

On Warren's Wavelength

Practice Builder

by Joel P. Bruckenstein

Few would argue with the proposition that Warren Buffett is the world's greatest living investor. In the 41 years that he has been at the helm of Berkshire Hathaway BRK.B, per share book value has grown from \$19 to \$59,377, or 21.5% compounded annually. Despite insurance losses estimated at \$3.4 billion in 2005 due to hurricanes Katrina, Rita, and Wilma, Berkshire Hathaway managed to increase net worth by \$5.6 billion in 2005, for a 6.4% increase in book value.

Any advisor or financial planner worthy of the name would be overjoyed to produce annual returns that top 20% over a 10-year period, let alone a 40-year period. As a result, advisors are constantly on the lookout for "the next Warren Buffett" or, failing that, a skilled investor who exhibits similar investment tendencies.

The Man

Understanding Buffett's investment philosophy is not as difficult as one might imagine, although putting it into practice is considerably more difficult. Ten years ago, Buffett himself wrote an "owners manual" for Berkshire Hathaway shareholders. In it, he highlighted the firm's broad economic principles of operation:

1. Treat shareholders as partners
2. Managers and directors should have a substantial stake in the business (eat your own cooking)
3. Maximize the average rate of gain in intrinsic business value on a per share basis
4. Own a diversified group of businesses that generate cash and consistently earn above average returns on capital
5. Ignore consolidated numbers. Concentrate on the economics of each business
6. Do not allow accounting rules to influence operation or capital allocation decisions
7. Use debt sparingly. When you do use it, try to borrow long term at fixed rates
8. Only purchases businesses at prices capable of increasing the intrinsic value of the firm
9. Retain earnings only if you can earn an acceptable return on them
10. Don't issue common stock unless you receive as much value as you give
11. A reluctance to sell the businesses they own
12. Report candidly to shareholders
13. Good investment ideas are rare

While each principle outlined above is not directly applicable to the mutual fund world, managers Bruce Berkowitz, Wally Weitz, and David Winters, who will appear together June 30 on a panel titled "On Warren's Wavelength" at the Morningstar Investment Conference, apply at least some of these principles in their investment processes.

Before we get to the managers, however, there is one more point that needs to be addressed: If Buffett is such a successful investor, why not just buy Berkshire Hathaway itself, thereby gaining access to his investment prowess directly? The answer is that perhaps you should, but there are a few caveats.

First, by Buffett's own admission in Berkshire's 2005 annual report, the firm's existing businesses are expected to generate "in aggregate, modest growth in operating earnings" in the years ahead. To produce truly satisfactory earnings in the years ahead, Berkshire will have to make major acquisitions that can add to the bottom line. While Buffett has been able to do so in the past, there is no guarantee that he can continue to do so in the future. A second impediment is Berkshire's sheer size. With assets of \$200 billion, the universe of acquisitions that can make an impact on the bottom line is somewhat limited. Third, there is concern over succession. Buffett, and his partner, Charlie Munger, aren't getting any younger. If something were to happen to one or both of them, what effect might that have on the price of the stock?

Clearly, these concerns have not influenced the outlooks of Berkowitz, Weitz, and Winters with regard to Buffett and Berkshire Hathaway. All three own the stock.

But perhaps the best rationale for not owning the stock directly comes from Berkowitz: "With regard to Berkshire Hathaway, or any stock for that matter, you have to constantly evaluate the businesses you invest in. We own it. If it got to the point where it was not a good investment

On Warren's Wavelength

Practice Builder (cont'd)

for our shareholders, we would sell it. If it came down in price to the point where it became attractive again, we would repurchase it. The typical shareholder in our fund is not as well equipped as we are to make that call."

Other hand, if an investor could accurately gauge the intrinsic value of Berkshire Hathaway shares, purchasing them opportunistically should be rewarding. Now may be one of those times. All three managers told me that they think Berkshire Hathaway is reasonably priced currently. Morningstar analysts agree. Morningstar rates the stock a 5-star equity. They assign the B shares a fair value estimate of \$4,052 versus a market price of around \$3,058.50.

The Managers

The three mutual fund managers appearing on the Buffett panel at the Morningstar Investment Conference are often said to have some of the attributes of the great man himself, but that is not to say that they are Buffett clones. True, they share some investment beliefs with Buffett, and with each other, but the mutual funds they manage are not interchangeable.

Each of the three managers has his own approach to value investing. David Winters searches the globe for a wide range of investment opportunities. Bruce Berkowitz makes concentrated investments in his few best investment ideas. Wally Weitz tends to concentrate his research and investments in the industries he is most comfortable with. "Knowing what you don't know is crucial when investing," he says.

David Winters—Wintergreen Fund

David Winters had an illustrious career at Mutual Series funds before launching the **Wintergreen Fund** WGRNX late last year. Morningstar categorizes the Wintergreen Fund as a world-stock fund. Due to its short history, it has not yet earned a star rating.

So why did he set out on his own? "I had a fantastic 18 years at Mutual Series, but I wanted to be an entrepreneur. I wanted to run my own fund, and I wanted to do it with the maximum amount of flexibility."

So far, the Wintergreen Fund is off to a good start. From its inception Oct. 17 through April 30, the fund returned 10.42%. As a result, the fund is starting to attract a following. Currently, net assets stand at more than \$364 million.

Winters says he learned a great deal by studying Buffett and Munger. "I pay a lot of attention to who is running the businesses I invest in," he says. He likes to see managers' interests aligned with those of the shareholders. "I look for managers who think and act like long-term owners of a business," he says. In addition, Winters says that he learned from Buffett to view investments with an eye to the long term. "You can't get too obsessed with Mr. Market."

Winters follows the "eat your own cooking principle," saying he has the bulk of his money in the fund. In addition, he indicated that friends and family represented a good portion of the early investors.

Like the other two managers who will share the dais with him on June 30, Winters holds a position in Berkshire Hathaway. "You always have to buy Berkshire Hathaway on weakness," he says. "Right now, the market is focusing on the negatives, but the stock hasn't done anything since the late 1990s even though the intrinsic value of the company has increased. The stock used to have a premium built into it. That's not the case today"

While Winters has clearly incorporated much of Buffett's philosophy into his investment approach, he uses a number of key elements that are not usually associated with Buffett. Winters is truly a global investor. He will invest wherever the best opportunities are, be they here or abroad. Buffett has shown an increased interest in overseas recently, but Winters has been at it for years. Winters is comfortable investing in companies that are in, or anticipated to be in, bankruptcy. He also invests in arbitrage situations, "distressed" securities, and hedging strategies. Buffet may employ some of these techniques from time to time, but they are not generally associated with his investment style.

On Warren's Wavelength

Practice Builder (cont'd)

A final key ingredient to Winters' current mix is size. With only \$364 million to manage at the moment, Winters can invest in companies of any size. In the case of Berkshire Hathaway, investments in small firms will not meaningfully affect the bottom line unless a firm can grow at a rapid, sustained pace over time.

While some advisors view a large cash position as a negative, Winters doesn't necessarily see it that way. "Cash is a strategic asset," he says. "It let's me buy opportunistically. I follow a number of stocks that I'd like to buy if the price is right. If I have cash available, I can put it to work quickly when the opportunity presents itself."

According to Winters, most Americans have too much of their net worth tied up in the U.S. markets. Wintergreen Fund can provide a measure of diversification. The fund's charter and size allow it to seek out bargains that may elude others. "We can fish in all ponds, and because of our size, we can fish in both larger and smaller ponds. This allows us to fish where there are fewer fishermen."

A successful, experienced manager at the helm of a new fund with a small asset base and a go-anywhere charter just may be a whale of an opportunity.

Bruce Berkowitz—Fairholme Fund

The \$2.5 billion **Fairholme Fund** FAIRX falls into the Morningstar mid-cap blend category. Morningstar ranks it as a 5-star fund. From its inception Dec. 29, 1999, through May 31, the fund returned an annualized 18.68%, versus -0.6 for the S&P 500.

Fairholme may be the most Buffett-like of the three funds profiles here, but Bruce Berkowitz, who was a finalist for Morningstar's 2005 Domestic-Stock Manager of the Year, does not necessarily view himself or his fund as a Buffett clone. "There is a lot to learn from the guy," he says, "but there is only one Buffett."

So what are some of the things Berkowitz has learned from observing Buffett? "Buy good businesses with strong balance sheets and above average returns on capital," Berkowitz says. "For us, some of the best businesses are those with huge free cash flows. Forget GAAP accounting. Cash is all you can spend."

He continues, "Like Buffett, we want companies run by great people. Our ideal company is one that is run by an owner/manager or by people who act like owner/managers. We want managers who are honest, talented, and hard working. We want their interests aligned with ours. Price is also a factor. We are willing to pay a fair price, but we will not overpay. Buying on weakness provides us with an extra margin of safety."

Berkowitz and Fairholme believe that good investment ideas are rare. As a result, the fund is organized as a non-diversified open-end fund. This means that it can hold fewer securities (typically 10 to 25 positions) and that it can hold larger positions in Berkowitz's best ideas. According to the latest available portfolio report, the fund's two largest holdings Berkshire Hathaway A (12.1%) and EchoStar Communications DISH (11.31%) accounted for almost 25% of assets. The fund's top five holdings account for nearly 45% of its assets.

"We want to put most of our money to work in our top few ideas, not our 50th best idea or our 100th best idea," Berkowitz says. In addition, Berkowitz believes that the size of his investments in a company provides him with better access to management. "When we put enough money into a firm, they treat us like we are owners."

In his 2005 letter to shareholders, Buffet discusses how the costs investors pay can negatively affect their overall wealth. Fairholme Fund is sensitive to their shareholders cost burden. Fairholme's expense ratio is 1%, well below the 1.41% average of its peers. "We do not participate in any marketing platforms, and we do not charge any 12b-1 fees" Berkowitz says.

One way Berkowitz keeps costs down is by operating as a virtual mutual fund. "We have less than 10 employees. We try to make use of new technologies and outsource wherever possible. If

On Warren's Wavelength

Practice Builder (cont'd)

we need an expert on oil drilling or on mining, we don't hire a full-time person to do that. We find an independent expert, and we put them on a retainer."

Like Winters, Berkowitz is heavily invested in his own fund. "I have 95%-plus of my investable assets in the fund," he says.

Also like Winters, Berkowitz believes that Berkshire Hathaway is an attractive investment today. "In the late 1990s, the stock price was ahead of the value of the business. That is not the case today." While last year's hurricanes spooked some, Berkowitz actually believes they could be a long-term positive for Berkshire Hathaway; "In today's environment, they have more pricing power. They have capacity, plus they have the ability to pay. Buffett really understands the insurance business. We expect him to capitalize on his strengths."

Due to its heavily concentrated positions, this fund, more than most, is heavily dependant on the manger's best few ideas, but so far, shareholder's faith in Berkowitz has be well rewarded. With his firm's value discipline, there is ample reason to believe that he will continue to produce highly satisfactory results.

Wally Weitz—Weitz Funds

Buffett isn't the only value investor who calls Omaha home. It is also the home of Wally Weitz and **Weitz Funds**.

Weitz's two largest funds, Weitz Value Fund WWALX (\$2.9 billion in assets) and Weitz Partners Value Fund WPVLX (\$1.8 billion) are both categorized as large-cap value funds by Morningstar, and both are currently rated 4 stars. For the 10-year period ending May 31, the Weitz Value fund returned 13.5% annually, while the Weitz Partners Value returned 13.6% annually.

"I think it is fair to say that I am a Graham/Buffett-style investor," Weitz says. "My theoretical approach is similar to Buffett's, but I make no pretense of being able to do it as well as Warren does."

On the other hand, he points out, he is smaller and more flexible than Berkshire Hathaway, since he has a far smaller pool of money to manage.

Like Buffett, Weitz looks at the intrinsic value of a business. If he is patient, he believes that he can purchase good businesses at a discount and sell them when the market appreciates their true value. Like Buffett, he favors businesses that have niche or a franchise that insulates it from competition. He also favors businesses that generate excess free cash flow and solid managers that are honest and intelligent.

"I like Buffett's idea of making fewer, larger high probability bets, but I'm less confident of any single bet I make," Weitz says. As a result, Weitz's funds tend to be more diversified than, say, Fairholme Fund. But compared with the average equity fund, the Weitz funds would be considered rather concentrated. As of March 31, the top 10 holdings in the Weitz Value Fund accounted for 58.9% of the fund's assets. The largest single holding was Berkshire Hathaway at 8.5% of assets. The top 10 holdings in the Partners Value Fund accounted for 57.5% of assets. The largest holdings were Berkshire Hathaway (7.4%) and Countrywide Financial CFC (7.4%).

Weitz, like our other managers, invests in his own fund. "I have 99% of my investable assets in the fund. All of the other investment professionals working here have the majority of their family's investable net worth in the funds. Our interests are aligned with those of our shareholders."

Like Buffett, Weitz is a buy-and-hold investor. "We want to buy businesses at a discount to their intrinsic value. If we buy the right businesses at the right price, we are content to hold them for the long term."

Although Weitz's concentration in financials, media, and telecom has led to short-term periods of underperformance versus the benchmarks and peers, his long-term record is impressive.

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