happen, but think about what happened in Japan in the 1990s. Their stock market went down 90%, during a period in which our market was up six times. Those are huge relative figures. But Japan was hardly fazed by that. Why? Because all their people have a wad of savings. Here, all our population has a wad of debt. So the consequences of a housing bubble bursting could be enormously serious here. The market's not pricing that in at all.

Also, what other country have you ever heard of that's in the financial situation we're in? We're dependent on the Chinese and Japanese to buy our debt. People seem to think the Chinese will keep buying our debt so their exports will be fine, but I kind of question that. They've got a lot of their own bad loans at home, which they may have to pay off with the positive trade balances they get from us, rather than using that to buy our bonds.

I can't time when the bubble will burst, but if we do go into decline, we've got some serious problems. How do you get out of it? You can't lower interest rates – it's difficult now for them to get much lower. I certainly don't think we're going to have another tax cut. And refinancing of home equity won't continue to be a positive.

ON NEW IDEAS:

We're spending a lot of time looking at emerging markets, trying to find baby Googles or baby eBays.

How is this view translating into how you're managing your money?

JR: As you can tell, I'm not a wild bull. In all fairness, though, I've had this negative view for some time and we've managed through it very well – until this year, which has been a bad one.

So are you sticking more with blue-chips, to the extent you're in equities at all?

JR: Wal-Mart [WMT] is one of our largest positions. In a potentially difficult economy, you want to align yourself with companies with cost advantages, and Wal-Mart is clearly one. Cost leadership is a real defensive moat. I also admire Wal-Mart's management because they are great environmentalists. They do the job they shouldn't have to do – the U.S. government should do it – by setting standards and being tough on Chinese companies that pollute, for example.

Another very large holding of mine is one of the world's cheapest transporters of people, Ryanair [RYAAY], the Irish company. Another stock that's been knocked around a lot that we own quite a bit of is UnitedHealth [UNH]. It's a great company and the stock's been under pressure for reasons other than the quality of its business.

For the more fast-growing companies, we spend a lot of time looking at emerging markets, trying to find baby Googles or baby eBays. We currently own the baby Google in Korea, called NHN, which is very well-run and an Internet leader.

So investing outside the U.S. is still an important part of what you do?

JR: Always. I remember people asking me in the early 1990s how I could afford to send our analysts over to Japan all the time. My feeling was how could you afford not to? It's a great big world out there.

Thank you, Julian, for taking to time to speak with us.

JR: My pleasure, it was fun. VII

Why Isn't Everyone a Value Investor?

As we interview one highly successful investor after another, all of whom apply the timeless principles of value investing, we keep asking ourselves, "Why isn't every investor a value investor?" It's been proven time and again to work and what could make more sense than trying to buy something for a lot less than it's really worth?

Dresdner Kleinwort's James Montier tackles why value investing isn't more ubiquitous in his recent excellent report, "Why Not Value? The Behavioural Stumbling Blocks." He first identifies what he sees as true value-investor traits: 1) Concentrated portfolios; 2) Concern with business risk, not price volatility; 3) Willingness to hold cash in the face of a lack of opportunities; 4) Long time horizons; 5) Acceptance of bad years; and 6) Willingness to limit the size of their funds.

To these we'd add: 1) Focused on valuing businesses, not predicting macroeconomic trends; 2) Willing to stay within one's circle of competence; 3) Independent and confident enough to go against conventional wisdom; and 4) Focused first on avoiding permanent capital loss and only secondarily on earning big gains.

These 10 traits are by no means universal, but they can all be learned or developed. So what's holding people back?

The first reason Montier cites is loss aversion. Research shows that people feel the pain of loss about twice as much as the pleasure they feel from a comparable gain. With its decidedly contrarian bent, value investing can fail to work for even long periods of time. Given their aversion to loss, investors are drawn into a sucker's game of rapidly trading their portfolios rather than waiting out inevitable periods of underperformance or even loss.

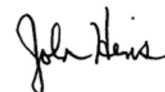
A second reason why investors eschew value investing is that it's a get-rich-slowly approach. Humans are hard wired to pursue actions that offer immediate gratification, but often stocks are cheap precisely because they have no apparent catalyst to go up. Without a catalyst, the natural inclination is to move on and try to find something that will move faster.

Investors also chase performance due to the human desire to be part of the crowd. If you didn't own Internet stocks during the late 1990s, not only did you suffer lousy returns, but you also felt excluded – what psychologists call social pain. As Montier points out, "Contrarian strategies are the investment equivalent of seeking out social pain." That's not easy to do.

Finally, value investing lacks a bit of excitement. Poring over numbers and digging for deeper insight into a company or industry isn't exactly the adrenaline rush sought by the *Mad Money* crowd. To that, we'd suggest an alternative view of excitement: Compounding money at a greater rate over time seems pretty darn fun to us.

Kindred Souls

We'd like to offer those of you who haven't yet subscribed to *VII*'s sister publication, *SuperInvestor Insight*, a small sample of what you missed in last week's issue. To receive a copy of *SII*'s Stock Spotlight feature on Legg Mason, please e-mail customerservice@valueinvestorinsight.com and put "Legg Mason" in the subject line. Better yet, subscribe now and see the entire issue! VII



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