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Interview With Bruce Berkowitz
Founder, Fairholme Capital Management

After the Apocalypse

by Lawrence C. Strauss

(The following has been excerpted.)

Bruce Berkowitz, the founder of Fairholme Capital Management and president of the Fairholme Fund (ticker: FAIRX), has a very straightforward investing approach. He looks for undervalued companies—preferably ones that throw off a lot of cash—and he runs a concentrated portfolio.

His philosophy, which is supported by a lot of in-house fundamental research, has led to very strong investment performance. As of March 24, the fund's 10-year annual return of 14.29% bested the Standard & Poor's 500 by a whopping 15 percentage points, placing it at the very top of Morningstar's large-cap blend category. In January, Morningstar named Berkowitz one of its three "managers of the decade." He also received the top nod for the domestic stock-fund-manager category, both for 2009 and the decade.

Barron's interviewed Berkowitz, 51, two years ago, in what turned out to be the worst downturn for stocks since the Great Depression. Fairholme was down nearly 30% in 2008, but nonetheless finished in the top 6% of its category. It has rebounded nicely since then, having gained nearly 40% last year.

The firm's assets under management are above $16 billion, with more than $14 billion in the Fairholme mutual fund.

These days, Berkowitz likes some of the big-name financials—including Bank of America (BAC), Citigroup (C) and American International Group (AIG)—due to their attractive risk-reward tradeoffs. Barron's caught up with Berkowitz, who is based in Miami, last week by telephone.

Barron's: **What's your assessment of the current stock-picking environment?**

Berkowitz: My sense is that the investments made in the past 18 months will continue to do quite well. But we are starting to get to the point where it is going to be harder and harder to find interesting investments. There are always two sides to every environment, and this very difficult environment that we seem to be coming out of yielded some fabulous opportunities, especially in fixed income. You were able to get equity returns of over 20% per annum, which is above historic returns, while being in the senior credit structures, from well-known companies. That opportunity no longer exists.

Do you mean investments like high-yield bonds?

Yes. For example, when we started buying the corporate bonds of Hertz Global Holdings [HTZ], we got yields-to-maturity above 20%. Of course, the negative side of that is, it only lasts so long, until the maturity of the bonds. But there were some obvious and wonderful places to invest for those who had cash. Today, as always, we continue to hold lots of cash, and we like very much what we own. But it is going to be more difficult now to find really great investments. That being said, we've been unbelievably busy in the past couple of months. We are laying down the last set of investments that should see us through for at least the remainder of this year.

In 2008, the Fairholme Fund lost nearly 30%. What did you learn from that experience?

"We have held stakes in different parts of AIG's capital structure, including the debt and equity. AIG is starting to recover. It is a global brand. All of my insurance is now with AIG." —Bruce Berkowitz

Hopefully, at my point in the game, after doing this for about 30 years, there are no new lessons. But an experience like that reinforces some important lessons—one of which is that you can't predict the future or the extreme nature of events.

In running the fund, we were talking about bad times, and headwinds coming for years—and we made the move toward health care and defense, believing that

(over please)

Berkowitz's Picks

Company	Ticker	Recent Price
AIG	AIG	$34.51
AmeriCredit	ACF	23.40
Bank of America	BAC	17.74
Citigroup	C	4.27
Hertz Global Holdings	HTZ	9.87
St. Joe	JOE	32.00
Sears Holdings	SHLD	109.29

Source: Bloomberg

even in a severe recessionary time, those two industries are recession-proof, and that's proven to be the case.

But when times are very tough, almost all assets are highly correlated, except for cash.

So it was a mistake to think there were places to hide in the equity world. There were not any places to hide, because when liquidity dries up, people sell what they can sell, no matter what the price is of what they are selling.

When we spoke about two years ago, one of your stock picks was St. Joe, a Florida real-estate-development company whose stock has been a disappointment. Is there still value there?

St. Joe [JOE] is just a deep-value play. They own some of the most beautiful real estate in the United States. It's hard to imagine, unless you go there. And starting in May, it is going to be much easier to go there, with the opening of a new international airport near Panama City—Northwest Florida Beaches International Airport—which is in the Florida Panhandle. Southwest will start flying to the new airport this spring.

St. Joe is really the last open space on the coast of Florida, with spectacular beaches. There will still be nonbelievers, and we'll see how it develops. They have fairly new management, they are net-debt free, and they have the patience to wait for the economic recovery.

Turning to the portfolio today, you have some big financial names, including Citigroup, AIG and Bank of America. What's your overall assessment on the health of the financial firms?

There is always a flip side to a difficult environment, whether it is Citigroup, Bank of America, AmeriCredit [ACF], Regions Financial [RF], or any of the financials.

During a difficult period, normally everyone is focused on what I would call the pig in the python—the pig being bad debt—and wondering if the python is going to live. But what is not thought about too much is that while that is happening, those institutions that can write new business are going to do quite well. That's because it is during tough times that you write your best business, whether it is an auto loan, a mortgage, a credit card, whatever. Your standards are significantly tighter because of what has happened. You've gone from one extreme of loose, easy credit to the other credit extreme, of giving credit to people who maybe don't even need it.

Let's just assume that the average commercial loan is about three years, on average, and that the average consumer loan is, let's say, five years, all in. Peak values probably occurred in late 2006, early 2007—and things began to unravel in mid-2007.

So there has been enough time now where financial companies, if they are still around, are getting over the hump of the bad debt and, at the same time, have taken on new loans. So they are through the worst of it with their loans, which they have been writing off at a furious pace. And the loans that they've been making since around the end of 2008 have been quite good.

One of your holdings is Citigroup, which has been through the wringer. What's the upside?

We initiated our position at the point when the stock started to recover. It was in the low-single digits, and we've made a few dollars on Citi—but nothing to write home about. Yet, it's a global brand, I like the government being their partner for now, and the balance sheet is better than ever.

Citigroup has had two years of intense scrutiny by the government. And the company is hated by investors. Citi reported a loss for last year, but they generated a tremendous amount of cash. So they are rising from the ashes of the quite stupid moves they made in the past. Hopefully, those moves, which were clearly exacerbated by the recession, will not be made again.

What gives you confidence in the management team led by Vikram Pandit, the chief executive?

I see a better job being done than before. But I must admit that the jury is still out.

Still, compared to the price you pay now for what you are getting, there is a reasonable margin of safety. The patient is recovering, and I can see a full recovery.

What is the stock's intrinsic value?

I don't know. It's a reasonable amount, but the range is wide, depending on management moves in the future. But I see value beyond the price of the stock today.

What got you interested in Bank of America, which is a newer holding?

Bank of America also has been under intense scrutiny, but now, it is time to start to appreciate the asset side of the ledger a bit more. It is more important for me to think about how much we could potentially lose than how much we can make.

So it sounds like you think that the ship has been righted, so to speak.

When you think about Bank of America, Citigroup and others, including Wells Fargo [WFC], they and a half dozen others are the financial system of the United States. The financial system in the United States doesn't work without Citigroup and Bank of America and, hence, the government's involvement. But what's nice about the government is that at the end of the day, it will make a profit on all of its investments in these companies.

There are just certain institutions that are interwoven into the fabric of the United States. That's the case with Citigroup and Bank of America, which make up a key part of our banking system. The same is true for AIG in the insurance area.

What's to like about AIG?

Here is a company that is tremendously solid, but just really blew it on the derivatives, which has been a worry of ours for decades. You can go back 10 years and read how little disclosure there was on derivatives.

AIG is in partnership with the government, and it still has risks. And you have to make certain assumptions that there will still be adverse developments with the derivatives portfolio and with the property-and-casualty reserve. But this past year was a chance to start to get it right in terms of reserving. So, we have held stakes in different parts of AIG's capital structure, including the debt and equity. AIG is starting to recover. It is a global brand. Some would say that they've lost their brand, I but don't see that. All of my insurance is now with AIG.

The company, with the aid of the government, has done a reasonable job of restructuring its balance sheet and lowering risks.

Go through AIG's 500-page 10-K [the comprehensive financial report that is required annually by the Securities and Exchange Commission]—it came out last month. You will see that the company is generating cash, that it is stabilizing, that it is starting to grow in certain areas, and that it has been paying the government back.

You have a big holding in Sears, which hit a new 52-week high last week.

Sears Holdings [SHLD] has more than $40 billion of annual revenues, and it's generating reasonable free cash flows in a very difficult housing-related environment.

We are quite happy. Chairman Edward Lampert has been making money for our shareholders, and we don't see any downside with hanging around.

Our worst-case scenario remains receiving more cash than invested during a liquidation of the company. Our best case remains getting much more from a growing enterprise. We look forward to the next 20 years.

What was it that got you interested in AmeriCredit, a finance company specializing in auto loans?

We were buyers of the equity and the bonds. Then we did a securitization with AmeriCredit when the markets were locked. We helped to deleverage them by exchanging some of our bonds for new equity. And the company has turned the corner; it is growing and it is doing quite well.

But prior to that, people were worried that maybe the company wouldn't survive. Management there was smart, and that's why we bought stock—because they understood how to get through a difficult environment.

When you are a leveraged entity in tough economic times-whether it's a bank or a broker or an auto lender or a rental car company—you have to shrink. When you shrink, the money starts coming in the door faster then it is going out the door. You don't bleed to death, and you get to fight another day. And those companies that did not recognize the need to cut down on expenses and to lower volumes during the most difficult of times are still in a pickle—or they did not survive.

Thanks, Bruce. ■