MORNINGSTAR FundInvestor

Fairholme Is Focused Like a Laser

The FundInvestor Focused 10 | Todd Trubey

Even compared with the group of concentrated funds in the FundInvestor Focused 10, **Fairholme Fund** FAIRX is highly concentrated.

While managers Bruce Berkowitz, Larry Pitkowsky, and Keith Trauner clearly enjoy making big bets on favored stocks, they also don't mind having a few tiny positions at the bottom of the portfolio. (One reason is that the fund will stop making transactions in a firm's stock if one of the managers is placed on its board of directors.) So the fund's top 15 positions—including its cash stake—hold 95% of the fund's assets. By that measure, it's the most concentrated of all the Focused 10 funds.

From yet another angle, one could make a case that three positions hold just shy of 60% of the fund's assets. First, the fund has a 20% cash stake, and the managers do indeed see their cash as an investment. Second, 18% of the fund is devoted to the two shareclasses of **Berkshire Hathaway** BRK.A, BRK.B. Finally, the fund's three top energy holdings, **Canadian Natural Resources** CNQ, **Penn West Energy Trust**, and **Ensign Energy Services**, are different versions of the same investment. That's because Berkowitz and his crew see them as investments in the management prowess of Murray Edwards, whom they refer to as a young, Canadian Warren Buffett. Taken together, that trio of positions holds 21% of fund assets.

Conventional wisdom suggests that a fund devoting a majority of assets into its top three positions is taking on a massive amount of risk. Berkowitz, Pitkowsky, and Trauner have no problem defying conventional wisdom; in fact, their enterprise serves as a refutation of the capital asset pricing model (CAPM), which is the source from which much conventional wisdom about investing flows. According to CAPM, a portfolio contains both systematic or market risk and unsystematic or company-specific risk. CAPM dictates that through diversification, one can—and should—diversify away unsystematic risk. That's because risk in this system ultimately boils down to an investment's volatility of returns.

Berkowitz and his crew, like many devotees of Warren Buffett's investing philosophy, dispute this notion of risk. They don't see market price fluctuations, or volatility, as risk. To this crowd, risk is the chance that one could lose value permanently. In other words, it's the possibility that an asset's economic value could sharply degrade or disappear. And at Fairholme, rule number one is to avoid destroying economic value. When viewed through this lens, the top of Fairholme's portfolio looks much different.

Cash Is Not Trash

The fund's large cash stake is a signature expression of this philosophy. Typically between one fifth and one fourth of the fund's assets are held in an asset that has essentially zero risk of loss. And while cash has no risk, it does have return: Today's Treasury bills are yielding about 4.7%. To Fairholme's skippers, that is an attractive trade-off for a significant portion of the fund. Plus, they see the cash stash as an opportunistic reserve. If the market—or an attractive security—plummets, these investors can act immediately. They've seen how Buffett at Berkshire Hathaway and Ian Cumming and Joseph Steinberg of **Leucadia** LUK have been able to transform cash from a defensive bulwark into an offensive weapon in times when other investors were fearful.

The Berkshire Bet

Next let's examine the significant stake in Berkshire Hathaway. To most, an 18% stake in one firm represents a massive risk, even if the stock is undervalued—as Berkowitz and his comanagers argue Berkshire stock is. But while many prize the skill of Buffett as an investor, few seem to take as much appreciation as this crew in the economic system he's created. They see Berkshire as a profit-making machine that has great advantages over similarly sized firms. That's because Warren Buffett and Charlie Munger have selected each of the many businesses held within it carefully; each is capable of above-

The FundInvestor Focused 10

Fund Name	Category	Manager Name (Tenure Years)	5-Yr Total Return%	5-Yr Cat Rank%	# of Holdings	Turn-over%	Expense Ratio	Top Three Holdings
Ariel Appreciation CAAPX	Mid-Cap Blend	Rogers Jr./Sauer (4.8)	10.5	90	34	25	1.16	Accenture, Tribune, Carnival Corp.
Clipper CFIMX	Large Blend	Davis/Feinberg (1.5)	7.3	94	19	63	0.62	AIG, Conoco Phillips, Tyco International
FMI Large Cap FMIHX	Large Blend	Kellner/English (5.6)	14.4	4	21	29	1.00	Berkshire Hathaway, Wal-Mart, Accenture
Fairholme FAIRX	Mid-Cap Blend	Management Team (7.6)	17.5	9	24	20	1.00	Berkshire Hathaway, Echostar, Cndn Nat Res
Torray TORYX	Large Blend	Torray/Eby (16.6)	9.2	74	40	22	1.10	Markel Corp., Level 3, Medtronic
Jensen JENSX	Large Growth	Management Team (14.5)	7.2	75	25	10	0.85	Abbott Labs, Stryker, Emerson Elec.
Mairs & Power Growth MPGFX	Large Blend	Frels/Henneman (7.6)	11.8	19	43	4	0.69	Wells Fargo, Target, Emerson Elec.
Matrix Advisors Value MAVFX	Large Blend	David A. Katz (11.0)	12.1	15	35	28	0.99	MedImmune, GE, First Data Corp.
Neuberger Ber Fasciano NBFSX	Small Growth	Michael Fasciano (18.7)	8.7	90	77	39	1.20	Tetra Tech., Bucyrus Intl., Middleby Corp.
Oakmark Select I OAKLX	Large Value	Nygren/Berghoef (10.7)	10.6	37	20	22	0.99	Wa Mu, Yum Brands, McDonald's Corp.

Data through June 30, 2007.

We shine the spotlight on 10 funds from the FundInvestor 500 that follow a focused, low-turnover strategy.

average growth for a significant amount of time. Thus, taken together, the Fairholme investors argue, you have a slew of nicely growing, uncorrelated businesses all in one package.

Consider for a moment what an investment in Berkshire Hathaway represents. The list of subsidiaries now includes 47 entities. Insurance firms, from General Re to National Indemnity to GEICO, dominate the list. But Berkshire also owns Acme Brick, Iscar Metalworking, Fruit of the Loom, Dairy Queen, Nebraska Furniture Mart, carpetmaker Shaw Industries, and so forth. In addition, Berkshire owns a portfolio of common stocks, including **American Express** AXP, **Coca-Cola** KO, **Johnson & Johnson** JNJ, **Anheuser-Busch** BUD, **Procter & Gamble** PG, and **Burlington Northern Santa Fe Corporation** BNI. As Keith Trauner said in a recent conversation with us, "How could you permanently impair Berkshire? It would be very, very tough to kill." As we see it, in just about any scenario in which the value of all of its businesses fell very sharply, the value of your stock portfolio would probably not be your greatest worry.

Energy Exploitation

Of the three big chunks comprising the majority of Fairholme's portfolio, the three-firm energy slice would seem to be far riskier than the first two. While it might well be more risky in terms of volatility, and it is more risky than the other two on a business level, Fairholme's managers argue that it's a pretty safe investment. One piece of macroeconomic forecasting helps them to make the claim: They believe the era of cheap oil is over for a long time. Berkowitz calls energy "the ultimate addiction," noting that on a global basis, people will want increasing amounts of energy even as fossil fuel supply becomes more scarce and difficult to extract from the Earth.

That said, the comanagers would argue that they're by no means betting the farm on a macro forecast. The three big energy holdings in the portfolio are all under the watchful eye of Murray Edwards. The comanagers note that he does not pursue an energy exploration strategy, but an energy exploitation strategy. That is, with Canadian Natural Resources, he owns the land with enormous oil reserves—in oil sands—and the challenge is extracting the commodity, not finding it. The comanagers note that Edwards has a remarkable record of capital allocation, meaning that his firms are able to deploy capital toward the most profitable projects. They argue that if one or more facilities became unprofitable based on falling oil prices, Edwards' firms would cease production rather than operate at a loss.

Conclusion

Within a CAPM-oriented view, then, Fairholme is gambling on Berkshire Hathaway and three volatile Canadian oil stocks—and hedging with cash. From the point of view of the focused, absolute-value investors who run it, the three big chunks of the portfolio are strong, low-risk economic propositions that operate independently of each other.

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