Value Investor INSIGHT

The Leading Authority on Value Investing

December 2, 2010

Mining Misunderstanding

Companies' long-term prospects aren't often top of mind for special-situations investors. They are to James Crichton and Adam Weiss, to exceptional effect.

Investment committee meetings at Scout Capital, which James Crichton and Adam Weiss founded in 1999, tend not to be timid affairs. "I refer to them as 'Fight Club,'" says Weiss, "but there's a respectful way of valuing your colleagues while at the same time questioning every word that comes out of their mouths."

Scout's Socratic ethic has paid big dividends for its investors. The firm now manages $2.3 billion and its main fund has earned a net annualized return since August 1999 of 15.5%, vs. 0.9% for the S&P 500.

Focused on companies in transition – of which there are many today – Weiss and Crichton are finding opportunity in such areas as information services, bottling, industrial sensors and railroads. See page 2

INVESTOR INSIGHT

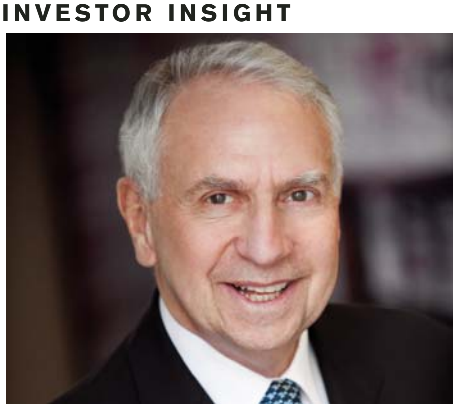
Adam Weiss *(l)*, James Crichton *(r)*
Scout Capital

Investment Focus: Seek companies with sustainable, favored business models whose earnings power is misunderstood for event-driven or other identifiable reasons.

On the Mark

As macro concerns weigh broadly on valuations, serious fundamental analysts should find plenty to invest in, says Morris Mark, who today is doing just that.

INVESTOR INSIGHT



Morris Mark
Mark Asset Management

Investment Focus: Seeks companies best positioned to benefit from industry, cyclical or macroeconomic trends for which the market has misjudged the scope and/or timing.

He resists all attempts to peg him as a growth investor, but Morris Mark has made a career out of investing mostly in high-quality businesses with secular winds at their backs. "I've never understood the resistance to paying more for a great business," he says.

Mark's brand of "quality-value" investing has served his Mark Asset Management clients well. A composite of separate accounts managed by his firm since 1987 has returned a net annualized 12.3%, vs. 8.6% for the S&P 500.

Still-high risk aversion on the part of equity investors overall is creating plenty of opportunities today, he says, in such areas as wireless technology, Internet services, consumer electronics, hotels and residential real estate. See page 12

Inside this Issue

FEATURES

INVESTMENT HIGHLIGHTS

Other companies in this issue:
Apple, Cisco, Citigroup, Coca-Cola, CoreLogic, Devon Energy, MasterCard, McDonald's, Northwest Bancshares, Visa

Investor Insight: Scout Capital

Scout Capital's James Crichton and Adam Weiss describe why the market today is conducive to their brand of special-situations investing, why they call investment-committee meetings "Fight Club," where their "digital lawnmower" short thesis is playing out, and why they see mispriced value in Verisk, Coca-Cola Enterprises, Sensata and QR National.

The two of you originally met as fresh-faced associates at Donaldson, Lufkin & Jenrette. How did you eventually conclude you'd make good partners?

Adam Weiss: We had gone our own ways – I was at Third Point working for Daniel Loeb and James was at Zweig-DiMenna working for Joe DiMenna – but we routinely kept in touch and shared ideas. Before finally deciding to work together, we would run these mock portfolio meetings once a week to go through ideas and hone in on what we would or wouldn't do. Unconsciously, it was a way to guarantee in advance we'd be able to get along and that we could agree on what was important.

What came out of that were really the core investment values we use today. We essentially concluded there was a lot of opportunity in combining a special-situations approach – where you're intent on identifying misunderstandings about a company's stock – with a focus on higher-quality companies with increasing earnings power.

Describe in more detail Scout's core investment values: circle of competence, quality, and misunderstanding.

James Crichton: Circle of competence essentially comes down to whether we understand the business. There are several sub-questions under that: Do we know the right people in the industry? How well do we understand the products and the customer decision-making process? Are there unanalyzable things that could have a big impact? No matter how well you understand the steel industry, for example, there's tremendous volatility and variability in the business that may not be susceptible to prediction, which makes it difficult for us to underwrite the business with adequate confidence.

We focus on companies with long competitive-advantage periods, which puts a premium on our truly understanding the business dynamics over time. As a result, features of businesses we're tempted by typically include stable market shares, stable margins, pricing power and long data series, so we can evaluate how the business has performed through good times and bad.

How has your circle of competence expanded in recent years?

AW: We will add areas in which we've developed enough expertise and contacts to make them investable. One recent example would be the waste industry, where we now feel we can get to the bottom of it if something is happening there.

While we're active in developed international markets, we've also gotten more comfortable after several years of effort with emerging markets like Brazil. In China we've made one or two smallish investments, but haven't yet found firm ground. I don't know if we ever will, but we'll keep going there and paying attention because of how much we learn about the world when we do.

Are there industries you tend to avoid?

AW: We don't typically bet on scientific innovation, so we rarely find things we'll consider in healthcare. We avoid many areas in technology because of the speed of the product cycles and the magnitude of change from cycle to cycle. In areas like basic materials and other commodity businesses, there usually just isn't enough of a moat, which makes it hard for us to get interested on a fundamental basis.

JC: We've struggled to underwrite moats based on intellectual capital, say in a company like Qualcomm [QCOM],

Adam Weiss, James Crichton

Coming Together

Their backgrounds certainly weren't identical prior to meeting – Adam Weiss was an art history major with a JD/MBA from Columbia and an entrepreneurial resume that included launching a chain of New York Bagel stores in Hungary, while James Crichton was a West Point engineering graduate who served two years in the Army prior to getting a Harvard MBA – but the two new hires of Donaldson, Lufkin & Jenrette in 1996 quickly found a common passion in investing. Within three years they had teamed up to launch their own investment firm, Scout Capital. "Like a lot of people our age we overestimated our competence and skill sets and decided we were ready to take over the world," says Weiss.

The secrets of their wildly successful partnership? "We have always had complementary industry expertise which at some level I suppose has added value," says Crichton. "But the more thoughtful answer is that we both love the business and we love to learn. The back and forth of our dialogue can progress our collective thinking faster than if we were just tackling things on our own. There's no question that leads us to a better place."

where its earnings power is enormous if all its patents hold up. That's another reason we're not active in things like pharmaceutical or biotech companies.

What are the key elements of quality you're looking to assess?

JC: We're looking for businesses with low capital intensity, the ability to generate high levels of free cash flow and a privileged business model that enables the company to produce excess capital. We want the financial and business models to be transparent. In terms of competitive dynamics, we want to understand the value of the company's product or service to customers and the strength of its competitive moat. From an industry perspective, we ideally want to see long-term sustainable growth and secular tailwinds.

AW: As our holding periods started to lengthen, in assessing quality we also began to place greater emphasis on management. If you buy something with a 10% free cash flow yield and hold it for three years, management is going to be responsible for allocating a third of the value of the company over that time. You have to really care about that.

How do you vet management quality?

AW: It comes down to doing business with people you trust. We pay careful attention to all management communication. Does the CEO write the shareholder letter himself or herself? Do they tell you when they've been right and when they've been wrong? Do they talk about what's difficult about the business? Do they articulate how they allocate free cash flow, and do so with an owner mentality? Are the key benchmarks consistent? We worry about companies that one year focus you on adjusted net operating EPS, then the next year on EBITDA margin and the year after that on something else.

We also do the basic math around compensation plans and how they work, on which there's more transparency than ever. That means understanding where management is being incented to focus and whether that focus is aligned with what is in shareholders' best interest. For example, if you have a bull case about something five years down the road, you should know what the options dilution is going to cost you if you're right.

If the CEO owns $1 million worth of stock and gets paid $10 million per year, it's pretty clear he'll value his job more than the value of the stock. If he's paid $1 million per year and owns $50 million in stock, we think that's predictive of his making better long-term decisions for the company. James has had a nice focus over the years on companies where the founder owns 20-30% of the business. They'll work with Wall Street because they don't completely control the company, but at the same time they can take a longer-term perspective. CEOs with tons of options rather than actual shares can be prone to adopt Wall Street's short-term focus, which can cause value to be eroded more quickly than you'd think as one bad decision piles on top of another.

ON VARIANT VIEWS:

Multiples never expand when companies don't beat earnings, so you've got to believe earnings are going to surprise.

Your last core investment value is misunderstanding. What do you mean by that?

JC: Misunderstanding refers to our having a variant perception versus consensus with respect to the earnings power or the free-cash-flow-generating potential of the business. Some misunderstandings come from Joel Greenblatt *You Can Be a Stock Market Genius* types of events – such as spinoffs, emergence from bankruptcy, and recapitalizations – where the movement of debt, equity or assets around on a balance sheet leads to analytical complexity or some form of irrational selling.

Variant perceptions can also arise from having a differential view about the ongoing business itself, such as new product launches, the impact of a change in management, or on how operating or financial leverage plays out over time.

AW: The key in almost all these cases is that something is changing. If a business has been around for 20 years and public for the last 15, it's hard to argue that people are really missing something if there's nothing relatively big going on. That gets to the importance of knowing why there is information asymmetry. If you can zero in on that, you're better able to handicap how likely you really are to be seeing something other people aren't.

This goes back a few years, but when MasterCard [MA] went public in 2006, we identified what we thought were material misunderstandings about both litigation exposure and the operating leverage in the business over time. Litigation puts people off, but our view was that it was an excuse for them not to do the hard work of determining whether the legal overhang was material, which we concluded it wasn't. The reason operating leverage was misunderstood was that management misrepresented – or underestimated, if I'm being charitable – what incremental profitability was likely to be over time. You stack a few of those misunderstandings together and in our original thesis we were literally saying the stock was worth roughly $160 – 20x earnings power of $8 per share – while the Street was projecting 12x approximately $4 in earnings, for a value of $48.

In this case we had both, but we put more credence in a differential view on earnings than on multiples. The reality is that multiples never expand when companies don't beat earnings, so you've got to believe earnings are going to surprise.

How do you generate ideas?

JC: We've over time built a number of systems and reports that enable us to track globally the movement of debt, equity and assets around on balance sheets. We follow things like spinoffs, rights offerings, new equity issuance and buybacks. We also run many screens to identify businesses that are either short on capital or have excess capital.

It's also just coming in every day and reading the paper and talking to people and doing research. As part of our analysis of Coca-Cola last year, for example, we constructed a detailed global bottling model to understand the economics of that business. So when we saw that Coke was buying back its North American bottling operations from Coca-Cola Enterprises [CCE], we were able to assess and then take advantage of the opportunity in CCE quickly and with confidence.

How did something like Northwest Bancshares [NWBI] get your attention?

AW: This was a second-step demutualization of a Pennsylvania-based thrift that took place in the fourth quarter of 2009. We've invested in these types of things several times, with the general thesis being that the process is somewhat rigged to come up with a cheap price at which to offer stock to depositors. After the demutualization, you often end up with a company that's cheap on book value but expensive on earnings because it's overcapitalized. The bet then is on how well you believe management can deploy that excess capital at a reasonable rate of return, which plays out over time as the capital is deployed. This hasn't yet been a rousing success, but the thesis is still intact and the stock is still cheap.

Describe some of the key internal processes you've built around research and investment selection?

JC: We believe there are questions to which every responsible capital allocator should know the answer, so we've developed an investment-committee memo framed to address all of our core investment values. It's not a brainless exercise of box checking, but meant to insure that the analysis gets done in the way that we've learned over time should produce high-quality results.

Our feeling is that if you can't write it, you can't think it, so we require all the analysis on paper. It's one thing to say incremental margins are X%, but we need to show all the detail used on things like pricing and fixed and variable costs to justify why that conclusion is accurate.

AW: We distribute the memo to everyone before ideas are presented and their job is to submit hardcore, probing questions in advance so that when we sit down to discuss any idea, the debate is squared off. I refer to the investment-committee meetings themselves as "Fight Club," but there's a respectful way of valuing your colleagues while at the same time questioning every word that comes out of their mouths – to get at what we know and what we don't know. We set these meetings up five years ago so people could participate in the type of debate James and I have been having since we started. People don't believe that we want to be questioned in that way, so we want to show them that we do.

ON BIAS FOR QUALITY:

If you're going to have a 10% position and you get it wrong, the consequence can't be that it's down 90%.

JC: One really valuable aspect of our partnership is that if it's my idea, Adam can rip it apart, point out all the things I'm missing and where my blind spots are, and I can do the same with him. It's too easy in a benign dictatorship, with one person running the fund, to say it's my way or the highway. We're obviously biased, but we think that can lead you not to question an investment thesis in as balanced a way as you might otherwise.

Your fund has become more concentrated over time. Why?

AW: That was really driven by just observing where our returns had come from and trying to focus even more on those types of situations. That made us more concentrated and more interested in quality. If you're going to have a 10% position in something and you get it wrong – and you have to be very prepared to get things wrong because it happens all the time – the consequence can't be that it's down 90%.

More generally, we think there are profound research advantages in concentration. This is a world of very smart people and you can't enter that marketplace without a profoundly humble view about how you're going to win. For us, concentration and depth of research allows us to go to bed at night and feel like we have a defensible source of our returns.

Describe the typical make-up of your portfolio.

JC: We target a net exposure of 20% to 60%, although typically it runs in the range of 30% to 50%. We try to be smart and opportunistic about how we get to that net. We will use cash, stock shorts, options and ETFs, as well as non-equity instruments that we call "insurance." We do not use leverage.

The number of longs is usually between 15 and 25, while the number of shorts varies a bit more, but is usually in the mid to high single digits.

How did you arrive at that target net exposure?

JC: We always start off by asking ourselves how we want our own capital to be deployed. Because we have our entire financial net worth in the fund, we care more about avoiding large permanent losses, and less about managing small swings in performance.

AW: James is describing why our exposure isn't higher, now I'll describe why it's not lower. In other words, why does a net of 50% serve to protect us enough when things go wrong? We have been doing this for 11 years, so have learned by observation how our portfolio responds when things go very badly in the world. Compared to the market, our long portfolio has higher-quality businesses with lower financial leverage and our shorts tend to be of lower quality and more highly levered. We think that explains why our portfolio has acted a lot better than its net exposure would indicate during times of trouble.

What are the typical characteristics of your shorts?

JC: We're looking for companies with weakening moats, often coupled with a resulting deployment of capital into areas in which they have no competitive advantage. Even better is when they're deploying not just excess capital, but leveraging the balance sheet to do so.

Eastman Kodak was a classic example. It took all of its excess capital when confronted by the threat of digital photography and redeployed it away from its analog film business into areas that were much less attractive and/or in which it had no advantage. You could make the same argument about Yellow Pages and newspaper companies.

AW: Playing off that for a second, one of the best trades we've ever made, which James deserves the credit for, was going long Google at its IPO while at the same time concluding that newspapers and Yellow Pages were great shorts. As much money as we made on Google, we actually made more dollars being short the businesses it was going after, at a time when people still thought newspapers and Yellow Pages companies were great-cash-flow, deleveraging, high-dividend stories.

JC: We call this the "digital lawnmower" phenomenon, in which new digital habits erode or destroy traditional non-digital business models. We don't want to mention any specific companies, but you can see this taking place in a variety of areas today, such as the cable-television industry, the textbook business, and in firms with expertise around sending mail. We focus on companies that combine operational leverage with some financial leverage, which is more common than you might think as companies don't adequately anticipate the tipping point when slow growth turns into rapid decline.

You mentioned being long "insurance." What does that mean?

AW: We have used puts and calls on commodities, interest rates and currencies to hedge against specific outcomes in our portfolio that concern us. We also make use of credit default swaps [CDS] to be short credit.

For example, if we're long Coca-Cola Enterprises, which operates exclusively in Europe, we'll hedge out our exposure to the value of the euro. If we're long QR National [QRN:AU], which we'll speak about later, we'll hedge against China blowing up and killing demand for the natural resources its rail business transports. We're always looking for the cheapest protection and aren't trying to hedge away every risk, just those that could upset our apple cart not by a little bit, but by a lot.

We limit this whole non-equity insurance piece to 200 basis points per year of premium paid, and it's generally smaller than that.

Talk generally about how you think about valuation.

AW: We quantify scenarios above and below our base case, but the base-case valuation typically looks two years out at our estimate of free cash flow, then applies a forward multiple we believe is reasonable. We target at least 25% gross annual returns in any given idea.

Warren Buffett talks about a company's value moving through innovation, imitation and then idiocy phases. We're most comfortable in the early stages when we think we're kind of writing the intellectual property. That's not to say there's not a lot of money to be made in the imitation and even idiocy phases, but it's not our native ground. If we're saying the same thing as the consensus and something is no longer misunderstood, chances are we're selling.

ON PHASES OF VALUE:

We're much more comfortable in the early stages when we think we're kind of writing the intellectual property.

What are some recent examples?

AW: We pulled back from McDonald's [MCD] last quarter, for no other reason than competition for capital and keeping a disciplined net and gross exposure. We still own and very much like the company, and in fact think it's gotten more interesting of late, partly because we believe it stands to benefit from the changes to come at Burger King under its new owners.

We'll also obviously respond to developments that we see working against us. We had owned Citigroup [C] earlier this year based on our view of normalized earnings power, but when the "mortgage-gate" story broke, we concluded that wasn't good for the entire group and that there were a lot more exciting opportunities to pursue instead.

You've been a big holder of MasterCard [MA] in the past. How are you handicapping its regulatory challenges today?

AW: We sold our stake purely on valuation in the summer of 2008, got back in after the crisis when the stock had gone from $300 to $125, and then stepped out again in the Spring of 2009 as we started to worry about the regulatory environment under the new administration.

We're back involved, but not with a large position. The cloud is obviously the Durbin bill [a debit-card focused amendment sponsored by Sen. Richard Durbin to the financial reform bill] and how it might affect interchange fees and MasterCard's profitability. There are real and complicated issues, but we're saying 12x forward earnings for a company with 20% EPS growth, secular tailwinds and one of the strongest competitive moats might be interesting. It was great to get out of the stock when no one was worried about regulation and it traded at a 50% higher multiple. Now with everybody talking about regulation, there's a fair chance the concern is overdone.

Describe the case for one of your largest positions, Verisk Analytics [VRSK].

AW: Verisk was started by the property and casualty insurance industry in 1971 and is now the *de facto* data and analytics provider to all P&C insurers in the U.S. The original idea was to create a cooperative that would assemble the data on premiums and claims paid for everyone in the country. In that way, if John Doe had a homeowners' policy in Georgia with Prudential and his house burned down, if he moved to Illinois and tried to take out a new policy with State Farm, they would know that his last house burned down. That makes the data, forms and analytics Verisk provides in all P&C lines – as well as newer efforts directed at health and mortgage insurers – vital to the assessment of risk in underwriting and claims.

This is literally one of the highest-quality businesses we've seen. In many areas they have no competitors and the network aspect of the business – the more information assembled, the more valuable Verisk's database – increases the barriers to entry. Customers pay in advance for the year, resulting in negative working capital and wonderful cash flow generation. Incremental EBITDA margins are at least 50% on a consolidated basis and 80% in the core P&C businesses. Capital spending is only 10% of cash flow and returns on capital are through the roof, with EBITDA running at 48% of assets.

The company operated as a not-for-profit for most of its life, paying little attention to new products, pricing or cost control. It converted to a for-profit in 1994 and the second stage in its demutualization occurred in October 2009 when its shareholders, the P&C insurers, sold some of their stakes in an IPO. With Verisk marked at next to zero on their balance sheets, the IPO allowed them to raise capital and cash that they very much needed, given that many of them were reeling from investment losses and depleted capital positions. By the way, only one large insurance company did not sell its stock, Berkshire Hathaway.

At the recent share price of $30.90, what do you think the market is missing?

AW: The stock is up 40% since the initial offering a year ago, so our differential view has narrowed. But we still believe the market is underestimating the company's ability to increase prices, the operating leverage in the business as it grows, and management's ability to reinvest excess cash.

We're expecting revenue growth in the 10-12% range and for free cash flow per share to increase at least 20% per year. Our free cash flow number for 2012 is ahead of the Street's, at around $2.40 per share. For a business of this quality, we think a less than 13x multiple of free cash is exceedingly cheap – 20x wouldn't at all be unreasonable.

Our valuation builds in very little for smart capital allocation, which management has done extremely well over time. They have a great M&A track record and buy stock back cheaply. This year, with-

INVESTMENT SNAPSHOT

Verisk Analytics
(Nasdaq: VRSK)

Business: Provider of actuarial and underwriting data and data-analytics services that property/casualty, healthcare and mortgage insurers use to assess risk and detect fraud.

Share Information
(@12/1/10):

Price	**30.89**
52-Week Range	26.65 – 31.75
Dividend Yield	0.0%
Market Cap	$5.32 billion

Financials (TTM):

Revenue	$1.11 billion
Operating Profit Margin	38.3%
Net Profit Margin	15.3%

Valuation Metrics
(@12/1/10):

	VRSK	Nasdaq
Trailing P/E	34.2	12.2
Forward P/E Est.	19.4	16.1

Largest Institutional Owners
(@9/30/10):

Company	% Owned
Eton Park Capital	6.6%
Neuberger Berman	6.3%
Morgan Stanley	6.1%
T. Rowe Price	4.2%
Scout Capital	3.8%

Short Interest (as of 11/15/10):

Shares Short/Float	0.8%

VRSK PRICE HISTORY

THE BOTTOM LINE

Operating "literally one of the highest-quality businesses we've seen," says Adam Weiss, the company has the potential to increase revenue at 10-12% per year and free cash flow at a 20% clip. At what he considers a not unreasonable 20x the $2.40 in free cash flow per share he's estimating for 2012, the shares would trade at $48.

Sources: Company reports, other publicly available information

out talking about it, they've bought back 7% of the stock.

Another upside option is a new product called Risk Analyzer, which brings claims data down to census blocks, which is significantly more granular than what has been provided before. Every underwriter knows that there are good neighborhoods and bad neighborhoods, and that claims rates in the bad areas are higher than in the good areas, but due to political sensitivity to red-lining you can't charge people more in the bad areas unless you have real data to justify it. This new product will provide that, which should be valuable to P&C insurers.

Verisk is now going state-by-state to get approvals for Risk Analyzer and is waiting until 75% have signed off before it launches. It's not in our numbers, but if they start selling in 2011 as expected, this could provide material upside in 2012 and beyond.

What are the biggest risks?

AW: The P&C insurance cycle hasn't been good and if that continues it wouldn't be a positive. They have produced terrific results through this soft market, however, so we see the cycle as more of headwind than a real risk.

The bigger risk is probably poor use of capital. We've spent a lot of time with the company on this issue and are positively inclined to believe they'll do the right things, but it's still a risk.

Why do you consider Coca-Cola Enterprises to be misunderstood?

AW: We initiated our position in CCE in February of this year when it announced that in return for Coca-Cola buying its North American bottling assets, CCE shareholders would get $10 per share in cash and the stub of a new security which consisted of CCE's remaining European bottling businesses in France, the U.K. and the Benelux countries. In addition, CCE agreed to purchase from Coca-Cola its bottling assets in Norway and Sweden.

The FTC approved the transaction in September and the deal officially closed on October 3rd. We received our $10 per share in cash and now own a new CCE that we believe is a higher-margin, higher-growth, less-leveraged business than it was previously, capable of increasing earnings per share at 15% per year. For that we're paying only 9x our 2012 estimate of earnings and free cash flow.

One reason for the opportunity here is that while we think highly of management, we believe they provided very conservative guidance on critical metrics for the new CCE, including its organic growth rate, corporate overhead expenses, leverage, cost of debt and tax rates. Their incentive for doing so was the fact that their existing old CCE options were being converted into new CCE options under a mechanism that was favorable to the option holder at lower stock prices, so it should have been no surprise they wanted to keep a lid on expectations.

Before going into your differential views on metrics, is bottling really that interesting of a business?

AW: U.S. investors look at the bottling business as a lousy one, where capital spending is high and Coke beats the hell out of you on price. But if you look outside of North America, bottling is a much

INVESTMENT SNAPSHOT

Coca-Cola Enterprises
(NYSE: CCE)

Business: Third-largest bottler and distributor of Coca-Cola products in the world, with operations after a recent asset swap now exclusively focused on Europe.

Share Information
(@12/1/10):

Price	**24.78**
52-Week Range	18.84 – 31.80
Dividend Yield	2.0%
Market Cap	$8.40 billion

Financials (TTM):

Revenue	$6.52 billion
Operating Profit Margin	12.8%
Net Profit Margin	9.5%

Valuation Metrics
(@12/1/10):

	CCE	S&P 500
Trailing P/E	12.8	17.1
Forward P/E Est.	12.3	13.8

Largest Institutional Owners
(@9/30/10):

Company	% Owned
Scout Capital	4.9%
FranklinTempleton	4.0%
Vanguard Group	3.6%
State Street	3.4%
Morgan Stanley	3.4%

Short Interest (as of 11/15/10):

Shares Short/Float	2.8%

CCE PRICE HISTORY

THE BOTTOM LINE

Due to incremental organic revenue growth, corporate-overhead savings, merger synergies, tax-rate savings and capital-allocation benefits, Adam Weiss believes the company will exceed Street expectations in producing free cash flow of $2.75 to $3 per share in 2012. At a peer-group multiple, the shares would then trade for $36 to $43.

Sources: Company reports, other publicly available information

better business. In Europe, for example, CCE earns more than twice the operating margins it made in North America (13% to 5%) and generates much better returns on capital (35% pre-tax, vs. 15%). A key contributor to that is that distribution is outsourced, so the business is much less capital intensive. At the same time, volume growth has been higher and more consistent in Europe, averaging 3% annually over the past ten years, compared to a 0.3% annual decline in volume in North America.

Where specifically do you see upside to expectations?

AW: We've identified several sources of upside to the Street's estimate of $2.25 per share in 2012 earnings. Summing our more conservative estimates of the impacts, we arrive at around $2.75 in 2012 EPS. With more optimistic assumptions, we get to more than $3.

I'll walk briefly through where our views differ from Street:

Historically, the new CCE has grown revenue organically at around 6% per year, but the Street is now carrying around 4.5%, the lower end of what management has been saying. Why after going through a terrible recession we're supposed to come down to 4.5% going forward is not clear, so we're comfortable assuming growth comes out as it has in the past.

Management has insisted they aren't guiding too high on corporate overhead expenses, but we just can't see how they should be as high as they're saying. The pro-forma financials show GAAP corporate overhead having risen 57% in the last three years, a period in which volume grew 26%. We imagine a lot of non-recurring stuff will come out of there.

We're expecting merger synergies from the new Norway and Sweden operations. Operating profit per serving is about 25% lower in those countries than in Western Europe and we don't see good reason they can't normalize that.

The last upside I'll mention has to do with the balance sheet. The company has announced it's going to buy back $1 billion worth of shares. It has also announced a target range of net debt to EBITDA of up to 3x. At 3x, they could issue debt in order to buy up to $2.8 billion worth of shares, which would be highly accretive to EPS expectations. If you can borrow at 2%, which they've done recently, and buy back your stock at a 10% free cash flow yield, that's an 8% arbitrage. If you do that on $1.8 billion of incremental shares, that's $144 million in incremental EBIT, or $90-95 million after taxes. Companies like this that have stable to growing earnings and can raise money cheaply have a once-in-a-generation opportunity to do this type of thing today – the relationship between stocks had bonds haven't been this out of whack for 50 years. [*Editors' note*: Dollar figures cited above assume an exchange rate of $1.39 to the euro.]

ON SENSATA'S BUSINESS:

We're skeptical about the quality of private-equity portfolio companies, but this is a pretty exceptional business.

What do you consider a more reasonable value for the shares, now trading at around $24.80?

AW: Applying a peer-group forward multiple of 13-14x our low and high estimates of 2012 EPS gets us to a $36 to $43 share price a year from now.

What risks concern you the most here?

AW: There's always a risk they'll overpay for an acquisition, or that debt-strapped countries will look to increase taxes. We don't think we are, but we could also be wrong about their maintaining historical volume and pricing growth.

The biggest issue is probably handling the currency properly. The risk if the euro collapses is too big not to essentially hedge it away, which is what we've done. We also have a European-bank credit default swap position that will help us if Europe falls apart.

What attracted your attention in Sensata Technologies [ST]?

JC: Sensata is a manufacturer of highly customized sensors and controls, used in such applications as airbags in automobiles, circuit breakers in airplanes and fuel injectors in engines. It has a 90-year operating history and was a division of Texas Instruments prior to being bought by Bain Capital in 2006. Broadly speaking, the company's growth is driven by the increased usage of its products to improve safety and fuel efficiency, as well as to control and manage environmental emissions. The automotive market accounts for about 60% of its end-market exposure.

The source of the idea was the syndicate calendar, as Bain sold a portion of its shares through an IPO in March of this year. We're generally pretty skeptical about the quality of private-equity portfolio companies, but we've concluded this is a pretty exceptional business. It benefits from a high-switching-cost moat. It has extremely low capital intensity, with capex to EBITDA of only 10%, and has very high free cash flow conversion, with every $1 in EBITDA converting into 70 cents of free cash flow after interest and capital spending.

The core of our variant view is that we believe revenue growth over our time horizon is non reverting to the mean, for three primary reasons. The first is that we expect high volume growth as content per vehicle increases 8-10% per year, driven by manufacturers increasingly incorporating Sensata's products in order to improve safety, fuel efficiency and emissions control – all of which increases a vehicle's value to the end consumer. We also see emerging markets, particularly China, as a material growth driver for the company, adding another 2-4% in annual unit growth. Finally, we have a pretty benign view of the automotive cycle, given that the rate of vehicle scrappage to production is near an all-time low. A cyclical boost from the overall auto market could add another 3-6% in annual volume growth.

So even with flat to moderately lower pricing, in a weak macroeconomic environment, we're looking at revenue growth over the next couple of years in the mid-teens.

Is there a change-in-management-incentives story here?

JC: Yes. Management owned very little stock when the business was owned by Texas Instruments. In 2006, 84% of top-executive compensation was in cash, while today the number is only 9%, with the rest stock-based. The CEO owns $50 million worth of stock and all directors and executives own 4% of the company, so they have the right incentives.

They also have an excellent track record. Most of the top players have been in place since 2001, and since then revenue has grown at a 6.5% annual rate and EBITDA at 11.3%. They've sustained returns on equity of greater than 25% and have completed two acquisitions where they paid 4-5x EBITDA after synergies. All this even with the monumental contraction in global auto sales in recent years.

INVESTMENT SNAPSHOT

Sensata Technologies
(NYSE: ST)

Business: Based in the Netherlands, develops, manufactures and sells sensors and controls used in a wide variety of industrial applications worldwide.

Share Information
(@12/1/10):

Price	**27.67**
52-Week Range	15.25 – 28.16
Dividend Yield	0.0%
Market Cap	$4.80 billion

Financials (TTM):

Revenue	$1.49 billion
Operating Profit Margin	13.6%
Net Profit Margin	5.1%

Valuation Metrics
(@12/1/10):

	ST	S&P 500
Trailing P/E	60.1	17.1
Forward P/E Est.	13.8	13.8

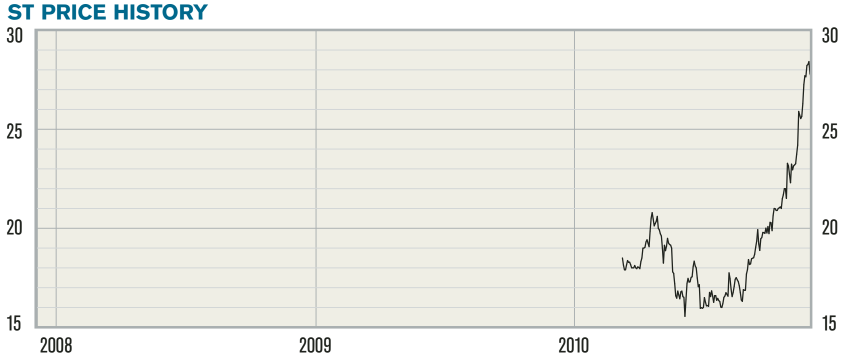
Largest Institutional Owners
(@9/30/10):

Company	% Owned
Marsico Capital	3.2%
Scout Capital	2.3%
Putnam Inv	2.2%
FranklinTempleton	1.5%
Mass Financial Services	1.3%

Short Interest (as of 11/15/10):

Shares Short/Float	3.0%

ST PRICE HISTORY



THE BOTTOM LINE

The market underestimates the company's potential for revenue growth from increased per-vehicle usage of its products, expanded emerging-market sales and a cyclical auto-industry rebound, says James Crichton. At 16x his $2.75 per share estimate of 2012 free cash flow, the shares would trade at $44, a 60% premium to today's price.

Sources: Company reports, other publicly available information

The shares have risen nicely since the IPO, to $27.70. What upside do you see today?

JC: Because of operating leverage, the 15% or so in annual revenue growth we expect converts into EBITDA growth of close to 20% and growth in free cash flow per share of 25%. Our 2012 estimate of free cash flow per share is $2.75, materially higher than the Street's, which is around $2.30.

There are no pure-play public companies in the sensors and controls space, but we believe the best public comp is Amphenol [APH], whose connector business has similar financial characteristics. With lower revenue growth, lower EBITDA margins and higher capital intensity, Amphenol trades for around 16x 2011 earnings estimates. Our feeling is that Sensata should trade for at least that multiple, which on our 2012 free cash flow number would result in a share prices of $44.

Turning to a brand-new opportunity, describe your interest in Australia's QR National [QRN:AU].

JC: This is Australia's largest rail-transport company, which the Queensland state government took public on November 22nd. It operates in three primary businesses: hauling coal, hauling non-coal freight such as iron ore and intermodal freight, and selling to third parties access to its regulated rail network.

The basic opportunity here revolves around going from a government-owned business with mostly regulated pricing and a cost structure to support high employment to a privately controlled business with market-based pricing and incentives to improve profitability and returns on capital. Management is now focused on efficiency and profitability benchmarks against Class 1 railroads in North America, a clear break from the past.

There's plenty of room for improvement. The EBITDA margin gap between QR and peers like Pacific National, the incumbent railroad in New South Wales, is about 1000 basis points.

Is the upside more from controlling costs than generating incremental revenue growth?

JC: It's both. Roughly half of the company's business is moving to market-based pricing, which is higher, but the impact is felt fairly slowly as old contracts with regulated prices roll off. Overall we're looking at 5% annual price increases in the coal business, on top of the same 6% annual growth in coal volumes that management is targeting. The wildcard on the volume side is the extent to which deregulation causes share loss in the company's home Queensland market – we're basically assuming any share losses in Queensland are offset by share gains in New South Wales, where QR can now compete.

There's also revenue upside in the regulated-network business. It's somewhat technical, but the basic reason is that in-place contracts have an overall regulated return based on an asset-appreciation model. This means that the regulated returns are based on an inflation-adjusted present value over time, such that the current revenue and margins are under-earning today but will grow meaningfully going forward to achieve the allowable regulated return. Given the recent capital deployment in this business, this dynamic will produce revenue growth and margin expansion over the next few years.

Overall, we're looking at revenue growth of about 12-13% per year.

On the cost side, we're modeling cash expense growth of 4-5% per year. That's driven by the change in management incentives to control costs and just the magnitude of the opportunity to cut back in certain areas like procurement. Plans are already in place to ensure that costs grow significantly slower than revenues, and we suspect our estimates on the cost side may prove conservative.

What potential do you see for the shares, which at A$2.75 are up roughly 8% from the IPO price?

JC: With operating leverage and cost containment, we believe the company should compound earnings per share at 40-50% through 2012, to 22 cents. (The Street is at around 17 cents.) Applying peer multiples of either 8.5x EBITDA on an enterprise value basis, or 17x earnings, you get a share price of around A$3.80.

I'd add that the company looks even cheaper relative to book value. QR's customers are mining companies like BHP and Vale, which liked that it was owned by a government that would sink inordinate amounts of capital into upgrading warehousing and the rail network. To get support for the privatization from customers, the Queensland government invested A$3.6 billion over the last three years to create a gold-plated network, with one of the youngest asset fleets in the world. The average age of locomotives and wagons is about half the North American peer group. Even with that, the equity trades at only 0.9x book value, against a global peer average of 2-2.5x.

Do you see any free options here?

JC: This isn't in our models, but we believe they can reduce capital investment through partnerships with customers and the government, which would lessen the capital intensity and increase free cash flow for the business. We're looking for the non-coal freight business to make marginal profits, but there's no reason it shouldn't have at least 10% margins over time. Longer term, there's a real possibility they can build an iron-ore franchise, for supply to China and India, that could rival the size of the current coal business.

INVESTMENT SNAPSHOT

QR National
(Australia: QRN:AU)

Business: Largest railroad freight transportation service operator in Australia. Company just went public in initial public offering of stock made on November 22nd.

Share Information
(@12/1/10, Exchange Rate: $1 = A$1.03):

Price	**A$2.75**
52-Week Range	A$2.53 – A$2.88
Dividend Yield	0.0%
Market Cap	A$6.76 billion

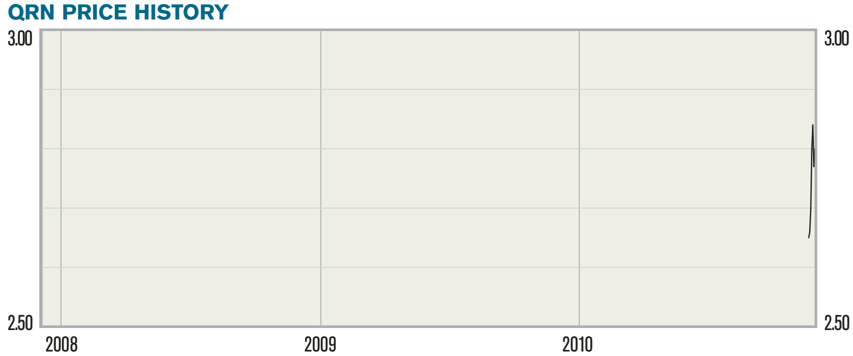
Financials (FY ending 6/30/10)

Revenue	A$2.90 billion
EBITDA Margin	21.6%
EBIT Margin	7.0%

Valuation Metrics
(Current Price vs. TTM):

	QRN	S&P 500
P/E	n/a	17.1

QRN PRICE HISTORY



THE BOTTOM LINE

In going from a business with regulated pricing and bloated costs to one with market-based pricing and incentives to improve profitability, James Crichton expects the company to earn 22 cents per share by 2012. At what he considers a reasonable multiple of forward earnings, the shares a year from now would trade at least 35% higher.

Sources: Company reports, other publicly available information

Risks?

JC: We think the nature of the business gives us pretty good visibility into share dynamics, but there could be greater share losses in Queensland and/or lower share gains in New South Wales than we're expecting.

The biggest risks are around coal, so we're hedged against an implosion of demand for basic materials through CDS and by shorting investment-grade credit in the basic-materials sector.

Do you ever take a view on the market's overall attractiveness?

AW: We mostly have nothing to say about the market overall. Given that we maintain a disciplined range of net exposure, whether we get the market right or wrong doesn't make that much difference. If our net exposure is at 40% rather than 60% and the market makes a 10% move, that's a 200-basis-point impact. That's not nothing, but it has far less impact on how we do than individual stock selection.

That said, we do believe equities today are relatively attractive. Our portfolio is full of companies with strong moats, good pricing power and strong earnings growth, which can issue debt at 2-3% yields and buy back stock at 10% free-cash-flow yields. That dynamic speaks to upside for companies that are willing and able to take advantage of that arbitrage. That clearly doesn't apply to every company, but it applies to many of our holdings.

We also consider it a great environment for special-situations investing. A key way in which the corporate world is solving its problems is by selling off divisions, restructuring, raising capital and buying assets to take advantage of competitive dislocation. That creates the type of change we're looking for – we can't remember as attractive a potential opportunity set, both in quantity and quality.

Tell us about something you've read recently that you learned from?

AW: Both James and I recently read *Groupthink*, Irving Janis' classic study of how small, cohesive groups of very smart people can make really bad decisions, such as getting deeper into Korea, the Bay of Pigs, and Vietnam. The main point is to make sure you have a culture that questions everything and vets out all the decision alternatives before zeroing in on one of them.

One of the personal insights I gained from the book is the value of playing one's cards a bit closer to the vest early in the decision-making process. I have a habit of speaking my mind all the time, but in the earlier stages of research that can set a direction that I and others may unconsciously anchor on, closing off a fuller exploration of alternatives. The last thing you want to do is shut down people's initiative. VII

Investor Insight: Morris Mark

Morris Mark of Mark Asset Management explains the component of value he considers relatively absent from stock prices today, the most important secular trends for which he's preparing, what advice Lee Cooperman always gave him about valuation, and why he sees unrecognized value in Qualcomm, Google, Host Hotels and Toll Brothers.

Ricky Sandler of Eminence Capital described your focus to be on "quality value" when he worked for you. Is that still true?

Morris Mark: If you're a serious analyst you learn to respect the fundamentals of both value and valuation. Value to me often derives from competitively strong companies in structurally attractive industries supported by secular growth. Great businesses are worth more, so I would rather own that type of company at a reasonable price than a mediocre company at a really cheap price. But I've also learned the hard way never to disregard valuation – you can easily overpay for even the best business.

In financial terms it's easy to describe a high-quality business. They generate high returns on unlevered capital and high returns on equity on an after-tax basis. They produce free cash flow or have attractive enough reinvestment opportunities to invest cash flow at high returns. Beyond that we're particularly focused on how well management has created value in the past and on handicapping how likely they are to create it in the future.

Coca-Cola [KO] is a classic excellent business, which we've owned off and on for some time. We own it now in large part because it's again run by a great businessman, Muhtar Kent. His emphasis is on product quality, on diversifying the product portfolio and on reinvesting cash flow in markets with almost open-ended growth potential. When performance has drifted in the past, it's ironically been when there's been an overly financial focus.

What makes quality businesses cheap enough?

MM: It's often because an important secular trend or structural industry change is not being appreciated by the market. We then look for individual companies that are best positioned to benefit from the trend. For example, the combination of tighter commercial real estate lending standards and risk-aversion toward new development means the rate of new hotel supply growth is likely to be very low for some time – especially in higher-end facilities in attractive urban locations. That says to me that the future profitability of existing assets fitting that description may be a heck of a lot higher than most people expect. That then leads us to a company like Host Hotels [HST], which we'll speak more about later, which is ideally suited to capitalize on that.

Another example: Because we believe higher inflation is likely, and because we also expect emerging markets to continue to generate increased demand for a wide variety of global goods, we're quite interested today in energy. Excess liquidity manifests itself most strongly in areas that have not increased production capacity prior to the onset of inflation, which has certainly been the case in the oil business, which hasn't expanded capacity to any important degree in the last ten years.

Devon Energy [DVN] is a representative example of how we hope to take advantage of that. We believe it's well-managed, well-financed and has more oil exposure than it's given credit for. We also like that nearly all its assets are in the U.S. and Canada at a time when relative political stability and security is likely to become increasingly important.

To what extent do you find the overall macroeconomic environment creating opportunities?

MM: There's no question that what's happened over the last ten years to equity markets and the financial system has taught people to be risk-averse. That has resulted in a lot of great businesses being

Morris Mark

Pedigree

In any highly productive investment career spanning more than 40 years, one could expect to cross paths with a leading industry light from time to time. In Morris Mark's case, such interactions have been both frequent and consequential. A recommendation from Loews Corp. founder Larry Tisch helped Mark land his first analyst position at First Manhattan, where he worked under company founder and Warren Buffett confidant Sandy Gottesman. In 10 years at Goldman Sachs he worked directly for both Lee Cooperman, now of Omega Advisors, and the firm's then risk-arbitrage chief, Robert Rubin. "I have been fortunate to have the right people to learn from," says Mark.

He's also done a fair amount of teaching. Mark Asset Management alumni include hedge fund stars Ricky Sandler of Eminence Capital and Cobalt Capital's Wayne Cooperman. Says Cooperman of his time under Mark's tutelage: "Morris would beat you up to make sure you understood everything about the quality of a company's business and whether it had a competitive advantage. You learned to never stop asking questions until you figured something out. That's a pretty good discipline to learn early on as an investor."

valued very conservatively, in many cases at half the multiple at which such companies might have historically traded. At a time when near-term concerns about the overall economy are high, the value from future growth reflected in stock prices can be quite low. So if you believe the recovery is real – even if it's long and drawn out – there are attractive values out there.

That dynamic can allow you to buy a company like Coca-Cola at a market multiple. You can buy Google [GOOG], which can grow earnings at least 20% annually, at a free cash flow yield of 6%. We don't own it right now, but you can buy JPMorgan Chase [JPM], the best-managed bank in the industry, at a very low multiple to tangible book value.

We're curious if the recent sell-off of Cisco [CSCO] attracted your attention.

MM: We actually sold our Cisco earlier this year. We owned it because the company would appear to be a prime beneficiary of the structural trend toward recentralizing information processing technology – the more information moving through the "cloud," the more and better routers and switches necessary to help manage it. We sold out of increasing concern, the company's rhetoric notwithstanding, that it was losing share in some of its core businesses. New best-of-breed technologies that companies at the margin were adopting to facilitate the cloud were coming from companies like F5 Networks or Riverbed Technology. We're not saying Cisco won't benefit from the cloud, or that after the recent pullback the valuation isn't interesting, but if the cloud evolves such that companies have more ability to mix and match technology to run it, that won't be as much of a slam dunk for Cisco as we originally thought. In this environment, we thought we had better opportunities elsewhere.

What's your time horizon when investing in "quality value" companies?

MM: If you listen to earnings conference calls, most of the questions are about what happened this quarter or what next quarter looks like. That focus would indicate that near-term issues are generally extremely well understood, so there isn't that much value in our trying to figure that out. But if you really understand how a company's business model works, how its industry is structured, the underlying trends impacting the industry, and where management is taking the company, there's a bit more opportunity to add value. That doesn't mean we own everything for a long time, but we analyze and value it with a multi-year horizon.

That's obviously a dynamic process. We started buying Apple [AAPL] in 2006 – our average cost is $61 – and we still own a full position. The stock has done extremely well [it closed recently at $318], but look at the business over that time. It has dramatically broadened its product portfolio. It has expanded and deepened its geographic footprint. It has built its brand profile through being the best retailer in the country in terms of sales per square foot. It has developed core software-based products and services that inure to the benefit of its mobile products to the exclusion of others. Management continues to demonstrate that it understands how to apply technology in ways that resonate with consumers, and there are potentially new product categories to come, say an iTV.

Had we not continuously updated our view on the prospects of the business, we would have long ago taken our profits and moved on. Today the most important question for Apple, which is weighing on its valuation, is the sustainability of its profit margins. Our view is more positive than the market's, but that's the key metric to keep an eye on.

You tend to outperform in good markets and underperform in bad, the opposite of many investors we interview. Why is that?

MM: Is that somewhat endemic to how I've done things? Definitely. There has generally been an underlying assumption in my mind that the market goes up two-thirds of the time – if it backed off, it came back, so you could be an investor focused on identifying long-term value and not try to time things too much. When that's the case, if you're successful in finding great companies, you'll do really well in good years when valuations increase along with earnings. But unless the beta of your stocks is less than one, which is rarely the case with the best growth companies, you'll underperform when the market goes down.

The latest bear market was particularly difficult, as people panicked by systemic risk turned to the best companies for liquidity. Apple went from $250 to $80 even though its earnings didn't really crack at all. I'm always trying to learn and get better and I hate to underperform in any type of market, but remaining disciplined and riding through the downturns with excellent companies has proven to work for me over time.

You've written about selling Visa [V], which you called an "inherently terrific business," earlier this year. Why?

MM: I didn't expect to sell Visa for years, but when Sen. Durbin filed his bill to clamp down on merchant fees there was just too much uncertainty about what the rules were going to be. I can tell you what I believe they should be, but one thing I've learned is that just because I think something should happen doesn't mean it will, which is particularly true in handicapping the political arena. We're watching the situation very closely and expect it to be resolved within the next six to 12 months. I'm looking forward to the time when I'm comfortable enough to buy the stock back.

How generally do you look at valuation?

MM: We do the same discounted cash flow analysis everyone does, but the most important variable – and the one that most impacts the "answer" – is the growth rate you assume for the business. Lee Cooperman always used to say that if you got that right, you were 90% there. I've always considered that to be true.

Describe your specific investment thesis today for Qualcomm [QCOM].

MM: This company is at the fulcrum of mobile computing, which is clearly one of the most interesting growth businesses out there. Roughly two-thirds of its profits come from an almost impenetrable wall of intellectual property that mostly covers CDMA, WCDMA and LTE technologies, the standards in third and fourth generation wireless technology. Virtually all of the major makers of wireless handsets and mobile computing devices license Qualcomm technology, paying a royalty on the purchase price of each device sold.

The other one-third of profits comes from the sale of semiconductors used in mobile devices to connect to networks and also from chips that essentially serve as the central processing units of these devices. The latter are called application processors and Qualcomm's version, for example, is now in every Android smartphone made by one of the biggest manufacturers, HTC.

Give some perspective on where wireless technology is around the world, generation-wise, and how quickly that changes.

MM: All three next-generation "3G" networks that are being adopted to provide faster data-transfer times use CDMA technology, and those are just being rolled out in emerging markets like China and India. Elsewhere, we're just at the beginnings of installing 4G networks, on which we believe Qualcomm has comparable intellectual property to 3G. These cycles take more than ten years, so we expect the runway for the company to be quite long.

One often-cited risk is that declining handset prices will erode Qualcomm's licensing revenue stream. Is that still a headwind?

MM: With the dramatic and ongoing shift to smartphones, we believe handset pricing is no longer a negative. Standard handset prices will likely continue to come down, but that should be offset by the increasing share of smartphones sold, to the point where we expect average device prices to be at least flat for a long time. That means Qualcomm should fully benefit from the number of devices sold, which is rising at almost a geometric rate.

For a connoisseur of quality businesses, how would you rate the chip business?

MM: It's clearly competitive, but chips overall have been a profitable, high-rate-of-return business for them. They keep capital costs down by outsourcing fabrication, and we believe that as the traditional communications chips in handsets become more advanced to work with third and fourth generation technology, that works to Qualcomm's advantage. They have the financial strength, technological know-how and scale to produce more efficiently and effectively, which we think should enhance their competitive advantage over time.

People have assumed the revenue growth for the chip business would at best match the growth on the IP side. We think there's every reason to believe the growth will be better. One key driver could be the Snap Dragon application processor line I mentioned earlier. Handset makers who choose it for their smartphones or tablet computers will be that much more likely to also use Qualcomm's baseband chips, on the

INVESTMENT SNAPSHOT

Qualcomm
(Nasdaq: QCOM)

Business: Provider of semiconductors used in mobile phones and owner of wireless intellectual property that it licenses to handset and device makers worldwide.

Share Information
(@12/1/10):

Price	**47.89**
52-Week Range	31.63 – 49.80
Dividend Yield	1.6%
Market Cap	$77.47 billion

Financials (TTM):

Revenue	$10.99 billion
Operating Profit Margin	29.9%
Net Profit Margin	29.5%

Valuation Metrics
(@12/1/10):

	QCOM	Nasdaq
Trailing P/E	24.5	12.2
Forward P/E Est.	17.2	16.1

Largest Institutional Owners
(@9/30/10):

Company	% Owned
Fidelity Mgmt & Research	3.9%
Vanguard Group	3.7%
State Street	3.4%
T. Rowe Price	3.4%
Capital Research	3.3%

Short Interest (as of 11/15/10):

Shares Short/Float	1.9%

QCOM PRICE HISTORY

THE BOTTOM LINE

The dramatic and ongoing shift to smartphones plays in many ways to the company's intellectual-property and chip-manufacturing strengths, says Morris Mark. If earnings grow at the 15-20% annual rate he expects, the 11x multiple of 2012 EPS at which the shares trade (after net cash) will prove "undemanding, to say the least," he says.

Sources: Company reports, other publicly available information

expectation that they're going to work better together.

How do you see this all translating into share upside from today's $47.90?

MM: Prior to 2008's paralysis to the system, the company's revenues were growing 20-25% per year. Now management is being conservative in its guidance, saying that 12-15% is more reasonable, which we expect will turn out to be understated.

Earnings estimates for the current fiscal year (ending next September) are around $2.80 per share, with maybe 10% growth the following year to $3.05 to $3.10. Our view is that the company over the next five years can grow its bottom line by 15-20% per year. After taking out $11 per share in net cash, the shares trade today for only about 11x the $3.30 or so we expect the company to earn in fiscal 2012. If we're right, that's an undemanding multiple to say the least.

By the way, this ascribes no value to other product lines the company has under development, such as platforms for mobile banking or for display technologies that could save significantly on a phone's power consumption. We don't need any of that to pay off for this to work as an investment, but they are nice free options to have.

Are you seeing similar unrecognized growth potential in Google [GOOG]?

MM: Our positive view on Google has two very basic components. The first is that its core business in developed markets still has considerable growth potential. The targeted promotional real estate it delivers, typically focused on driving measurable, immediate transactions, makes the company more of a marketing partner to customers than has ever been the case with traditional media. For that reason, we believe the shift in marketing and advertising dollars to Google – and Internet companies overall – still has a long ways to go.

The second element of growth is the company's strong position in a number of important emerging economies such as Brazil, India, Indonesia and Singapore. We also believe it has maintained the opportunity, despite some difficulty, to profitably participate in China's economic growth. In these countries it's not just Google's slice that is growing, but also the overall pie.

With 90% of revenue still coming from paid search, you're not concerned they're too much of a one-trick pony?

MM: Not when it's this good of a trick. But we also believe at least some of the new businesses in which they're investing will pay off. The company was criticized for buying YouTube in 2006 for $1.65 billion in stock, but it's now one of the top five most-visited sites on the Web and we believe is reaching critical scale and will be a significant moneymaker in a broadband video world. Android is not yet an obvious direct revenue generator, but it provides a platform that helps insure that Google's search technology is as relevant in the mobile world as it is in the desktop world. Some of what they're doing doesn't make sense – investing in wind farms, for example – but we like some of the free growth options they have outside of paid search.

INVESTMENT SNAPSHOT

Google
(Nasdaq: GOOG)

Business: Provider of world's most-utilized Internet search engine, generating most of its revenue from targeted advertising displayed next to search results.

Share Information (@12/1/10):

Price	**564.35**
52-Week Range	433.63 – 629.51
Dividend Yield	0.0%
Market Cap	$180.47 billion

Financials (TTM):

Revenue	$27.55 billion
Operating Profit Margin	35.9%
Net Profit Margin	28.8%

Valuation Metrics (@12/1/10):

	GOOG	Nasdaq
Trailing P/E	22.9	12.2
Forward P/E Est.	16.9	16.1

Largest Institutional Owners (@9/30/10):

Company	% Owned
Fidelity Mgmt & Research	6.2%
Capital Research	5.1%
T. Rowe Price	4.0%
Vanguard Group	3.7%
State Street	3.4%

Short Interest (as of 11/15/10):

Shares Short/Float	1.9%

GOOG PRICE HISTORY

THE BOTTOM LINE

As its slice of the advertising and marketing pie grows in both developed and emerging markets, the company should be able to increase earnings at 20% per year, says Morris Mark. Even if what he considers an unjustifiably low multiple of 17x estimated 2011 earnings doesn't budge, "we'll have an excellent rate of return" on the stock, he says.

Sources: Company reports, other publicly available information

The lifecycle of dominant Internet companies – for example, AOL – has proven relatively short. What gives you confidence Google can avoid the same fate?

MM: I made the point earlier with Coca-Cola about the danger of having management that knows the business side cold but doesn't understand the product and its relationship to consumers. The best managers bring both skill sets to the table, which I believe is the case at Google with Sergey Brin, Larry Page and Eric Schmidt. The company needs to continue to innovate as well as execute to avoid irrelevance – our bet that it's able to do that rests in large part on the quality of its top executives.

I'd also add that the biggest looming competitor for Google now appears to be Facebook. I don't think I need to take a position on who wins that battle because the businesses are different enough, and the opportunity big enough, that there's room in the market for both to prosper.

With the shares around $564, how are you looking at valuation?

MM: From increased organic growth in paid search, international search growth, overall economic growth and inflation, we expect revenues to grow 15-20% per year for a significant period of time. Assuming they don't blow it on things like renewable energy, bottom-line growth should be even better.

Using analysts' estimates of $32-33 in EPS for 2011, you're paying 17x earnings for a company that probably will grow close to 20% per annum. Paying one times the growth rate used to be very low for an extremely high-quality business. There's also optionality beyond that from increasing share in display advertising, mobile apps and advertising, and the $50 per share and counting in cash on the balance sheet, some of which they're likely to use one day to pay a dividend.

It makes no sense to us that Google trades at an earnings multiple no greater than those on other high-quality consumer and industrial companies, while it's growing two to three times faster. But even if the multiple doesn't change and it performs as we believe it can, we'll have an excellent rate of return.

Describe the upside you see for Host Hotels, a company you mentioned earlier.

MM: This is a real estate investment trust that owns approximately 110 of what I would call A or A+ hotels, mostly hard-to-replicate properties in U.S. major cities or next to large airports. Most of the hotels are managed by Marriott and Starwood, and examples of the type of property they own are the Marriott Marquis in Times Square, The Ritz-Carlton in San Francisco and the Hyatt Regency in Maui. There are other hotel REITs out there, but to my knowledge none of them have the overall class of assets that Host does.

What's good about that, as I mentioned, is that in a better environment the barriers to entry around these types of properties is going to result in much more pricing power. At the same time, we expect management to continue to make acquisitions if the numbers make sense – they've spent around $480 million so far in 2010 to acquire four hotels – which should further improve long-term earnings power.

INVESTMENT SNAPSHOT

Host Hotels
(NYSE: HST)

Business: REIT which owns approximately 110 mostly upscale or luxury hotels in urban and airport areas. Most properties are managed by either Marriott or Starwood.

Share Information
(@12/1/10):

Price	**16.65**
52-Week Range	10.20 – 17.09
Dividend Yield	0.2%
Market Cap	$11.09 billion

Financials (TTM):

Revenue	$4.25 billion
Operating Profit Margin	3.9%
Net Profit Margin	(-4.6%)

Valuation Metrics
(@12/1/10):

	HST	S&P 500
Trailing P/E	n/a	17.1
Forward P/E Est.	17.7	13.8

Largest Institutional Owners
(@9/30/10):

Company	% Owned
Vanguard Group	9.7%
APG Asset Mgmt	5.0%
State Street	4.8%
Morgan Stanley	4.0%
Cohen & Steers	3.3%

Short Interest (as of 11/15/10):

Shares Short/Float	6.8%

HST PRICE HISTORY

THE BOTTOM LINE

Driven by well-timed acquisitions and pricing power at its unique properties, Morris Mark believes the company in a recovery will meet or exceed its pre-crisis earnings levels. If he's right, he expects the dividend yield on today's share price to be around 8%, and for the stock to reach his overall property-replacement-cost estimate of $25.

Sources: Company reports, other publicly available information

Does the balance sheet support that?

MM: After the acquisitions made to date, the company still has $650-700 million in cash on the balance sheet, so they have the flexibility to act if opportunities arise. A few years ago many hotel REITs were buying everything in sight, but Host between 2006 and 2008 sold $1.2 billion worth of properties that didn't fit its criteria for quality and uniqueness. They poured a lot of that into renovations across the portfolio, but still came through the crisis with one of the least leveraged balance sheets in the business. We consider all that a real credit to management's capital-allocation skills.

Occupancy and room rates have improved a bit but are still way below pre-crisis levels. Are you counting on profitability to get back to where it was?

MM: The company's funds from operations [FFO], which we estimate will be around $1 per share in 2011, has historically been $2 to $2.50 per share. I believe it can get back to that, and eventually go beyond with better pricing. Getting the FFO back to historical levels would result in their paying a dividend of $1.25 to $1.50 per share, which on the current share price is a yield of around 8%.

How are you valuing the shares, now trading at $16.65?

MM: We come at it a few different ways, but with normalized earnings we believe the stock is worth at least our estimate of the reproduction cost of all their properties, which is around $25 per share.

One added issue here is the potential attractiveness of this type of real estate portfolio to large capital pools from outside the U.S. If you look at individuals who have made a lot of money in places like India, China, Russia, Singapore or Switzerland, it's almost natural for them to put some of that money to work buying an apartment with a first-class address in New York, London, Paris or San Francisco. The same dynamic is true when it comes to premium commercial property. In a world we're likely to be in, particularly as inflation pressures mount, real property should hold value quite well. If I were running a sovereign wealth fund, for example, a company like Host at a point before it starts to show the earnings power it can generate would strike me as particularly interesting.

Moving to an even more challenged industry, explain your interest in homebuilder Toll Brothers [TOL].

MM: I'll start first with the environment, which has been the worst for housing since the Great Depression. The fall off in new home construction has battered all homebuilders, who have responded by dramatically retrenching, writing down assets and delevering their balance sheets. Their stated book values are now about as hard as they can be. They've gotten tax relief, so that tax loss carryforwards can be used over five years rather than two.

The big question then is whether we're bottoming out with housing starts in the current 500,000 to 600,000 annual range. Vacancies are clearly too high, with some 10% of the 120 million or so household units in the country currently unoccupied. We believe as that continues to be worked off, pent-up demand will

INVESTMENT SNAPSHOT

Toll Brothers
(NYSE: TOL)

Business: U.S. homebuilder focused primarily on high-end construction across a broad range of home types and geographies, with operations in 20 different states.

Share Information
(@12/1/10):

Price	**18.46**
52-Week Range	15.57 – 23.67
Dividend Yield	0.0%
Market Cap	$3.06 billion

Financials (TTM):

Revenue	$1.58 billion
Operating Profit Margin	(-3.3%)
Net Profit Margin	(-10.5%)

Valuation Metrics
(@12/1/10):

	TOL	S&P 500
Trailing P/E	n/a	17.1
Forward P/E Est.	123.1	13.8

Largest Institutional Owners
(@9/30/10):

Company	% Owned
Fidelity Mgmt & Research	15.0%
Wellington Mgmt	4.7%
FranklinTempleton	3.2%
KeyBank	3.2%
Vanguard Group	3.1%

Short Interest (as of 11/15/10):

Shares Short/Float	11.4%

TOL PRICE HISTORY

THE BOTTOM LINE

Morris Mark believes the housing cycle is at or near its bottom and that the company's balance sheet and diverse, higher-end product portfolio ideally position it to benefit as market conditions improve. At 11-12x what he considers normalized earnings power of $3-3.50 per share, the stock would trade for roughly double today's price.

Sources: Company reports, other publicly available information

start to exert upward pressure on starts. With no income growth and no population growth, we'd expect to see maybe 300,000 starts just due to natural disasters and physical obsolescence. When we assume income and population growth and some basic level of natural demand for new homes, we get beyond the current level of housing starts fairly quickly.

With that as a premise, we focus on a company like Toll for a few key reasons. One is that they've financially structured their business for the long haul – net debt to total book value is about 20% – which allows them to ride out the difficult times and even capitalize on them. They believe it now makes sense to buy land, for example, which they've started doing.

We also like Toll's market position, with a focus on upper-income consumers who prefer newly built units and the more customized floor plans and higher-end fixtures that translate into better profits for the homebuilder. The company also has a more diverse product portfolio. Most builders focus on the first-time and move-up buyer of a single-family home outside a city center, while Toll targets urban, suburban and even resort areas with townhomes, condos and traditional stand-alone houses. That diversity should serve them well as the market recovers.

The market certainly seems unconvinced, with the shares, now at $18.50, having gone nowhere over the past two years.

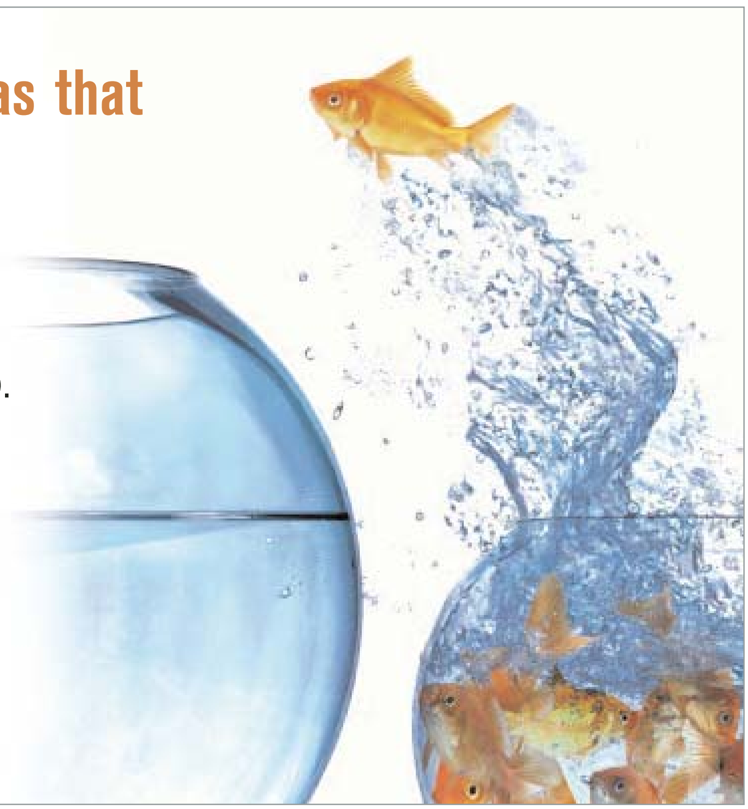
MM: It's a cyclical business and the cycle has been terrible. We're not at all expecting earnings to get back to 2005-2006 levels any time soon, but we do believe the company in an environment with clear improvement in housing starts and in housing prices can earn $3-$3.50 per share. Put an 11-12x multiple on that and you've got a share price that's roughly double the current level.

We don't claim great insight into how long that could take, but the IRR isn't terrible even if it takes five or six years. I've followed this business for a long time and if you're right about buying close to the bottom of the cycle, you're likely to come out just fine.

How has the investment business changed the most since you started out more than 40 years ago?

MM: One big way is the number and caliber of the people in the business, which makes it harder than ever to assume you've seen something that few others have. At the same time, because of digital technology, information flows much faster and in greater volume. That doesn't mean the information is better – misinformation travels faster too – but there's more to digest and synthesize.

Even with all that, the market still offers up plenty of opportunity if you have an informed, long-term outlook on a business. As long as that remains true, I can't imagine doing anything more dynamic or fulfilling. VII



World of Trouble

"People who've known me for more than the past couple of years can attest that I can be a very optimistic person," says Hayman Advisors' Kyle Bass. When it comes to global economic prospects, such is not the case today.

INVESTOR INSIGHT

Kyle Bass
Hayman Advisors

On opportunity: ""If you're worried about the types of things we're worried about, you're not going to want to be aggressive in equities."

Editors' Note: *Few investors distinguished themselves better during the financial crisis than Kyle Bass. Within six months of its February 2006 launch, he had positioned his "global-macro" Hayman Capital Master Fund to profit handsomely from the subprime credit debacle he saw on the horizon. This and other deft portfolio moves have resulted in remarkable returns for his investors over a period in which the market has been no better than flat. We spoke with Bass recently about how he's positioning his portfolio against still-formidable global macroeconomic risks, why he financed his mortgage in Yen, and the "Carnegie moment for creating generational wealth" that he expects to come.*

You made your name by being early to short subprime mortgage credit. Was that the motivation for starting your own firm in early 2006?

Kyle Bass: The strategy from day one was to have a global event-driven fund. Regardless of asset class and regardless of geography, we're looking at the assumptions driving asset prices and the extent to which we agree with those assumptions. If there's a big divergence between our belief and the market's belief, that warrants additional investigation and we're more likely to uncover opportunity.

Early on we were finding long opportunities in emerging markets, from South American coal to deep-value situations with catalysts in Hong Kong. At the same time we were short financials and mortgage credit in the U.S. Our mortgage-credit work ended up taking an increasing amount of our time and focus, and thank goodness it did. We didn't set out for it to be a focus, it became one naturally.

What tends to cause the pricing inefficiencies at a macro level on which you try to capitalize?

KB: It often comes down to psychology. Something that's been a pro-cyclical thought for 5, 10, 20 or 30 years becomes a structural belief that people expect to persist *ad infinitum*. No one believed housing prices would come down, and the argument became in many ways that it couldn't happen, because if it did the mortgage-credit market was exposed, the bond insurers would go broke and the banking system might collapse. When that type of thinking gets built in, pricing anomalies happen.

Another example today is Japan. It doesn't forward anyone's self interest for Japan to have to restructure its debt, and the consequences for the Japanese economy, Japanese interest rates and the value of the Yen are so enormous that no one wants to believe it can possibly happen. That not wanting to believe – in the face of evidence to the contrary – causes assets to be mispriced.

You called on global-macro managers for years as an institutional salesperson prior to becoming one yourself. What do you think it takes to be good at it?

KB: In roughly equal measures I'd say it takes humility and an intense desire to learn. What other business is as intellectually stimulating as this? Other than maybe intelligence gathering for national security, I don't know of one. If you like winning, there's a scorecard. If you like game theory and trying to logically deduce what's likely to happen, this is a great application for that and it's very gratifying to be proven correct.

"Humility" isn't the first adjective that comes to mind for hedge-fund managers. Why do you consider that so important?

KB: You obviously need to develop strong opinions and to have the conviction to stick with them when you believe you're right, even when everybody else may think you're an idiot. But where I've seen ego get in the way is by not always being open to question and to input that could change your mind. If you can't ever admit you're wrong, you're more likely to hang on to your losers and sell your winners, which is not a recipe for success.

When has humility served you well?

KB: We were in front of a lot of people in positioning ourselves to profit from sovereign-debt problems in European countries that had run out of foreign currency reserves, were no longer able to borrow at reasonable rates, and were for all intents and purposes broke. In April of 2009 Timothy Geithner went to the G-20 meeting in London and magically came up with a $1 trillion credit facility to save the world, which immediately hurt the positions we had aggregated.

We'd done the work on sovereign balance sheets and still absolutely believed we were going to be right, but the G-20 meeting pushed the events out much further into the future. I reduced our relevant positions by 75% as fast as I could –

we ended up losing 10% on those, but if I hadn't acted quickly we would have lost 40%. We were wrong on the timing and didn't let our ego keep us from reacting.

Your overlay bet on financial dislocation in the European "periphery" – certainly supported by recent events – is back on. Describe what you expect to happen.

KB: If people looked at sovereign balance sheets the way value investors look at company balance sheets – as we've done – the enormity of the debt problem in several European and Eastern European countries becomes clear. We expect to see serial defaults on sovereign debt, as countries hit their Keynesian end-point, in which they're no longer able to postpone their fiscal and economic problems with more debt and more cross-guarantees from desperate central bankers. They will literally see their debt service exceed government revenues and they will have no choice but to default and restructure.

It's too late to get religion. Iceland – which let loans in its banking system grow to more than 10x the size of its GDP – has cut spending by around 10% this year, but government revenue will be down probably 15%. The net result is its fiscal deficit will go up 40%. Many countries are in a similar situation and don't have a way out. When their balance-sheet debts are 100% or more of GDP, they can't inflate their way out of trouble – though they will certainly try – because the debt service grows faster than the income. They've check-mated themselves, and the only way out is default.

We're still in the midst of what economists refer to as the "golden period," when the long-term effects of deficit spending and money printing haven't really been felt. This period typically lasts 12 to 18 months before trouble hits. We expect to see defaults as early as six months from now.

You've argued that Japan is then next. Is that still your view?

KB: My view is that it's a question of when, not if, Japan defaults. The dynamic is similar to what we'll see in Europe – I just don't see how Japan can fund itself for more than a couple of years.

It's already reached the point where Japanese central government tax revenues are less than its debt service and social security obligations alone. The government has stayed liquid to date by funding its deficits with sales of Japanese government bonds to its own citizens at less than the rates it would be obligated to pay on international capital markets.

ON GOLD:

If the developed world all of the sudden decided fiscal austerity was the way forward, we might consider selling.

But as the debt requirements weigh ever more heavily on a no-growth economy, that model becomes unsustainable. Before long, domestic demand for government bonds will fall off, putting significant upward pressure on interest rates. The government can allow rates to rise, which they probably know they can't afford to pay, or they can increase quantitative easing to try to keep rates low. We believe the net result, even prior to a formal default, will be higher interest rates and a weaker Yen. We've positioned our portfolio accordingly.

Describe how you've positioned your portfolio overall.

KB: Given our thesis of impending inflation and competition for sovereign capital as world governments run huge fiscal deficits – and sell debt to finance them – we're investing cautiously in credit. Our longs are primarily in mortgage securities, bank loans and a broad range of corporate debt, including distressed and high-yield. The average duration is very short – one to one and a half years – and almost every position we have is event-driven, meaning we expect to be refinanced out or for some event to result in a valuation upgrade. We're not allocating money to fixed income and looking for a carry.

We're mostly using credit default swaps to be short sovereign debt of the countries we consider most vulnerable. We also have significant cross-currency positions, in many cases the short side of which is the Yen and the long side is in what we consider stronger currencies. The list is pretty short – Norway, Canada, Australia and Brazil – but there are a few countries out there doing more right than wrong.

Our bet against Japanese government bonds is fairly complex, but if interest rates there rise off the bottom, we're well-positioned to benefit. At a time when the bond we think is one of riskiest assets in the world is priced using the Black-Scholes model as high as it's ever been, we have this huge convex moment when you can put enormous positions on in Japanese interest rates very cheaply. That position has cost us several hundred basis points so far this year, but nothing has changed in our thesis.

We're 10% long gold, a position we initiated when the price was in the $800s, and I don't think we will ever sell it. I guess if all of the sudden the developed world decided fiscal austerity was the only way forward, we might consider selling our gold. That will happen on the 12th of Never.

What about equities?

KB: We're 20-25% net long, which includes some risk-arbitrage positions we expect to roll off this year and other short-duration special situations we think will be agnostic to market direction. If you're worried about the types of things we're worried about, you're not going to want to be aggressive in equities. The consequences of us being right in our European and Japanese positions would be very detrimental to stocks.

How does that play out?

KB: Global GDP is expected to grow by roughly 4% a year. If we have sovereign defaults in Europe and Japan, we believe the response on the part of businesses, consumers and markets worldwide is likely to cause global GDP to decline somewhat. Think about the enormity of a move between plus 4% growth, say, and minus 2%, and how that gets modeled into all asset prices. The world sets asset prices off of "risk-free" rates – think about the change in the ideological positioning of market participants when previously assumed risk-free rates don't turn out to be free of risk.

Once these restructurings start to happen, there will be enormous cross-border capital flows as money moves toward perceived safety. The reason our portfolio today is so hedged, liquid, and short in duration is that we want the flexibility to respond to that. It will feel like the wrong time to invest, but it will be the absolute right time to invest in countries like Greece, Ireland, Iceland, Latvia, Hungary and Japan that are forced to restructure. Currencies will overshoot to the downside. Interest rates will overshoot to the upside. That's when we need to be prepared to go all in.

You've barely mentioned the U.S. What's your prognosis here?

KB: Our focus on the problems in Europe and Japan is no endorsement of U.S. policy or its fiscal solvency, but reflects our belief that the U.S. has a bit more running room before the day of reckoning. Our turn will come though.

The silver lining in all this may be that it provides the crisis necessary to move the fiscal and monetary ideology of the Federal Reserve and of Congress. We don't seem to have learned any lessons from the latest crisis. Congress, for example, seems to believe we're out of the woods and we just need to put a bid under assets, get things growing again, and everything will be fine.

The right thing to do, of course, is the hardest thing, which is to dramatically cut government spending, reduce the deficit, and allow the U.S. economy to delever. That means GDP is likely to drop and the unemployment rate will be higher for a while. Washington, where elected officials are on this hamster wheel of electoral cycles and refuse to face reality, keeps papering over the problem. Unfortunately, that's only going to come back to haunt us.

Every time I go to Washington, I leave demoralized. Maybe crisis elsewhere forces us to change, but there's very little reason at the moment to be optimistic.

You assembled an impressive group of investors for your Barefoot Economic Summit recently in Texas. Were any of your core ideas challenged?

KB: This is the second year I've done the summit and I find it to be very productive time spent with as many smart people as I can assemble, without phones going off or planes to catch.

In general, while there was no consensus on timing, there was collective agreement that the sovereign stresses around the world would continue and manifest themselves over the next several years. One challenge to my thinking was that this golden period we've been in – before the effects of deficit spending and money printing come to a head – could last longer than I expect. I agree that's possible, but I'm not going to significantly change my portfolio positioning to try to get at that last possible 10% increase in the Dow.

Is it true you financed your house in Yen?

KB: Yes. It took four or five months to set up, but J.P. Morgan's private bank agreed to work on it with me. The mortgage is denominated in Yen – for five years, interest-only – with an effective rate of 2.65%. I got a great rate and if I'm right about the Japanese situation, I'll be paying the loan off in a much cheaper currency. I expect it to pay off nicely, but I did it mostly for the principle of it and to have a little fun.

Is it tough carrying around the negative outlook you've had for the past few years?

KB: People who've known me for more than the past couple of years can attest that I can be a very optimistic person. But as a fiduciary, my job is to assimilate hundreds of social, political, economic and company-specific inputs in order to craft an investment strategy that, first, protects capital and second, earns good risk-based returns on it. The best way I see to do that today happens to involve preparing for some unpleasant things to happen. VII

Lost in the Shuffle

The market can find it very difficult to give a company justly deserved credit for doing the right things when the secular trends in its business are dismal. Case in point: title-insurer First American Financial.

While most U.S. industries are showing modest signs of life, the same cannot be said for housing. Housing starts and new-home sales remain at generational lows. Existing-home sale closings fell again in October, as did average housing prices. Mortgage foreclosures and delinquencies remain at shockingly high levels – if the paperwork from mortgage lenders can even be believed. As an economist for research firm IHS Global Insight recently told *The Wall Street Journal*: "The housing market is stuck at the bottom, and we've been stuck there for months."

Amid the wreckage, Daruma Asset Management's Mariko Gordon (*VII*, December 30, 2009) believes she's found potential treasure in First American Financial [FAF]. The company was formed following the split in June of First American Corp. into two pieces, First American Financial and CoreLogic [CLGX]. FAF generates around $4 billion in annual revenue, almost exclusively from the sale of residential and commercial title insurance, where it is the industry's second-largest player behind publicly held Fidelity National Financial.

The investment case for FAF revolves around the top-to-bottom overhaul of the company that has been largely obscured by the dismal housing environment, says Gordon. The company has taken out roughly $1 billion in operating costs since 2007, through such efforts as consolidating offices, centralizing administration, standardizing systems and moving work offshore. Management has been given new incentive compensation plans, focused on margins and returns on equity. "No one wants to hear about a title insurer in this market," says Gordon, "but coming out of this, the company's earnings power is going to be much higher than people expect."

How much higher? If U.S. mortgage originations don't move from this year's level of roughly $1.2 trillion – for both new loans and refinancings, and less than 50% of 2006's volume – she expects by 2012 for FAF's operating margins to double from this year's expected level, to 8-10%. That would result in a doubling of earnings as well, to at least $2 per share.

At FAF's current market price of $14.90, such upside appears lost on the market, says Daruma analyst Mort Simpson. Adjusting the current market value and the $18-per-share GAAP book value for $1.50 per share in cash and CoreLogic stock on the balance sheet, $1 per share in value for FAF's specialty-insurance operations, and $2 per share in excess capital freed up in consolidating separate title-insurance legal entities, FAF's core business trades for around 75% of book value.

"We could come up with forecasts based on how good things would be if the mortgage-origination market came back even modestly," Simpson says. "but we don't need to when we're paying only 75% of book. We get all that upside potential for free, and then some." VII

INVESTMENT SNAPSHOT

First American Financial
(NYSE: FAF)

Business: Provider of residential and commercial title insurance and a range of other related real estate settlement services.

Share Information (@12/1/10):

Price	**14.92**
52-Week Range	11.90 – 19.57
Dividend Yield	1.7%
Market Cap	$1.56 billion

Financials (TTM):

Revenue	$3.91 billion
Operating Profit Margin	6.0%
Net Profit Margin	3.3%

Valuation Metrics
(@12/1/10):

	FAF	S&P 500
Trailing P/E	11.9	17.1
Forward P/E Est.	14.8	13.8

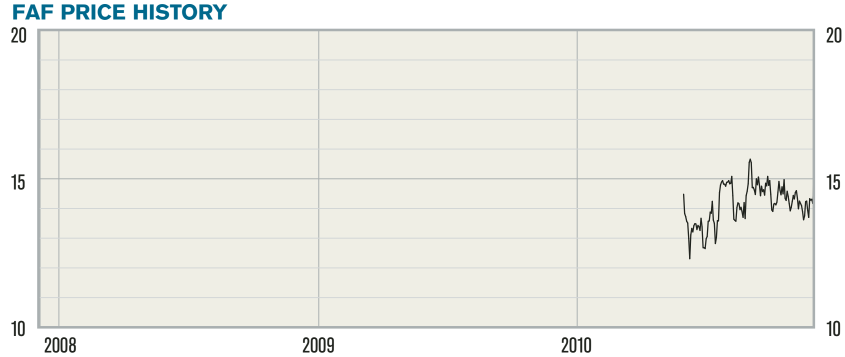
Largest Institutional Owners
(@9/30/10):

Company	% Owned
Highfields Capital	7.8%
T. Rowe Price	6.6%
Fidelity Mgmt & Research	5.7%

Short Interest (As of 11/15/10):

Shares Short/Float	4.7%

FAF PRICE HISTORY



THE BOTTOM LINE

Having overhauled its operations, the company can sharply increase earnings without a housing rebound, says Mariko Gordon. With the shares trading at 75% of book value, she says, that upside – let alone potential from a better market – is not at all priced in.

Sources: Company reports, other publicly available information

A Generation of Overoptimists

As the market roared back from its summer doldrums, it became common for investors to draw comfort that things weren't getting overheated from the fact that equities overall seemed surprisingly cheap. After all, based on information compiled by Birinyi Associates, the Dow Industrials still trade at only 12.9x forward 12-month earnings estimates. At 13.8x, the S&P 500 is a bit pricier, although hardly in nose-bleed range.

All of which argues for a timely reminder on the accuracy of "consensus" estimates. Consultants at McKinsey & Co. have compared analysts' consensus earnings-per-share growth forecasts since 1985 against the actual compound growth in reported EPS that occurred. On average over the 25-year period, analysts' earnings-growth estimates ranged from 10-12% annually, almost double the actual growth of around 6%.

Value investors pride themselves on buying cheaply after building in considerable room for error in estimating a company's future prospects. Given today's tenuous macroeconomic environment, that ethic is likely to prove more important than ever.

Self Examination

In 1974, two years before his death, Benjamin Graham offered these words of counsel to experienced and would-be investors alike. The passage of time has only reinforced the wisdom of his words.

"Let me close with a few words of counsel from an 80-year-old veteran of many a bull and bear market. Do those things as an analyst that you know you can do well, and only those things. If you can beat the market by charts, by astrology, or by some rare and valuable gift of your own, then that's the row you should hoe. If you're good at picking the stocks most likely to succeed in the next twelve months, base your work on the endeavor. If you can foretell the next important development in the economy, or in the technology, or in consumers' preferences, and gauge its consequences for various equity values, then concentrate on that particular activity. But in each case you must prove to yourself by honest, no-bluffing self-examination, and by continuous testing of performance, that you have what it takes to produce worthwhile results.

If you believe – as I have always believed – that the value approach is inherently sound, workable, and profitable, then devote yourself to that principle. Stick to it, and don't be led astray by Wall Street's fashions, its illusions, and its constant chase after the fast dollar. Let me emphasize that it does not take a genius or even a superior talent to be successful as a value analyst. What it needs is, first, reasonable good intelligence; second, sound principles of operation; third, and most important, firmness of character.

But whatever path you follow as financial analysts, hold on to your moral and intellectual integrity. Wall Street in the past decade fell far short of its once praiseworthy ethical standards, to the great detriment of the public it serves and of the financial community itself. When I was in elementary school, more than 70 years ago, we had to write various maxims in our copybooks. The first on the list was: Honesty is the best policy. It is still the best policy." VII

John Heins
Co-Editor-in-Chief

Whitney Tilson
Co-Editor-in-Chief

Value Investor Insight™ is published monthly at www.valueinvestorinsight.com (the "Site"), by Value Investor Media, Inc. Chairman and Co-Editor-in-Chief, Whitney Tilson; President and Co-Editor-in-Chief, John Heins. Annual subscription price: $349.

Contact Information: For all customer service, subscription or other inquiries, please visit www.valueinvestorinsight.com, or contact us at Value Investor Insight, 2071 Chain Bridge Road, Suite 400, Vienna, VA 22182; telephone: 703-288-9060

General Publication Information and Terms of Use

Value Investor Insight and *SuperInvestor Insight* are published at www.valueinvestorinsight.com (the "Site") by Value Investor Media, Inc. Use of this newsletter and its content is governed by the Site Terms of Use described in detail at www.valueinvestorinsight.com/misc/termsofuse. For your convenience, a summary of certain key policies, disclosures and disclaimers is reproduced below. This summary is meant in no way to limit or otherwise circumscribe the full scope and effect of the complete Terms of Use.

No Investment Advice
This newsletter is not an offer to sell or the solicitation of an offer to buy any security in any jurisdiction where such an offer or solicitation would be illegal. This newsletter is distributed for informational purposes only and should not be construed as investment advice or a recommendation to sell or buy any security or other investment, or undertake any investment strategy. It does not constitute a general or personal recommendation or take into account the particular investment objectives, financ ial situations, or needs of individual investors. The price and value of securities referred to in this newsletter will fluctuate. Past performance is not a guide to future performance, future returns are not guaranteed, and a loss of all of the original capital invested in a security discussed in this newsletter may occur. Certain transactions, including those involving futures, options, and other derivatives, give rise to substantial risk and are not suitable for all investors.

Disclaimers
There are no warranties, expressed or implied, as to the accuracy, completeness, or results obtained from any information set forth in this newsletter. Value Investor Media will not be liable to you or anyone else for any loss or injury resulting directly or indirectly from the use of the information contained in this newsletter, caused in whole or in part by its negligence in compiling, interpreting, reporting or delivering the content in this newsletter.

Related Persons
Value Investor Media's officers, directors, employees and/or principals (collectively "Related Persons") may have positions in and may, from time to time, make purchases or sales of the securities or other investments discussed or evaluated in this newsletter.

Whitney Tilson, Chairman of Value Investor Media, is also a principal of T2 Partners Management, LP, a registered investment adviser. T2Partners Management, LP may purchase or sell securities and financial instruments discussed in this newsletter on behalf of certain accounts it manages.

It is the policy of T2 Partners Management, LP and all Related Persons to allow a full trading day to elapse after the publication of this newsletter before purchases or sales are made of any securities or financial instruments discussed herein as Investment Snapshots.

Compensation
Value Investor Media, Inc. receives compensation in connection with the publication of this newsletter only in the form of subscription fees charged to subscribers and reproduction or re-dissemination fees charged to subscribers or others interested in the newsletter content.