

UP FRONT

Illusion of Control

Psychologists long ago identified in humans a consistent belief that they have some influence over the outcome of uncontrollable events. This so-called “illusion of control” has manifested itself in a variety of controlled experiments. In one, subjects were willing to pay four and a half times more for a lottery ticket that contained numbers they chose rather than those that were randomly generated. In another, participants bet more on a coin toss before the coin was tossed rather than after – “as if they could influence the spin of the coin in the air,” wryly observes noted equity strategist James Montier.

In the real world, the illusion of control is one of many behavioral underpinnings – along with envy, the desire to conform, and a propensity to overweight recent experience – that have helped fuel the speculative excesses that have afflicted various markets in the past decade. Under an assumption that all bases are covered, potential risks become less important, speculation increases, prices further detach from value and bubbles grow. Investors who fell victim to such a dynamic in their own decision-making are likely licking their wounds today.

The best investors make plenty of mistakes, but hubris is rarely the culprit. They make their own decisions independent of what the crowd is doing. They actively and often challenge their investment assumptions. They spend as much or more time on what can go wrong as on what can go right. Finally, while there's no shortage of ego, they remain humble about what they can and can't control. As Baupost Group's Seth Klarman explained in a letter to his investors: “We are big fans of fear, and in investing it is clearly better to be scared than sorry.”



At the Value Investing Congress in Pasadena earlier this month, Mohnish Pabrai gave a typically detailed description of one of his favorite ideas, managed-care operator WellCare Health Plans. Based on exhaustive research, he concluded that the market had overreacted in pummeling the company's shares after the announcement of a government fraud investigation. He considered the worst-case downside to be limited, while the company's growth prospects remained intact.

Our reason for mentioning this? Pabrai said this idea was inspired by an SEC filing by an investor he highly respects, Bruce Berkowitz of the Fairholme Fund. Tracking other investors' activity for potential ideas ... what a great idea! [SII](#)

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IN THIS ISSUE

What They're Buying

When share prices seemingly diverge sharply from underlying business values, SuperInvestors are typically ready to pounce. [Page 2](#)

[Table:](#) Value Gaps

[Table:](#) Biggest New Bets

What They're Selling

Even great investors sell too early, as evidenced by SuperInvestors taking money off the table in energy stocks in the first quarter. [Page 4](#)

[Table:](#) Don't Look Back

[Table:](#) Selling Out

What They Own

Half the firms Morningstar tracks have no economic moat. That's not at all the case with the most widely held SuperInvestor stocks. [Page 6](#)

[Table:](#) Moat Control

[Table:](#) Amid the Financial Ruins

Stock Spotlight: WellPoint

Did changes in its prospects justify a decline of \$25 billion in its market cap? Judging by SuperInvestor buying behavior, no. [Page 8](#)

The SuperInvestors

SuperInvestor Insight tracks the activity of an elite group of value-oriented hedge-fund managers (plus Berkshire Hathaway), based on their holdings as filed in Forms 13F with the SEC. While certain activity of specific investors will be highlighted, the focus is on drawing collective insight from this group of 25-30 of the world's best investors, which currently includes **William Ackman, David Einhorn, Joel Greenblatt, Carl Icahn, Seth Klarman, Edward Lampert, Warren Lichtenstein, Stephen Mandel, Larry Robbins, Jeffrey Ubben** and many more.

Waiting for Fat Pitches

The first quarter provided plenty of evidence that stock prices can be far more volatile than fundamental business values. Here's how SuperInvestors took advantage.

In a recent *SmartMoney* interview, Mohnish Pabrai of Pabrai Funds describes the root cause of a common, but difficult to overcome, inefficiency in share prices: "Our brains are in sync with the speed at which the market is moving and totally out of sync with the speed at which a business is moving. You have to learn to dramatically slow your brain, which is very hard for most people. The reality is that you should make decisions based on how the business is changing, and that's a very slow process."

You wouldn't know that businesses change slowly from the share price activity in the most widely bought stocks by SuperInvestors in the first quarter (see

table, below). The share-price highs over the three months were, on average, 50% above the lows. For two stocks, **WellPoint** and **Focus Media Holding**, the highs were more than double the lows.

Such volatility, of course, can be manna from heaven for disciplined investors waiting for what Warren Buffett refers to as a "fat pitch." Most maintain a wish list of what they consider to be superior companies that they would be happy to buy, but only at the right price. That would appear to explain heavy buying last quarter in blue-chips such as **American Express** and **Google**, each of which attracted the increased attention of four SuperInvestors in a peri-

od in which their share prices took significant hits. Concerns over increasing defaults by credit-card holders and an overall decline in consumer spending sent Amex shares below \$40, a level it had not seen in five years. Google shares took a sickening plunge from nearly \$700 at the start of the year to as low as \$412 on March 17. Had Google's business really declined in value by \$90 billion in less than 90 days? According to some very smart investors, no.

Healthcare-related companies attracted particular SuperInvestor attention during the quarter, including insurance providers **WellPoint** and **UnitedHealth**, dialysis-services company **DaVita**, and

What They're Buying: Value Gaps

Three or more SuperInvestors last quarter established new positions or increased their existing share positions by more than 10% in these stocks. The healthcare (WellPoint, UnitedHealth, Wyeth) and technology (Microsoft, Infosys, Oracle) sectors generated particular interest.

Company	Ticker	Industry	Price@ 5/22/08	Q1 2008		# of New or Inc. Positions	% Change In Shares Held
				Low	High		
WellPoint	WLP	Managed Healthcare	55.45	43.02	90.00	6	76.7%
Microsoft	MSFT	Computer Software/Services	28.47	26.87	35.96	5	107.3%
UnitedHealth	UNH	Managed Healthcare	35.30	33.57	57.86	5	24.9%
Wyeth	WYE	Pharmaceuticals	43.88	38.39	48.84	5	All new positions
American Express	AXP	Credit Card Services	46.36	39.50	52.32	4	112.4%
Domtar	UFS	Paper	6.22	5.93	8.41	4	53.3%
Fidelity National Information	FIS	Transaction/Loan Processing	38.88	35.73	43.83	4	15.6%
Google	GOOG	Internet Services	549.46	412.11	697.37	4	167.5%
Ingersoll-Rand	IR	Diversified Industrial	43.27	34.46	46.57	4	76.1%
SLM Corp.	SLM	Student Lending	23.00	14.70	23.00	4	31.8%
Clear Channel Communications	CCU	Radio Stations	34.77	25.90	36.55	3	28.5%
DaVita	DVA	Dialysis Services	52.06	41.86	60.23	3	62.9%
Focus Media Holding	FMCN	Chinese Advertising Media	39.00	29.25	59.37	3	595.7%
Infosys	INFY	Technology Services	44.21	32.65	45.65	3	164.2%
Oracle	ORCL	Computer Software	22.31	18.18	23.11	3	468.7%

Sources: Forms 13F filed with the Securities and Exchange Commission for holdings as of March 31, 2008

WHAT THEY'RE BUYING

pharmaceutical giant **Wyeth**. WellPoint's already sinking shares fell 28% on March 11, the day after it took down for the second time this year its 2008 earnings guidance, citing slowing enrollment and unexpectedly high medical costs. (*For more on WellPoint, see p. 8.*)

Like most pharma companies, Wyeth faces litigation risks – primarily over alleged harm caused by its Premarin and Prempro hormone-replacement drugs – and uncertainty over how well it can extend patent protection for blockbuster drugs like Effexor, an anti-depressant. But the company is strong in biotechnology – its nearly \$5 billion in existing biologics sales would make it among the top biotech firms on a stand-alone basis – and it is also considered to have an attractive portfolio of both existing and in-development drugs. Many analysts believe its Alzheimer's treatment in final-stage clinical trials, if approved, could become one of the biggest-selling drugs of all time.

Chinese advertising company Focus Media, in which three SuperInvestors sharply increased their holdings during the quarter, would appear to be among the more speculative bets. From a standing start in 2002, the company has grown rapidly – and profitably – by delivering advertising through television displays placed primarily near elevator banks in high-rise office buildings. Through acquisitions and organic growth it aspires to be a digital advertising leader in China, and with a market cap exceeding \$5 billion – roughly 10x trailing 12-month revenues – investors appear to believe in its chances.

Far more prosaic businesses proved popular as well. Paper company **Domtar**, struggling with a difficult demand environment and integration issues following its merger with the fine paper business of Weyerhaeuser, made the most-bought list for the second consecutive quarter. Highfields Capital's new position in alu-

minum giant **Alcoa**, worth \$555 million as of March 31, was the quarter's biggest single new bet (*see table, below*), followed closely by Lone Pine Capital's large stake in independent oil and gas producer **XTO Energy**. The latter two purchases appear to have been particularly well-timed: from the midpoint between the quarter's high and low prices, Alcoa and XTO shares are each up more than 20%.

Aside from American Express, the only financial firm tempting multiple SuperInvestors last quarter was student lender **SLM Corp**. Even after recovering somewhat from March lows, the shares are still more than 60% off their 52-week high. One notable dissenter to the SLM turnaround story, however, is Baupost Group, which made it the largest single eliminated position in the quarter (*see table, p. 5*). [SII](#)

Funds managed by Co-Editor Whitney Tilson own shares in AXP.

What They're Buying: Biggest New Bets

Below are the 15 largest brand-new positions taken by different SuperInvestors in the first quarter. The bets became bolder: While the average new position on the fourth quarter's list was worth \$140 million at quarter's end, these buys were worth an average of \$228 million as of March 31.

Company	Ticker	Industry	Price @ 5/22/08	Q1 2008		Investor	Value @ 3/31 (\$mil)
				Low	High		
Alcoa	AA	Aluminum	40.80	29.69	39.67	Highfields	\$555.4
XTO Energy	XTO	Oil & Gas	66.03	45.56	64.00	Lone Pine	\$499.2
Ingersoll-Rand	IR	Diversified Industrial	43.27	34.46	46.57	Chieftain	\$414.5
Precision Castparts	PCP	Industrial Products	114.74	92.66	142.94	Atlantic	\$244.6
Google	GOOG	Internet Services	549.46	412.11	697.37	Blue Ridge	\$217.2
WellPoint	WLP	Managed Healthcare	55.45	43.02	90.00	Baupost	\$196.5
Microsoft	MSFT	Computer Software/Services	28.47	26.87	35.96	Third Point	\$194.4
Calpine	CPN	Electricity Generation	23.00	15.00	19.51	JANA	\$188.0
Amylin Pharmaceuticals	AMLN	Pharmaceuticals	30.96	23.75	37.38	Icahn	\$185.2
Wendy's	WEN	Restaurants	29.73	22.36	26.97	Pershing Square	\$164.7
Willis Group Holdings	WSH	Insurance Brokerage	36.54	30.40	37.97	Glenview	\$151.5
Cypress Semiconductor	CY	Semiconductors	28.15	18.42	36.50	Eminence	\$123.0
UltraShort QQQ ProShares	QID	Exchange-Traded Fund	40.08	37.66	57.75	Steel	\$105.9
Alliance Data Systems	ADS	Marketing Services	56.82	39.54	75.00	ValueAct	\$95.5
Wyeth	WYE	Pharmaceuticals	43.88	38.39	48.84	Bridger	\$83.3

Sources: Forms 13F filed with the Securities and Exchange Commission for holdings as of March 31, 2008

Fighting the Tape

"Don't try to buy at the bottom and sell at the top," quipped financier Bernard Baruch. "It can't be done, except by liars." On the selling side, SuperInvestors seem to have found out as much in 2008's first quarter.

The stock market over the past two years, argues Legg Mason's Bill Miller in his latest investor letter, has been largely momentum-driven: "In such markets, price trends persist, and wide gaps open up between price and value. That is why fertilizer stocks such as Potash can go from the \$20s to the \$200s in two years, and why Microsoft can bid over 60% more than where Yahoo was trading and still be getting a great deal."

Wide gaps between price and value, of course, are exactly what smart long-term value investors seek. But the transition out of less attractive risk/reward opportunities into more attractive ones can be awkward in momentum-driven markets. Stocks perceived to have reached estimated fair value are sold and often keep

going up, while beaten-down stocks are purchased and often keep going down.

The four SuperInvestors who sold railroad CSX Corp. shares in the first quarter, for example, could certainly have imagined that the company's share price run was getting long in the tooth. After climbing from around \$15 five years ago, the shares hit a high of \$58 during the quarter, but a looming U.S. recession threatened to derail the strong volume and pricing gains made by the company in recent years. On top of that, CSX is in an increasingly nasty and public fight with activist investors, led by the U.K.'s The Children's Investment Fund, over a broad range of operating and governance issues. So what has the stock done lately? Following an excellent quarterly earnings

report, the shares traded recently at \$67.55, up 20% since quarter's end.

A similar dynamic has occurred so far with the sales of energy-related stocks during the quarter. Four of the largest eliminated positions (*see table, next page*) were in the energy sector – Schlumberger, Chesapeake Energy, ENSCO and Walter Industries – and all have continued to perform strongly. Walter, the featured stock recommended in the first *SuperInvestor Insight* (August 25, 2006) by JANA Partners, has been a particular moonshot. Having spun off its Mueller Water Products division in late 2006, the company is now primarily a coal company whose fortunes have risen along with the price of coal. At a recent \$87.80, the shares (adjusted for the Mueller spin-off)

What They're Selling: Don't Look Back

Three or more SuperInvestors reduced or eliminated their positions last quarter in the 11 stocks below. While there was unanimous opinion regarding Macy's, the views concerning technology bellwethers such as Microsoft and Oracle were far more divergent.

Company	Ticker	Industry	Price@ 5/22/08	Q1 2008		# of Decreased or Closed Positions	% Change In Shares Held
				Low	High		
CSX Corp.	CSX	Railroads	67.55	39.87	58.10	4	(-90.7%)
International Game Tech	IGT	Gaming Equipment	34.56	35.80	49.41	4	(-38.2%)
Macy's	M	Department Stores	23.21	20.94	28.47	4	(-100.0%)
Oracle	ORCL	Computer Software	22.31	18.18	23.11	4	(-24.7%)
SAIC	SAI	Technology Services	19.52	17.33	20.10	4	(-29.3%)
Cisco Systems	GSCO	Network Technology	25.58	21.77	27.30	3	(-40.2%)
Microsoft	MSFT	Computer Software/Services	28.47	26.87	35.96	3	(-32.1%)
Mirant	MIR	Electricity Generation	41.54	33.75	39.53	3	(-57.6%)
PharMerica	PMC	Pharmacy Services	20.18	12.99	17.50	3	(-81.0%)
Wal-Mart	WMT	Discount Retail	56.05	43.11	54.15	3	(-59.1%)
Williams	WMB	Oil & Gas	38.40	26.82	37.10	3	(-15.2%)

Sources: Forms 13F filed with the Securities and Exchange Commission for holdings as of March 31, 2008

WHAT THEY'RE SELLING

are up 245% since the first mention in *SII*. Since March 31 alone, they've risen 40%.

Although their respective fortunes would appear to be diverging, retailers **Macy's** and **Wal-Mart** both came in for collective selling in the first quarter. Four investors completely sold their positions in Macy's, the former Federated Department Stores, which has struggled to deliver on its promise of building a truly national department store brand under the Macy's name. The company is now shifting gears to increasingly tailor store merchandise to local preferences, but with consumer spending flagging overall and middle-of-the-road department stores under competitive pressure from above

and below, SuperInvestors are not waiting around to see how it turns out.

Wal-Mart, after a brief attempt to make its merchandise and brand "hipper" and more fashionable, has endeavored to return to its roots as a dependable low-price leader. As this effort has coincided with strapped consumers placing more emphasis on bargains, sales growth and earnings have improved and the company's long dormant stock has shown signs of life, rising 33% from its 52-week low of \$42 last September. SuperInvestor enthusiasm for continued upside, however, appears to have waned: while six investors owned Wal-Mart at the end of 2007's first quarter, only three did a year later.

Oracle, **Microsoft** and **Cisco** all made the most-sold list in the first quarter, but views on these technology bellwethers appear particularly divergent. While Blue Ridge Capital and Bridger Management eliminated their Microsoft positions during the quarter in which the software giant continued its pursuit of Yahoo, JANA Partners and Third Point established new ones. The story was similar for Oracle: four investors reduced positions, but two (JANA and Glenview Capital) made new buys. Of course if everyone agreed, what fun would that be? [SII](#)

Funds managed by Co-Editor Whitney Tilson own shares in WMT.

What They're Selling: Selling Out

These 15 stocks, four of which are energy-related, were the largest complete sales made by different SuperInvestors during 2008's first quarter. While four investors were buying student-lender SLM Corp., Baupost Group made it the quarter's biggest sale.

Company	Ticker	Industry	Price @ 5/22/08	Q1 2008		Investor	Value @ 12/31 (\$mil)
				Low	High		
SLM Corp.	SLM	Student Lending	23.00	14.70	23.00	Baupost	\$441.3
Schlumberger	SLB	Oilfield Services	102.47	72.30	102.71	Lone Pine	\$401.9
Mirant	MIR	Electricity Generation	41.54	33.75	39.53	JANA	\$234.5
Level 3 Communications	LVLT	Telecommunications	3.50	1.68	3.53	Blue Ridge	\$201.1
Macy's	M	Department Stores	23.21	20.94	28.47	Icahn	\$133.6
Philips Electronics	PHG	Diversified Electronics	38.47	34.91	42.91	Omega	\$133.6
Charles Schwab	SCHW	Financial Services	21.93	17.86	25.69	Eminence	\$132.3
ChoicePoint	CPS	Information Services	48.53	31.15	49.24	ValueAct	\$126.0
Thomson Reuters	TRI	Business Information	37.02	31.96	41.16	Glenview	\$121.3
Chesapeake Energy	CHK	Oil & Gas	54.08	34.42	49.87	Highfields	\$116.2
ENSCO	ESV	Oilfield Services	73.99	45.94	65.23	Steel	\$104.2
Morgan Stanley	MS	Investment Banking	42.95	33.56	53.40	Bridger	\$58.4
Ericsson	ERIC	Telecommunications	27.25	17.04	24.56	Pzena	\$54.1
CV Therapeutics	CVTX	Pharmaceuticals	8.77	5.41	9.75	Third Point	\$49.3
Walter Industries	WLT	Coal	87.82	30.78	64.45	Greenlight	\$48.3

Sources: Forms 13F filed with the Securities and Exchange Commission for holdings as of March 31, 2008

Protective Custody

Fully half of the companies in Morningstar's research universe have no economic moat around their businesses. Such is not at all the case with the stocks most widely owned by SuperInvestors.

In the recently published *The Little Book that Builds Wealth*, Morningstar director of equity research Pat Dorsey makes an argument familiar to most value investors: "If you can identify companies that have moats and you can purchase their shares at reasonable prices, you'll build a portfolio of wonderful businesses that will greatly improve your odds of doing well in the stock market." Stocks of companies that can keep competitors at bay through things like dominant

brands, intellectual property protection and high customer switching costs, the argument goes – again, from the right entry price – are more likely to generate above-average returns for shareholders over longer periods of time. Warren Buffett has referred to such companies as "inevitables."

The presence of a moat is not a given. Of the 2,300 companies in Morningstar's research universe, fully 50% have no moat at all, while only 9% have wide

moats. The list of stocks most widely held by SuperInvestors (see table, below) has a much different profile, however. Sixteen of the 17 companies that Morningstar tracks from the list are considered to have a moat. Six of those moats, or 35% of them, are judged to be wide.

Many of the most competitively advantaged firms, such as **Microsoft**, **Oracle**, **Cisco** and **Wyeth**, derive much of their advantage from protected intellectual property and high customer switching

What They Own: Moat Control

Four or more SuperInvestors held positions of at least \$25 million in these stocks as of March 31. While Morningstar overall finds moats in 50% of the companies in its research universe, 94% of the companies tracked on this list are considered to have them. The sole holdout: NRG Energy.

Company	Ticker	Industry	Price@ 5/22/08	52-Week		# of Portfolios That Own	Change In Shares Held	Morningstar Economic Moat
				Low	High			
WellPoint	WLP	Health Insurance	55.45	43.02	90.00	8	29.2%	Narrow
American Express	AXP	Credit Card Services	46.36	39.50	65.89	6	5.0%	Wide
Microsoft	MSFT	Computer Software/Services	28.47	26.87	37.50	6	47.8%	Wide
Oracle	ORCL	Computer Software	22.31	18.18	23.31	6	13.6%	Wide
SAIC	SAI	Technology Services	19.52	16.11	21.13	6	(-11.5%)	Narrow
Anadarko Petroleum	APC	Oil & Gas	78.40	45.47	81.36	5	(-0.3%)	Narrow
Cisco Systems	CSCO	Network Technology	25.58	21.77	34.24	5	20.2%	Wide
First American	FAF	Real Estate Services	35.20	27.79	55.25	5	34.9%	Narrow
Wyeth	WYE	Pharmaceuticals	43.88	38.39	62.20	5	All new positions	Wide
America Movil	AMX	Wireless Communications	56.87	49.02	69.15	4	10.1%	Narrow
American Tower	AMT	Communications Infrastructure	43.73	32.10	46.53	4	3.9%	Narrow
ConocoPhillips	COP	Oil & Gas	92.00	67.85	95.07	4	3.6%	Narrow
Covidien	COV	Medical Equipment	48.31	36.90	50.24	4	28.1%	Narrow
DaVita	DVA	Dialysis Services	52.06	41.86	67.44	4	(-4.0%)	n/a
Fidelity National Information	FIS	Transaction/Loan Processing	38.88	34.11	57.80	4	15.6%	Narrow
Google	GOOG	Internet Services	549.46	412.11	747.24	4	167.5%	Wide
NRG Energy	NRG	Power Generation	40.35	23.03	47.19	4	31.1%	None
Qualcomm	QCOM	Telecom Equipment	45.87	35.17	48.36	4	(-9.1%)	Wide

Sources: Forms 13F filed with the Securities and Exchange Commission for holdings as of March 31, 2008; Morningstar

WHAT THEY OWN

costs. But in these cases and those of the other wide-moat firms such as **American Express** and **Google**, a powerful “network effect” also plays a role. Businesses benefiting from the network effect see the value of their product or service increase with the number of users. In the case of American Express, the more consumers use the Amex card, the more merchants will want to accept the card. The more merchants accept the card, the more Amex can invest in its reward programs for use of the card. The better the reward programs, the more consumers want to use their card ... and so on.

This is not to say, of course, that SuperInvestors will pay any price to benefit from a moat. At the end of last year's first quarter, only one such investor held a stake in American Express, worth a grand total of \$386,000. Similarly, only one investor at the end of 2008's first quarter held a stake in eBay, which is considered to possess one of the more classic and powerful network moats.

Six new names made the most-owned list in the past quarter: **Wyeth**, **America Movil**, **Covidien**, **DaVita**, **Google** and

Qualcomm. Latin American cellular giant America Movil and renal-care leader DaVita are both recent high flyers – Movil shares are up 10-fold over the past five years, while DaVita's have more than tripled over the same period. Each, however, has seen its stock price hit a wall as still-healthy growth rates have slowed.

Covidien, after its spinoff from Tyco, has been making what it considers long-overdue investments in sales, marketing and R&D, and has also started to reshuffle its broad portfolio of businesses. While the company's short-term earnings have been hit by such maneuvering, four superstar investors appear to be betting that the new investments will pay big dividends down the road.

Even though it has become somewhat of a mainstay on the most-owned list, the trading activity in Microsoft among star investors last quarter was anything but boring. Greenlight Capital, JANA Partners, Third Point and Pennant Capital all increased their Microsoft stakes by more than 50%, while both Bridger Management and Blue Ridge Capital sold completely out of the shares.

While their steps can best be described as small and tentative, SuperInvestors during the quarter did start buying into some prominent financial names that have been hammered by the credit crisis (*see table, below*). Four investors each, for example, established brand-new positions in investment bank **Lehman Brothers** and bond insurer **MBIA**. Two each took first-time flyers on **SLM Corp.** and **JPMorgan Chase**.

The crisis has hit shares of one less-well-known financial on the list, **PHH Corp.**, in at least two ways. Its core business of making and servicing private-label mortgages for real-estate brokers and financial institutions has fallen off sharply as the housing crisis has spread. On top of that, its planned \$31.50 per share buyout by GE Capital and Blackstone fell through late last year for lack of financing. After falling below \$15 per share in January, the shares have rebounded only modestly to a recent \$19. [SIII](#)

Funds managed by Co-Editor Whitney Tilson own shares in AXP, and are short those in LEH, MBI and MCO.

What They Own: Amid the Ruins

SuperInvestors haven't been buying up battered financial stocks in any volume, but at least three of them did hold positions in these challenged market players at the end of the first quarter. Trading furthest from its 52-week high: IndyMac, off 95%. Trading closest: JPMorgan, only 19% off its high.

Company	Ticker	Industry	Price@ 5/22/08	52-Week		# of Portfolios That Own	Largest Holder	% Change In Total Shares Held
				Low	High			
Lehman Brothers	LEH	Investment Banking	38.50	20.25	82.05	5	Pzena	21.0%
SLM Corp.	SLM	Student Lending	23.00	14.70	58.00	5	Highfields	23.3%
Freddie Mac	FRE	Mortgage Finance	26.29	16.59	68.12	4	Pzena	7.0%
MBIA	MBI	Credit Insurance	8.04	6.75	68.98	4	Blue Ridge	All new positions
Moody's	MCO	Credit Ratings	34.51	31.14	73.69	4	Berkshire Hathaway	8.9%
PHH Corp.	PHH	Mortgage Finance	19.00	14.91	31.52	4	Pennant	23.1%
Fannie Mae	FNM	Mortgage Finance	27.90	18.25	70.57	3	Pzena	7.9%
Goldman Sachs	GS	Investment Banking	177.20	140.27	250.70	3	Eminence	113.8%
IndyMac Bancorp	IMB	Banking	2.03	1.74	37.50	3	Second Curve	-48.8%
JPMorgan Chase	JPM	Banking	43.05	36.01	52.31	3	Pzena	27.6%

Sources: Forms 13F filed with the Securities and Exchange Commission for holdings as of March 31, 2008

Manageable Care?

Did changes in WellPoint's prospects justify a decline of \$25 billion in its market cap between January and March? Based on their buying behavior in the first quarter, SuperInvestors apparently don't think so.

From its initial public offering in late 2001 until earlier this year, managed-care organization WellPoint led a relatively charmed existence on Wall Street. Considered at the forefront of the secular trend toward greater cost-containment in the healthcare industry and (along with UnitedHealth Group) a lead consolidator in a fragmented industry with significant scale benefits, WellPoint's shares hit an all-time high of \$90 during the second week of January.

The bloom, to put it mildly, has come off the rose. Citing unexpectedly high medical costs and an unusually harsh flu season, WellPoint has twice taken down its forecasted 2008 EPS, the latest in March bringing the low end of its expected range to \$5.42 per share. The market responded by punishing the shares, which fell as low as \$43, wiping away nearly \$25 billion in market capitalization in less than three months.

Such short-term price dislocations can obviously present investors with a great opportunity to buy, if the fundamental long-term value of a company remains intact. SuperInvestors appear to have made just such a calculation about WellPoint in the first quarter, with three different investors taking new stakes and three others increasing existing positions.

Confidence in Wellpoint's long-term prospects is largely a function of its strong competitive market position and above-average growth potential, says Edward Dwek, who follows the company for the \$23 billion (assets) First Eagle Global Fund. Nearly 95% of WellPoint's members are located in markets in which it holds a #1 or #2 market share, important in a business that derives its strength from connecting the largest number of healthcare customers with the broadest network of healthcare providers. The larger the customer base, the more bargaining power the company

has with providers. The broader the provider base, the harder it is for employers to switch insurers or resist price increases. "Local economies of scale provide both a significant operating advantage and high barrier to entry," says Dwek. "Any market entrant trying to match their prices is likely to lose money."

WellPoint also benefits from the fact that some 90% of its customers are in 14 states in which it owns the license to operate under the Blue Cross and Blue Shield brands. This makes the company somewhat less susceptible to non-profit competition, given that Blue Cross and Blue Shield plans are typically the primary non-profit competitors in other states.

INVESTMENT SNAPSHOT

WellPoint (NYSE: WLP)

Business: Provider of network-based managed healthcare plans to small- and large-employer, individual, Medicaid and senior-citizen markets in the U.S.

Share Information

(@5/22/08):

Price	55.45
52-Week Range	43.02 - 90.00
Dividend Yield	0.0%
Market Cap	\$29.18 billion

Financials (TTM):

Revenue	\$61.60 billion
Operating Profit Margin	8.7%
Net Profit Margin	5.1%

Valuation Metrics

(@5/22/08):

	WLP	S&P 500
Trailing P/E	10.3	23.9
Forward P/E Est.	9.0	15.5

Largest Institutional Owners

(@12/31/07):

Company	% Owned
Dodge & Cox	7.0%
Wellington Mgmt	4.2%
State Street	3.7%
Barclays Global Inv	3.6%
Barrow, Hanley, Mewhinney & Strauss	3.5%

Short Interest (@4/25/08):

Shares Short/Float	1.4%
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WLP PRICE HISTORY



THE BOTTOM LINE

With its strong local competitive market positions and above-average growth potential, the company's fundamental business prospects remained intact after the market slammed its stock in March, says Edward Dwek. From a share price in the mid-\$40s, the shares offered a total return expectation of 17-18% per year, he says.

Sources: Company reports, other publicly available information

The current rise in medical costs relative to premiums should not be a permanent problem, Dwek says. Like other insurers, the company from time to time underprices premiums compared to its eventual cost exposure, especially with new products such as those rolled out last year focused on Medicare coverage. But WellPoint overall has been a sound underwriter, he says, and is able to reprice policies fairly quickly to compensate for unexpected increases in utilization and medical costs. More rational industry competition also provides pricing leeway: "Since the spinoff of the managed-care companies from the bulge-bracket insurance firms, there isn't a history of companies competing for market share at the expense of profitability," he says.

How to value WellPoint shares, which have recovered somewhat to trade recently at \$55.45? Dwek believes the company should generate around \$3 billion per year in normalized free cash flow, which at a mid-\$40s share price translated into a free cash flow yield of

around 12% (now 10%). Given it doesn't have significant capital investment needs, WellPoint traditionally has returned 85-90% of its free cash flow to shareholders in the form of share buybacks. On that basis, Dwek saw the

ON THE BIGGEST RISK:

The elephant in the room is the risk that campaign talk translates one day into a single-payer healthcare system.

ongoing business – assuming no growth – generating a cash return of roughly 10.5% per year for its shareholders (now around 9%).

On top of that he's counting on 7% annual revenue growth – in line with the long-term growth rate in overall healthcare expenditures in the United States – which he expects to at least flow through

to bottom-line earnings and cash flow. That should be conservative, he says: top-line growth driven by healthcare cost inflation typically drives improved operating margins, given that administrative expenses are largely fixed. "At share prices in March, we could make the case that Wellpoint was providing us with an annual total return profile of 17-18%," says Dwek, "That was very attractive to us."

The elephant in the room for a company like WellPoint, of course, is the risk that campaign talk about national healthcare solutions translates into some sort of single-payer system like those in France or Germany, destroying the company's business. In the worst-case scenario for the company, Dwek assumes WellPoint would be worth its net cash plus long-term investments, or around \$20 per share. Given the low probability he assigns to that happening, including the worst case in his analysis knocks about 3% per year off his annual total expected return. SII

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