

### UP FRONT

## The First Degree

**W**hile John Maynard Keynes is best known as an economist, he also had great insight and experience as an investor. In his classic, *The General Theory of Employment, Interest and Money*, he described the market's tendency to detach from first-order fundamental observation in the setting of market prices:

Professional investment may be likened to those newspaper competitions in which the competitors have to pick out the six prettiest faces from a hundred photographs, the prize being awarded to the competitor whose choice most nearly corresponds to the average preferences of the competitors as a whole; so that each competitor has to pick, not those faces which he himself finds prettiest, but those which he thinks likeliest to catch the fancy of the other competitors, all of whom are looking at the problem from the same point of view. It is not a case of choosing those which, to the best of one's judgment, are really the prettiest, nor even those which average opinion genuinely thinks prettiest. We have reached the third degree where we devote our intelligences to anticipating what average opinion expects the average opinion to be. There are some, I believe, who practice the fourth, fifth, and higher degrees.

One can imagine such "higher-degree" investing playing a key role in the inexorable decline in average equity holding periods, which were more than three years in the 1970s and now don't reach six months. It's consistent as well with the overall market rising in response to bad economic news, not because of the impact the news will have on individual-company performance, industries' health, or overall future cash flows,



but in anticipation of how hypothetical central-banker responses might hypothetically affect any of those fundamentals.

The investors tracked by *SuperInvestor Insight* are certainly attuned to the market's less-fundamental whims, but there's no question that their buy and sell decisions primarily reflect first-degree analysis of a company's fundamental prospects relative to its market price. So it's worth note when they're buying in volume shares of companies such as **AIG**, **Aetna** and **Capital One Financial**, as they did last quarter. Or when they're taking profits in **Sprint Nextel** and **CareFusion**. Or when 14 and 12 investors, respectively, of the 30 followed own **Apple** and **Google** shares. If beauty is in they eye of the beholder, knowing the beholder's motives makes a big difference. [SII](#)

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### The SuperInvestors

*SuperInvestor Insight* tracks the activity of an elite group of value-oriented hedge-fund managers (plus Berkshire Hathaway), based on their holdings as filed in Forms 13F with the SEC. While specific investors will be highlighted, the focus is on drawing collective insight from this group of 30 of the world's best investors, which currently includes **William Ackman**, **Leon Cooperman**, **David Einhorn**, **Glenn Greenberg**, **John Griffin**, **Carl Icahn**, **Seth Klarman**, **Stephen Mandel**, **John Paulson**, **David Tepper**, **Jeffrey Ubben** and many more.

# Price Shopping

*In a quarter in which indexes marched steadily higher, SuperInvestors found buying opportunities in heretofore market darlings that hit some turbulence as well as in market laggards working to craft brighter futures.*

In his book *Wall Street on Sale*, author Timothy Vick describes what he considers a surprising anomaly in Americans' buying behavior:

The concept of buying goods on sale is as ingrained in the American psyche as watching primetime sitcoms. We take for granted the idea that any good – a bar of soap, a Pontiac Grand Am or back-to-school clothing – is a better value when the price drops. The financial markets may be the only institutions in the world that turn the basic doctrine of consumerism on its head. Investors are coached to believe that a stock is a better buy when the price rises, that it's safer to join the

crowd in bidding the price up and riskier to buy a stock declining in price. Wall Street likes to implant a fear of omission in investors. We are led to believe that if we fail to buy a stock now, the price will only go higher and we will miss the rally.

That the masses resist stocks that are on sale goes a long way to explaining why value investing works, and why investors with the same price-to-value standards for their investments as for their choice of breakfast cereals are able to prosper.

In a quarter in which the S&P 500 marched steadily higher, the number of stocks SuperInvestors uniformly found to be on sale was relatively limited. At the

top of the list: insurer **American International Group**, in which ten star investors increased their positions and the total shares collectively held increased more than 150% (*see table below*). A one-time ward of the state following the financial crisis, the company has simplified its operations by selling off assets and is nearing the point where its operating execution matters more than its capital structure and balance-sheet composition. (The U.S. Treasury's ownership stake in the company, once over 90%, is now at 16% and falling.) With AIG's shares still trading at around 50% of tangible book value, top investors appear to see plenty of upside as

## What They're Buying: Make A Deal

Four or more SuperInvestors added to existing positions or established new ones in these stocks last quarter. The buying interest was most consistently high for AIG, Aetna and Capital One. Internet-services firms – both old and new – attracting interest: PCLN, GOOG, TRIP and YHOO.

Company	Ticker	Industry	Price@ 11/30/12	Q3 2012		# Of New or Inc. Positions	% Change in Shares Held - All Funds
				Low	High		
American International Group	AIG	Insurance	33.13	29.90	35.42	10	156.6%
Citigroup	C	Banking	34.57	24.91	35.25	7	24.4%
Qualcomm	QCOM	Wireless Technology	63.62	53.09	65.45	7	14.2%
Apple	AAPL	Computers/Consumer Electronics	585.28	570.00	705.07	6	(-14.5%)
Capital One Financial	COF	Banking/Credit Cards	57.60	52.88	59.74	6	58.5%
Priceline.com	PCLN	Online Travel Services	663.19	553.42	695.15	6	12.4%
Cigna	CI	Insurance	52.27	39.01	47.92	5	7.6%
Dollar General	DG	Discount Retail	50.00	48.19	56.04	5	11.0%
General Motors	GM	Automobiles	25.88	18.72	25.15	5	20.0%
News Corp.	NWSA	Media/Entertainment	24.64	21.28	25.18	5	(-1.9%)
Yahoo	YHOO	Internet Services	18.77	14.59	16.37	5	6.5%
Aetna	AET	Health Insurance	43.19	34.58	40.94	4	75.0%
Equinix	EQIX	Data Centers	185.76	158.98	212.00	4	2.7%
Google	GOOG	Internet Services	698.37	562.09	764.89	4	(-12.2%)
Liberty Global	LBTYA	Cable TV	56.04	48.49	61.00	4	(-16.1%)
SPDR Gold	GLD	Gold ETF	166.05	150.85	173.18	4	(-1.1%)
TripAdvisor	TRIP	Online Travel Services	38.19	31.71	47.81	4	28.4%

Sources: Forms 13F filed with the Securities and Exchange Commission for holdings as of September 30, 2012.

## WHAT THEY'RE BUYING

the company's financial-crisis woes recede further.

Fellow insurers **Aetna** and **Cigna** also attracted avid buying attention last quarter. Greenlight Capital's David Einhorn made the case for Cigna at October's Value Investing Congress, saying that the company's focus on "administrative-services-only" contracts with commercial customers generates superior and more-stable returns on equity than its competitors – warranting a premium-to-peer multiple on its stock rather than the current discount. He also argued that health-insurance exchanges to be set up as a result of healthcare reform posed far less risk to enterprise-centric Cigna than it would to competitors with greater reliance on individual-policy premiums.

**Yahoo** returns to the most-bought list for first time in more than five years, as five investors last quarter upped their positions or added new ones in the much-maligned Internet pioneer. It's hard to find much in the company's recent results

for optimism, as evidenced by Morningstar analyst Rick Summer's damn-with-faint-praise summary of the company's third-quarter earnings: "Given our very lukewarm forecast and skepticism about the company's long-term competitive positioning, we found very little new information that would give us additional cause for concern." What appears to be sparking enthusiasm from the market and SuperInvestors is the no-nonsense approach of new CEO Marissa Mayer, focused on improving product development, enhancing mobile-device offerings and instituting more shareholder-friendly capital-allocation practices. Since Mayer's appointment on July 16, Yahoo shares are up 20%, to a recent \$18.80.

Another long-ago market darling returning to the favor of at least one star investor is **Symantec**, which Third Point Capital made its biggest new buy of the quarter (*see table below*). The provider of security software and storage-management systems for both retail and enter-

prise customers remains nicely profitable, but has been criticized in recent years for operational and strategic missteps as it diversified from its traditional base in PC software. After deposing CEO Enrique Salem in July, Board Chairman Steve Bennett took the CEO reins, saying Symantec was "underperforming against the opportunity." At a recent \$18.75, the stock trades at an anemic 10.3x consensus forward earnings estimates.

The biggest bust so far among new buys: Glenview Capital's stake in **J.C. Penney**. After giving new CEO Ron Johnson the benefit of the doubt that his dramatic overhaul of the company's product, marketing and pricing strategy would succeed, reality in the form of cratering revenues and mounting losses has slammed the stock. At a recent \$18, the shares have fallen nearly 45% from their Q3 high of \$32.55 on September 19. [SII](#)

*Funds managed by SII co-founder Whitney Tilson are long AAPL, AIG and C.*

### What They're Buying: Biggest New Bets

These are the 15 largest brand-new positions taken by different SuperInvestors during the third quarter. One-time market darling Symantec attracted attention for the first time in years. Activist play Office Depot is so far a nice winner, while the same can hardly be said for J.C. Penney.

Company	Ticker	Industry	Price@ 11/30/12	Q3 2012		Investor	Price Vs. Q3 2012 High
				Low	High		
Williams Companies	WMB	Oil & Gas	32.84	28.47	35.39	Viking	(-7.2%)
Procter & Gamble	PG	Consumer Products	69.83	60.78	69.97	Scout	(-0.2%)
Schlumberger	SLB	Oil & Gas Services	71.62	64.19	72.12	Lone Pine	(-0.7%)
Deere & Co.	DE	Agricultural Equipment	84.05	72.85	83.45	Berkshire	0.7%
American International Group	AIG	Insurance	33.13	29.90	35.42	Appaloosa	(-6.5%)
Macy's	M	Department Stores	38.70	32.31	40.80	Maverick	(-5.1%)
Walt Disney	DIS	Media/Entertainment	49.66	46.85	53.40	Blue Ridge	(-7.0%)
Hess	HES	Oil & Gas	49.61	41.94	57.34	Highfields	(-13.5%)
Shire	SHPG	Pharmaceuticals	86.63	83.41	96.85	Paulson	(-10.6%)
J.C. Penney	JCP	Department Stores	17.94	19.06	32.55	Glenview	(-44.9%)
Symantec	SYMC	Software	18.76	13.06	19.54	Third Point	(-4.0%)
Office Depot	ODP	Office Supply Retail	3.36	1.51	2.85	Starboard	17.9%
Aetna	AET	Health Insurance	43.19	34.58	40.94	JANA	5.5%
American International Group	AIG	Insurance	33.13	29.90	35.42	Eminence	(-6.5%)
Yahoo	YHOO	Internet Services	18.77	14.59	16.37	Greenlight	14.7%

Sources: Forms 13F filed with the Securities and Exchange Commission for holdings as of September 30, 2012.

# On the One Hand ...

*SuperInvestors were far from united in most of their selling in the third quarter, consistent with an environment in which uncertainty is particularly high. To the extent divergent opinions foster mispricing, take note.*

It's likely a sign of the times that so many frequently held SuperInvestor positions – Apple, Google, Equinix, Citigroup, News Corp. and Liberty Global – made the lists of the most bought *and* most sold holdings during the third quarter (*see table below*). The lack of strong across-the-board decisions on common positions is consistent with an environment in which uncertainty is high. Apple is a prime example. For the first time in several quarters sentiment was more negative than positive on the stock, as nine of the 15 top investors holding shares at the beginning of the quarter reduced their positions, versus six who added to their stakes. But in a quarter in which the shares topped \$700 – quadruple their level of three years ago – it's not surprising that investors hedged their

bets on the company's future prospects. The sellers so far have proven prescient: at a recent \$585, Apple shares are off 17% from their Q3 high.

At the other end of the quality spectrum, top investors collectively waffled as well with respect to Citigroup shares. Pershing Square Capital and Blue Ridge Capital sold out of their once-large stakes during the quarter, while Viking Global established a new position and Glenview Capital and Maverick Capital more than doubled their holdings. That top investors are actively trading around their Citi positions is likely a function of the stock's volatility. In just the past year it has moved from roughly \$24 to \$38, back to \$24, and now – even after the recent ouster of CEO Vikram Pandit – back to nearly \$35.

Selling sentiment was more universal for medical equipment and supply company CareFusion – all five investors holding its stock reduced their stakes, with three selling out completely. Spun off in 2009 from drug distributor Cardinal Health, the company has strong market positions in products such as intravenous infusion pumps and medication-dispensing equipment, with many of its devices having long operating lives and generating recurring disposables revenue. While decreased hospital capital spending in recent years has crimped growth of many medical-device companies, CareFusion has fared relatively well, partly due to its products' penchant for improving cost efficiency and partly due to recalls of key competitive products. As its share price flirted with an

## What They're Selling: Mixed Messages

Four or more SuperInvestors reduced or eliminated positions worth at least \$15 million in these stocks last quarter. Opinion was divided on an unusually high number of stocks: Apple, Google, Equinix, News Corp., Citigroup and Liberty Global made both the most-bought and most-sold lists.

Company	Ticker	Industry	Price@ 11/30/12	Q3 2012		# Of Decreased or Closed Positions	% Change in Shares Held - All Funds
				Low	High		
Apple	AAPL	Computers/Consumer Electronics	585.28	570.00	705.07	9	(-14.5%)
Google	GOOG	Internet Services	698.37	562.09	764.89	8	(-12.2%)
Sprint Nextel	S	Wireless Services	5.73	3.15	5.76	6	(-40.8%)
CareFusion	CFN	Medical Equipment/Supplies	27.92	23.93	28.73	5	(-55.1%)
Equinix	EQIX	Data Centers	185.76	158.98	212.00	5	2.7%
News Corp.	NWSA	Media/Entertainment	24.64	21.28	25.18	5	(-1.9%)
Visa	V	Payment Services	149.71	119.10	136.65	5	(-3.0%)
Citigroup	C	Banking	34.57	24.91	35.25	4	24.4%
Crown Castle	CCI	Wireless Infrastructure	67.52	57.60	66.11	4	(-37.9%)
eBay	EBAY	Online Retail	52.82	38.06	50.65	4	(-14.5%)
Humana	HUM	Health Insurance	65.41	59.92	78.20	4	15.6%
JPMorgan Chase	JPM	Banking	41.08	33.10	42.09	4	(-24.5%)
Liberty Global	LBTYA	Cable TV	56.04	48.49	61.00	4	(-16.1%)
Oracle	ORCL	Software	32.17	28.61	33.29	4	(-12.9%)
Tyco International	TYC	Diversified Industrial	28.37	24.73	28.25	4	(-7.0%)

Source: Forms 13F filed with the Securities and Exchange Commission for holdings as of September 30, 2012.

## WHAT THEY'RE SELLING

all-time high during the third quarter, top investors apparently found better opportunities for incremental upside elsewhere.

A steady upward march in **Crown Castle** shares prompted a similar response by four investors, who sold in volume their holdings in the highly profitable lessor of wireless transmission towers. The sluggish economy has done little to dampen consumer demand for new-generation smartphones, prompting aggressive and highly visible leasing activity by the four major U.S. carriers that continue to build out and upgrade their networks. At today's \$67.50, Crown Castle shares continue to trade around their all-time high and are up 550% since their recession low.

Profit-taking was also the norm in phone-service provider **Sprint Nextel**, as six SuperInvestors sold down their positions in a quarter in which the shares ran up sharply, seemingly in anticipation of at least something similar to the \$20 billion deal announced in October by Japan's Softbank to purchase 70% of the

company. Though the multi-stage deal calls for the buy-in of a portion of today's outstanding shares at \$7.30 apiece, the market's assessment is that a current share – the value of which on average will be diluted when the deal is done – is worth around \$5.75.

In a good year overall for healthcare-related stocks, several in the broad industry – **CVS Caremark**, **AmerisourceBergen**, **Baxter**, **Pfizer** and **UnitedHealth** – were among the largest complete sales among top investors last quarter (*see table below*). After years in the market's doghouse as it faced patent cliffs on existing drugs with a not-up-to-the-task new-drug pipeline, Pfizer has made considerable strides in cutting costs to maintain 30%-plus operating margins and now sports a broader and deeper pipeline of promising drugs. Despite that, with its shares significantly outpacing the S&P 500's growth over the past two years, Viking Global decided last quarter to take all of its Pfizer chips off the table.

The best-timed large sale of the quarter: Omega Advisors' exit from enterprise-software company **Citrix Systems**. The company has prospered as demand for its products that efficiently deliver applications over computer networks and the "cloud" has risen nicely. As can happen in high-expectations stocks, the shares have vacillated sharply over the past two years. The latest trend is down – since the end of the third quarter the shares are off 20%.

In keeping with the divergent views star investors appear to be expressing on several stocks, oil-services provider **Schlumberger** made both the high-conviction-buy and the high-conviction-sale list for the quarter. While Lone Pine Capital established a brand-new stake worth \$464 million at September 30, Maverick Capital went entirely the other way, selling out of what had been a \$167 million position at the beginning of the quarter. [SII](#)

*Funds managed by SII co-founder Whitney Tilson are long AAPL and C.*

### What They're Selling: Selling Out

These 15 stocks were the largest positions eliminated by different SuperInvestors last quarter. Healthcare-related stocks – CVS, AmerisourceBergen, Baxter, Pfizer and UnitedHealth – accounted for several prominent sales. The best-timed sale so far: Omega's exit from Citrix Systems.

Company	Ticker	Industry	Price @ 11/30/12	Q3 2012		Investor	Value @ 6/30 (\$mil)
				Low	High		
Teradata	TDC	Data Warehousing	59.48	62.05	80.97	Lone Pine	\$304.1
Fidelity National Financial	FNF	Title Services	24.21	18.07	21.48	ValueAct	\$300.1
CVS Caremark	CVS	Pharmacy Services	46.51	43.65	48.69	Berkshire Hathaway	\$247.8
Unum	UNM	Insurance	20.39	18.28	20.92	Relational	\$243.6
Lowe's	LOW	Home-Improvement Retail	36.09	24.76	30.56	Blue Ridge	\$223.9
Schlumberger	SLB	Oil & Gas Services	71.62	64.19	72.12	Maverick	\$166.6
Pfizer	PFE	Pharmaceuticals	25.02	22.00	25.15	Viking	\$156.6
Baxter	BAX	Medical Products	66.27	53.23	61.67	Paulson	\$143.5
AmerisourceBergen	ABC	Pharmacy Services	42.22	36.73	40.36	Glenview	\$137.7
UnitedHealth	UNH	Health Insurance	54.39	50.32	59.31	Greenlight	\$133.7
Energizer	ENR	Consumer Products	79.76	64.36	80.36	JANA	\$120.7
AutoZone	AZO	Auto Parts/Supply	383.77	351.27	387.82	Scout	\$110.2
Lam Research	LRCX	Semiconductor Equipment	35.12	31.17	37.99	Eminence	\$106.2
Target	TGT	Discount Retail	63.13	56.70	65.80	Farallon	\$98.1
Citrix Systems	CTXS	Computer Software/Services	61.16	68.17	85.65	Omega	\$93.8

Source: Forms 13F filed with the Securities and Exchange Commission for holdings as of September 30, 2012.

# What Could Go Wrong?

*SuperInvestors frequently address what can go wrong in an investment before looking at what can go right, which manifests itself in many of their most-common holdings boasting attractive defensive characteristics.*

Before he turned his focus to writing books and creating mostly automated value-based trading strategies for beating the market, Gotham Capital's Joel Greenblatt put up eye-popping annual returns – reportedly 40% – over some 20 years as manager of a concentrated hedge fund. So it's of great interest when he describes, as he does in a recent interview with Columbia Business School's *Graham & Doddsville* newsletter, one of the primary ways he has always looked to mitigate risk:

Positions with limited downside are the types of positions I have loaded up on in the past, not the positions with the biggest payoff. I could buy a lot knowing that I wouldn't lose much and that there were good possibilities that it was worth a lot more over time. At the very least,

I knew that my downside was well-protected and so I could create an asymmetric risk/reward by saying if I don't lose much, there are not many alternatives other than to make money.

This focus on the downside is prevalent among top investors and is a key reason many stocks they hold in volume (*see table below*) sport proprietary technology, network economies and other defensive characteristics that create the types of "moats" that defend against competitive incursions. It also comes out in how they analyze opportunities, often starting with an assessment of whether the concerns built into the stock price are warranted.

An excellent example of focusing first on what can go wrong is the recent

investor-letter description by one SuperInvestor, who preferred not to be named, of its bull case for **Google**. It rattled off the bear case for the company, including how mobile computing threatened its margins and search traffic, the competitive challenge of Facebook and pessimism over its Motorola acquisition. Only after addressing those concerns does the argument turn to Google's upside, which this investor expects to be driven by increasing e-commerce and Internet-advertising penetration, both of which it considers to be in the "early innings" of development. Excluding net cash, Google shares at a recent \$698 trade at less than 13x next year's consensus EPS estimate.

Internet powerhouse **Priceline.com** also attracted incremental buying interest dur-

## What They Own: Taking Comfort

Six or more SuperInvestors held stakes in these companies as of the end of 2012's third quarter. Technology stalwarts such as Apple, Google, Qualcomm, Priceline.com and Oracle remain particularly popular. Back yet again as a refuge for the most defensive minded: ETF SPDR Gold Trust.

Company	Ticker	Industry	Price@ 11/30/12	52-Week		# of Portfolios That Own	Price vs. 52-Week High
				Low	High		
Apple	AAPL	Computers/Consumer Electronics	585.28	377.68	705.07	14	(-17.0%)
Google	GOOG	Internet Services	698.37	556.52	774.38	12	(-9.8%)
American International Group	AIG	Insurance	33.13	22.19	37.67	11	(-12.1%)
Qualcomm	QCOM	Wireless Technology	63.62	51.76	68.87	11	(-7.6%)
Citigroup	C	Banking	34.57	24.40	38.72	9	(-10.7%)
Equinix	EQIX	Data Centers	185.76	97.33	212.00	9	(-12.4%)
Visa	V	Payment Services	149.71	95.05	149.93	9	(-0.1%)
Capital One Financial	COF	Banking/Credit Cards	57.60	41.27	61.83	8	(-6.8%)
Liberty Global	LBTYA	Cable TV	56.04	37.66	62.86	8	(-10.8%)
News Corp.	NWSA	Media/Entertainment	24.64	16.68	25.50	8	(-3.4%)
Priceline.com	PCLN	Online Travel Services	663.19	438.76	774.96	8	(-14.4%)
Cigna	CI	Insurance	52.27	39.01	53.75	7	(-2.8%)
SPDR Gold	GLD	Gold ETF	166.05	148.27	174.07	7	(-4.6%)
Dollar General	DG	Discount Retail	50.00	38.85	56.04	6	(-10.8%)
Oracle	ORCL	Software	32.17	24.91	33.29	6	(-3.4%)

Source: Forms 13F filed with the Securities and Exchange Commission for holdings as of September 30, 2012.

## WHAT THEY OWN

ing a quarter in which its shares suffered an ugly 17% one-day drop after the company reported a deceleration in quarterly bookings and revenue growth. While the shortfall prompted concerns that internationally driven growth was hitting more than a temporary lull, SuperInvestors showed little signs of panic. Six investors added to their positions or bought new ones in the quarter and a total of eight held stakes as of the quarter's end. The shares have somewhat rebounded, but at today's \$663 remain 14% off their 52-week high.

While no U.S. cable-TV companies are among the most-owned stocks of star investors, John Malone's Europe-centric **Liberty Global**, in which eight managers held stakes at quarter's end, has made the list for three quarters running. As befits a Malone company, Liberty has generated a whirlwind of activity in recent years, shuffling its geographic footprint, pursuing messy takeovers and investing heavily in network upgrades to battle phone-company and Internet competitive challenges. It

remains highly leveraged, but is generating sufficient cash to fund some \$1 billion in share buybacks this year. After a period of indifference, the market has taken note: Liberty's shares have increased by more than 40% over the past year.

SuperInvestors' affinity for gold remains intact, with seven managers holding the **SPDR Gold** exchange-traded fund at September 30. Greenlight Capital's David Einhorn in his Q3 investor letter offered a full critique of the U.S. Federal Reserve's latest loose-money policies and worried about what would happen if a still pedal-to-the-metal Fed confronted another U.S. economic downturn: "If the Fed is willing to deploy this new set of desperate measures in these frustrating, but non-desperate times, what will it do then? We don't know, but a large allocation to gold still seems like a very good idea."

Activism is evident in several of the largest individual SuperInvestor holdings (see table below), including the strategic and operational transformations under-

way at **Canadian Pacific Railway**, Pershing Square Capital's largest holding, and **Yahoo**, where Third Point LLC has exerted considerable influence on the company's board. Relational Investors, which is credited for prompting **Illinois Tool Works** to refine its vaunted acquisition strategy, can be expected to provide prominent counsel following the death of ITW's CEO, David Speer, earlier this month.

Earlier in the activist process, Canadian fertilizer and agricultural-products company **Agrium** has rejected JANA's calls for it to cut costs, better manage working capital and split itself in two, prompting the hedge fund firm to announce on November 19 that it would nominate five new members to Agrium's board. Shareholders thus far can't complain: At \$102, the shares are up 35% from their low in this year's second quarter, when JANA started buying. [SII](#)

*Funds managed by SII co-founder Whitney Tilson are long AAPL, AIG and C.*

### What They Own: Playing Favorites

These are the 15 largest holdings of different individual SuperInvestors as of the end of last quarter. Activist investments of differing tenures include Canadian Pacific Railway, Yahoo, Illinois Tool Works and Agrium. The most clearly out-of-favor big bet: Eddie Lampert's stake in Sears.

Company	Ticker	Industry	Price@ 11/30/12	52-Week		Investor	Price vs. 52-Week High
				Low	High		
Coca-Cola	KO	Beverages	37.92	32.94	40.67	Berkshire Hathaway	(-6.8%)
SPDR Gold Trust	GLD	Gold ETF	166.05	148.27	174.07	Paulson	(-4.6%)
CVR Energy	CVI	Oil & Gas Processing/Fertilizer	45.74	17.44	46.47	Icahn	(-1.6%)
Sears	SHLD	Department Stores	42.01	28.89	85.90	Lampert	(-51.1%)
Canadian Pacific Railway	CP	Railroads	93.34	61.23	94.83	Pershing Square	(-1.6%)
Motorola Solutions	MSI	Communications Devices	54.45	44.18	54.86	ValueAct	(-0.7%)
Liberty Global	LBTYA	Cable TV	56.04	37.66	62.86	SPO	(-10.8%)
Yahoo	YHOO	Internet Services	18.77	14.35	19.16	Third Point	(-2.0%)
Priceline.com	PCLN	Online Travel Services	663.19	438.76	774.96	Lone Pine	(-14.4%)
Illinois Tool Works	ITW	Diversified Industrial	61.57	45.48	63.33	Relational	(-2.8%)
News Corp.	NWSA	Media/Entertainment	24.64	16.68	25.50	Highfields	(-3.4%)
Agrium	AGU	Fertilizer	102.02	63.39	108.42	JANA	(-5.9%)
News Corp.	NWSA	Media/Entertainment	24.64	16.68	25.50	Viking	(-3.4%)
Apple	AAPL	Computers/Consumer Electronics	585.28	377.68	705.07	Greenlight	(-17.0%)
Life Technologies	LIFE	Medical Products	49.35	37.97	51.47	Glenview	(-4.1%)

Sources: Forms 13F filed with the Securities and Exchange Commission for holdings as of September 30, 2012.

# What's In Their Wallet?

*Traditional U.S. financial institutions haven't been a key area of interest for SuperInvestors for some time. But as one-time iconoclast Capital One Financial goes more mainstream, top investors are taking notice.*

It would be difficult to characterize SuperInvestors' interest in traditional U.S. financial institutions in recent years as anything but lukewarm. JPMorgan Chase and Wells Fargo, for example, attracted some level of buying interest in the early recovery period after the financial crisis, but neither has been widely owned for some time. Nine top investors owned Citigroup at the end of this year's third quarter, but its stock is as apt to show up on the widely sold list in a given quarter as it is the widely bought one.

Bucking that proclivity toward apathy, SuperInvestors have shown increasing interest of late in Capital One Financial. Six investors increased their positions in it or established new ones in the third quarter, bringing to eight the total number who owned shares at the end of September.

While it's certainly a more traditional financial institution today than it was for much of its history as a monoline credit-card issuer, Capital One retains some unique attributes. Roughly 60% of its profits remain tied to credit cards, an area in which the company is known for ubiquitous and even sometimes clever advertising, as well as its sophisticated use of information systems to target potential customers and retain existing ones. Through acquisition, it has also become a large regional banker, with important beachheads in metropolitan New York, metropolitan Washington, D.C., Louisiana and Texas. It is one of the country's largest auto lenders and, following its acquisition earlier this year of ING Direct, a powerhouse in online banking. This mix of businesses not only makes Capital One more profitable than a typical bank – credit cards are among the most lucrative business lines in financial services – it also allows it to leverage its giant, low-cost retail deposit bases to fund well-established national lending franchises.

Though originally met with skepticism on Wall Street, Capital One's two large

opportunistic acquisitions this year appear on track to add significantly to the company's earnings power. After closing the \$9 billion ING transaction in February, it has thus far been successful in holding onto that large acquired customer base as it prepares to rebrand ING Direct as Capital One 360 starting in February. In May, Capital One spent another \$2.5 billion to buy around \$30 billion in credit-card

receivables from HSBC Holdings, which was looking to pull back significantly on its retail operations in the U.S. Harris Associates' Colin Hudson, who recommended Capital One in *Value Investor Insight* nearly 18 months ago [VII, July 29, 2011], expects the price the company paid for the HSBC assets to end up being less than 4x the annual profits it will earn from them. Overall, he believes both acquisitions by

## INVESTMENT SNAPSHOT

### Capital One Financial

(NYSE: COF)

**Business:** Bank holding company with primary operations in credit cards, auto lending and commercial and retail banking in the northeastern and southern U.S.

### Share Information

(@11/30/12):

<b>Price</b>	<b>57.60</b>
52-Week Range	41.27 - 61.83
Dividend Yield	0.3%
Market Cap	\$33.31 billion

### Financials (TTM):

Revenue	\$15.10 billion
Operating Profit Margin	28.5%
Net Profit Margin	20.4%

### Valuation Metrics

(@11/30/12):

	<b>COF</b>	<b>S&amp;P 500</b>
Trailing P/E	10.1	16.8
Forward P/E Est.	8.2	13.4

### Largest Institutional Owners

(@9/30/12):

<b>Company</b>	<b>% Owned</b>
Dodge & Cox	8.6%
Fidelity Mgmt & Research	5.6%
Vanguard Group	4.1%
Barrow, Hanley, Mewhinney & Strauss	3.6%
BlackRock	2.8%

### Short Interest (as of 11/15/12):

Shares Short/Float	2.2%
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### COF PRICE HISTORY



### THE BOTTOM LINE

As the company's two large opportunistic acquisitions this year are more fully integrated and tangibly add to annual earnings power, Colin Hudson expects the market to take even greater notice. At the 12x multiple of cash earnings at which regional banks typically trade, based on his estimate of 2013 earnings the shares would reach at least \$90.

Sources: Company reports, other publicly available information



next year will add close to \$1.50 per share to the company's roughly \$6 per share in annual GAAP earnings power.

Absent accretive acquisitions, the near-term growth story for Capital One appears relatively muted. The auto-lending book of business has increased some 25% in the past couple of years as the company aggressively expanded its national lending footprint with dealers, but Hudson expects that growth to plateau as local and regional banks step up their own lending in that area. On the credit-card side, the quality of the portfolio is high as the bulk of bad credit risks post-crisis have already been charged off, but growth in receivables is hard to come by with U.S. economic vitality low and unemployment still stubbornly high. "We're more or less expecting status quo near term for the credit-card business," says Hudson. "Not exciting, but not so bad either."

He argues that as the market recognizes the increment to earnings from this year's acquisitions, Capital One shares have plenty of room still to run. At today's

\$57.60, the shares trade for 85% of book value and only 7-8x the \$7.50 to \$8 per share in cash earnings (after adding back amortization) he expects the company to post in 2013. He believes there's no reason

### ON RETURNING CAPITAL:

**By 2014 the company will be in a position to direct nearly all its net income to share repurchases and dividends.**

the shares shouldn't earn the 12x multiple at which most regional banks trade, which on next year's estimated earnings would yield a share price of at least \$90.

The potential return of capital to shareholders is also likely to become an important part of the Capital One story going forward. As it has bolstered its capital base both to fund acquisitions and to meet more-stringent regulatory requirements,

the company hasn't been buying back any shares and is paying only a 20-cent per share annual dividend. Hudson doesn't expect it to be overly aggressive next year in returning capital to shareholders, given that U.S. regulators still have to sign off on such capital-allocation plans by big banks and they have resisted purse strings being loosened too quickly. But by 2014 he believes Capital One will be in a position to direct nearly all of its net income to share repurchases and dividends. "If the stock hasn't fully gotten the market's attention by then," he says, "one could imagine something like that having quite a favorable impact."

At the top of the list of primary risks: a double-dip recession in the U.S. But on this score as well, Capital One from both a capital-strength and business-mix perspective is likely prepared to weather the storm better than most. It has in the interim improved its regulatory capital ratios and further diversified its funding base, but even at the depth of the last crisis it did no worse than breakeven overall. [SI](#)

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