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ValueInvestor INSIGHT

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INVESTOR INSIGHT

Bruce Berkowitz
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"My crystal ball is horrible, so my focus has to be on reacting to the valuation extremes in individual securities."

Your firm's tagline is "Ignore the crowd." Is all the pessimism out there making you optimistic?

Bruce Berkowitz: It has historically always paid to be greedy when everyone is fearful. In the extremely pessimistic environment we're in, we're finding many cases in which market valuations relative to free cash flow generation reflect a depth and length of economic stress that we just don't agree with. It seems to me that most of the dangers are pretty well talked about, and I believe it's very rare that when you're focused on a risk that it kills you, because you're doing something about it. It's usually what people aren't talking about that ends up hurting you. So to answer your question, I'm more bullish than I've ever been.

Where are you finding the most attractive opportunities?

BB: We're heavily weighted today toward healthcare and defense. We'll talk later about Pfizer, our largest holding, but we also think the health maintenance organizations like UnitedHealth [UNH] and WellPoint [WLP] are much cheaper than they deserve to be. We've gone through every scenario we can think of to try to kill these businesses and we just can't. Does the U.S. healthcare system need to be more efficient? Yes, but the government can't do it by itself. The only way it can make that happen is by working productively with the health insurers. Who else could do it? We also keep coming back to this huge baby-boomer segment of the population that is just entering the stage of their lives when they will have much higher demand for healthcare. That's a long, huge wave that is going to be surfed for at least the next decade.

In defense, the shares of companies like Boeing [BA] and Northrop Grumman [NOC] are being treated as if their earnings have gone away, which is hardly the case. And that's happening while we're in the middle of a couple of wars and when defense budgets are bigger than ever. It's a very dangerous world and no sitting politician is going to back down from the priority of protecting the citizens of the United States – all of which is going to require spending a lot of money. Upgrading critical but outdated military systems is going to require spending a lot of money. Only a handful of companies create the defense systems for the U.S. and we own many of them, up and down their capital structures.

Have you been tempted to bottom-fish in financials?

BB: I've said in the past that I didn't understand what banks owned and what they owed. That still holds true, but now I don't even know who *owns* the banks. Investing is tough enough when you think you know something. When you have to start guessing, forget it.

It's possible the experiences of companies like Citigroup will finally put to bed – for the second time in my investing career – the myth that financial supermarkets are a good idea. Then again, maybe we really don't learn from history.

You typically hold plenty of cash. Have you used it up?

BB: We've been spending it, but we still have plenty – in the low-teens as a percentage of our portfolio. Given the volatile environment, we want to make sure with the fund that we're never in a position where our hands are tied behind our backs and we get shaken out of positions at exactly the wrong time – which would be the case if we were forced to sell almost anything into today's market.

You said when we last spoke that you "tend to be more about the jockey than the horse" in identifying great investments. Is that more or less true today?

BB: That has changed somewhat. We're still very focused on the jockeys, but we're equally focused on the cash the businesses produce. In cases where we can't find an absolute superb jockey, we'll still invest if the cash flow is there, although it may make us more likely to invest in more senior parts of the credit structure or to buy a basket of the strongest companies rather than just one.

Your largest holding, Pfizer [PFE], has certainly been in the news of late. Has that impacted your positive view at all?

BB: The short answer is no. The concerns about Pfizer are well-known: Lipitor is going off patent, its costs are too high, the government is going to take away its profits, etc. As has been happening a lot lately, we disagree strongly with the market's view about how that all plays out.

With respect to the revenue hit from blockbusters like Lipitor going off-patent, how does your view differ?

BB: In a couple of ways. The first is that we don't believe Pfizer is going to lay down and concede billions and billions in revenue to generics without a fight. If you look at the company's global manufacturing footprint, which you don't read about in *The Wall Street Journal*, you can see a boom in hiring and in gearing plant and facilities to the manufacture of what they call established brands. Three years from now when there's big generic competition for Lipitor, if Pfizer can sell the name brand at a reasonable price premium to generics, why wouldn't people buy it? A generic drug is not exactly the same as the real deal – it may or may not be as effective – and if people discriminate in the type of chocolate they put in their mouth, we think they'll do the same with drugs critical to their health. Beyond that, what's to stop Pfizer from competing with its own generic versions of branded products?

A second big issue is that the market seems to give Pfizer little credit for having the most powerful drug distribution system in the world. That makes it the ideal partner for any bright young company with a potential blockbuster and, as we'll see with Wyeth, even for established companies that can get wider and more efficient distribution by plugging into Pfizer's system. [CEO] Jeffrey Kindler understands that big pharma's not-created-here syndrome has to go. Taking advantage of that through partnerships, joint ventures and acquisitions can go a long way to replacing sales and profits lost to generics.

Have recent cost-savings announcements gone far enough in your estimation?

BB: We'll see. I do believe Kindler is a very smart operator, with a great pedigree and a clear understanding that there are billions in savings at a company the size of Pfizer. He has also proven to be an under-promise, over-deliver kind of guy, so we're optimistic he'll do the right things in fitting the cost structure to the business opportunities.

You spoke earlier about the effects of new government regulation on managed-care companies. Does that view translate to Pfizer as well?

BB: I'm not saying that change isn't necessary and desirable, but that the government can't push so hard that companies like Pfizer or UnitedHealth lose the incentive to innovate and improve. The government can cut checks, but if it wants a thriving and first-class healthcare system, it can only do it with the support and participation of the pharmaceutical and health-insurance industries.

Is the environment likely to be tougher for everyone? Yes. But the company is priced as if it's headed over the cliff, when we don't think it is.

At just above $15, how inexpensive do you consider the shares?

BB: Before the Wyeth deal was announced and assuming that Lipitor goes away – which is incorrect – we never saw the company earning less than $2 per share in free cash flow. After a first pass at looking at the Wyeth deal, we're now seeing a steady-state level of per-share free cash flow of around $2.50.

So at $15, the shares trade at a 6x multiple of free cash flow and a free-cash-flow yield of more than 16% – for a solid investment grade credit! Compare that to the 2-3% you can get on long-term Treasuries and something has to give. Either Treasuries are going to go way down in price and way up in yield, or, when markets start to regain some confidence, Pfizer's stock price is going to go way up and the free cash flow yield will go back down into the single digits where it belongs. We're betting on the latter.

We've calculated what we think is the liquidation value of the company if you just ran off their existing products until patent expiration, and the net present value of that alone is higher than the current stock price. That's assuming generics take 100% of their business. That's assuming their pipeline – and now Wyeth's – is valued at zero. That just doesn't make sense.

In general, have you had to put more emphasis on macro views to inform your decision-making?

BB: There's no question that getting the macro picture right is hugely valuable – I just wish I was capable of doing it. When it comes to macro events, you can either predict or react. I've proven time and again that my crystal ball is horrible, so my focus has to be on reacting to extremes in individual securities by selling at high valuations and buying at low valuations.

In our 2007 letter we talked all about the further catastrophes and stresses we expected in 2008 and thought we had our ark built pretty well as it continued to rain hard. Everything held up until November, when the price of the fund went over the cliff with the rest of the market. So we obviously weren't fully prepared for what ended up happening. But we said in that 2007 letter – and absolutely still believe – that horrible periods are when the seeds of great performance are planted. If you buy very cheaply – getting wonderful tangible and intangible assets for free – and can't figure out how to kill the business, things should turn out well. Time is on your side.

People ask me all the time if I think we've hit the bottom. Who knows? What I do know is that this has to be a better time to invest than a year ago, five years ago, ten years ago and than maybe only a few times in the past century. If not now, with pessimism so extreme, when? VII