

## Businesses and People

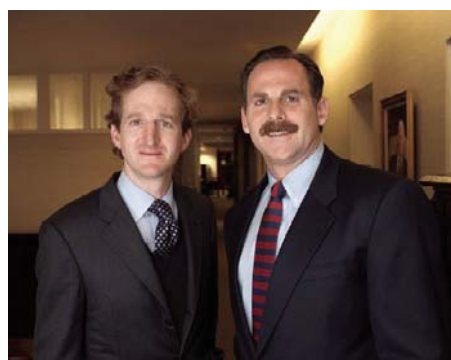
*It's hard for a big money manager to outperform the market over one 10-year period, yet Davis Advisors has done so in each rolling 10-year period since 1969.*

Working at his family's investment firm during summers growing up, Christopher Davis only got paid when his research reports were completed. "My father believed in work product, not hourly pay," says Davis.

Its focus on results undimmed, Davis Advisors now manages more than \$105 billion in assets. According to Morningstar, its flagship Davis New York Venture Fund has outperformed 90% of its peers over the past 10 years, returning 10.4% per year, vs. 8% for the S&P 500.

In constant search of "compounding machines" they can buy and hold, Davis and long-time partner Kenneth Charles Feinberg are today finding opportunity in such areas as banking, insurance, credit cards and warehouse clubs. [See page 2](#)

### INVESTOR INSIGHT



#### Davis Advisors

Christopher Davis (l), Kenneth Feinberg (r)

**Investment Focus:** Seeks companies with highly durable business models and attractive reinvestment opportunities that are not being recognized by the market.

## On the Contrary

*There's a big gap between the number of investors who claim to be contrarian and patient and those who really are, says Alex Troy ... which is fine with him.*

### INVESTOR INSIGHT



**Alex Troy**  
Troy Capital

**Investment Focus:** Seeks out-of-favor companies undergoing change that he expects will take longer to resolve than most money managers are willing to wait.

You wouldn't particularly expect a one-time merger arbitrageur to be preaching the virtues of patient investing, but Alex Troy is fond of doing just that. "I've concluded that when it comes to investing, less is more," he says.

Except when it comes to generating returns for investors. After an early career that included nine years as a protégé of hedge fund superstar Richard Perry, Troy started his own long-only money-management firm in March 2003 and has since earned an average annual return of 23.6%, net of fees, vs. 15.8% for the S&P 500.

Troy sees opportunity today in the market's skepticism toward companies facing corporate overhauls or well-documented operating challenges, particularly in financial services and healthcare. [See page 11](#)

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Betting on "compounding machines" JPMorgan Chase, Costco, American Express, American International Group and Loews. [PAGE 1 »](#)

#### Investor Insight: Alex Troy

Bucking the market's conventional wisdom on Boston Scientific, Tyco, IndyMac Bancorp and Friedman, Billings, Ramsey Group. [PAGE 1 »](#)

#### Uncovering Value: HMA

Why a leader in the less-than-healthy business of operating hospitals might be worth a closer look. [PAGE 18 »](#)

#### SPECIAL: Words of Wisdom

A greatest-hits collection of investing wisdom, highlighting the similarities – and many differences – in how great investors ply their trade. [PAGE 19 »](#)

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Pondering whether the buyout craze is a trend ... or a bubble. [PAGE 30 »](#)

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# Words of Investing Wisdom

*This “greatest hits” collection of wisdom from the many investors we’ve interviewed highlights the similarities – and many differences – in how the best investors ply their trade.*

**Editors’ Note:** While we certainly believe there are core principles upon which sound investments are made, it’s equally clear that, like snowflakes, no two investing strategies are exactly alike. Two brilliant, accomplished investors can view a given investment opportunity in precisely the opposite way. That’s a central reason we launched *Value Investor Insight*, to help inform the ongoing development of your own unique investment strategy with the experience and wisdom of a wide variety of great investors. This special section reassembles a small sample of the insight we hope to have imparted in our issues since the beginning of 2006, highlighting both the similarities and differences in how the best investors go about their craft.

## “EFFICIENT” MARKETS

We don’t have a discernible edge determining whether IBM’s earnings are going to beat the Street by a nickel. But there are a wide variety of situations in which there are dislocations – like mergers, spin-offs, short-term bad news, legal issues – where we think we understand why there might be a huge disconnect between supply and demand for a given security.

*Jon Jacobson, 2.28.06*

[W]e basically spend our time trying to uncover the promising turnarounds, dullards and assorted investment misfits in the market’s underbrush that are largely neglected by the investment community. One of the key metrics we assign to our companies is an “analyst ratio,” which is

simply the number of analysts who follow a company. The lower the better – as of the end of last year, about 65% of the companies in our portfolio had virtually no analyst coverage.

*Carlo Cannell, 3.31.06*

We don’t have a problem with cyclical-ity. Wall Street still looks for certainty in areas that are uncertain. We feel good about lumpiness. We just try to be cash counters – if you can buy something at 5x free cash with a limited chance of permanent impairment, even if it earns only half of what we originally thought, that’s okay.

*Bruce Berkowitz, 4.28.06*

It’s still true that the biggest players in the public markets – particularly mutual funds and hedge funds – are not good at taking short-term pain for long-term gain. The money’s very quick to move if

performance falls off over short periods of time. We don’t worry about headline risk – once we believe in an asset, we’re buying more on any dips because we’re focused on the end game three or four years out.

*Jeffrey Ubben, 1.31.06*

Lack of visibility on timing is one of the best things you can have as an investor with a long time horizon. We love situations where it’s very difficult to model this year’s earnings.

*Ken Shubin Stein, 2.28.06*

Companies in severe financial stress tend to be overlooked and underloved, because they have a risk or fundamental profile that many equity investors are not comfortable with. We also like what we call “crossover” equities, where a transition between value and growth shareholders causes them to fall out of focus.

*Mitch Julis, 3.31.06*

Time is our friend. Today there’s so much money chasing quarterly performance or driven by program trading, index funds or ETFs. That leaves a real opportunity for fundamental investors like us who are looking out two to four years to find inflections in businesses which aren’t currently appreciated by the market.

*Joe Wolf, 4.30.07*



We are often looking for broken growth stories, when a once-great company is no longer considered to be great. The market tends to overreact in these cases, as growth and momentum investors move on to the next new thing and the shareholder base turns. Since I wasn't in the stock before, I'm not disappointed if something is no longer a high-flier. All I care about is the future potential relative to what I have to pay for it.

*Alan Schram, 1.31.07*

I'd always said that if a guy was long the best 50 companies he knew and short the 50 worst, if that didn't work you were in the wrong business. But that strategy was literally a recipe for bankruptcy from 1998 to 2000. I said when I closed down that it was a market I didn't understand, and I didn't.

*Julian Robertson, 11.30.06*

Most of the time we're picking up the pieces after a high-growth company hits the wall at 80 miles per hour, having made at least one too many investments to try to

sustain an unsustainable growth rate. Public markets can actually conspire to screw companies up. When you're growing fast, you get this big P/E and pretty soon you have all the wrong investors with ridiculous expectations. You try to meet those ridiculous expectations and do things contrary to shareholder value.

*Jeffrey Ubben, 1.31.06*

The hedge-fund industry grew up by preying on the inefficiencies created by the mutual-fund mentality of only departing from a benchmark index weighting with reluctance. Events that transform companies can complicate things when you're focused on, say, having an 8% weighting in industrials. That's why these types of companies can often be mispriced. There's also change going on and the market can be remarkably slow in shifting its focus from how things have been to how they will be.

*Gary Claar, 3.30.07*

## GENERATING IDEAS

There's a clarity that comes with great ideas: You can explain why something's a great business, how and why it's cheap, why it's cheap for temporary reasons and how, on a normal basis, it should be trading at a much higher level. You're never sitting there on the 40th page of your spreadsheet, as Buffett would say, agonizing over whether you should buy or not.

*Joel Greenblatt, 10.31.06*

It would be unusual for someone to call us with an idea that we don't already have some knowledge of. As a result, the vast majority of our ideas come from thinking through the ramifications of industry developments or the recognition of changes within a market.

*Lee Ainslie, 12.22.06*

Our best ideas tend to come from what I call "old research, new events." That's typically the good company you've studied carefully and would love to own at the right price, that gets marked down after it trips or its industry goes out of favor.

*Ricky Sandler, 8.25.06*

The majority of our investments are originally driven from the top down. We'll identify an industry that has underperformed for the past five or ten years that we believe is due for a cyclical regression up to the mean. From that, we systematically review the micro-caps in that industry, sorting them on the basis of financial measures and subjective assessments of management to identify the companies we'll bore into.

*David Nierenberg, 7.28.06*

Another thing Peter [Lynch] does really well is to figure out how else to make money on a good idea. Look right down the industry structure and figure out the other ways that this particular information can generate an edge. In our



portfolio today, we identify a theme – say consumer-driven health care – and then we try to figure out where all the opportunities are.

*Jeffrey Ubben, 1.31.06*

We follow management teams we know are good. We talk to operators we respect about what other companies or businesses they think are doing interesting things. We might look at something because it's a product we use.

*Mario Cibelli, 6.30.06*

Bloomberg lists on a monthly basis the highest-ranked and lowest-ranked stocks by sell-side analysts. I look at the lowest-ranked for buying opportunities and the highest-ranked for selling opportunities.

*Jon Jacobson, 2.28.06*

I often find opportunity in companies where a compression of valuation has already taken place. GE is an example. Six years ago, it was at 40x earnings. Its earnings have continued to go up, but now the shares trade closer to 15x earnings. The stock six years ago was just overpriced. The company basically did what it was supposed to do, but the share price went from \$60 to under \$35 today.

*Thomas Gayner, 5.26.06*

If you look at technology-driven growth industries over the past two centuries – steam engines, railroads, telephony, electric power, the Internet – people become too excited about growth and overinvest in it. When the bubbles burst, markets overcorrect on the downside, even though the fundamental growth drivers may still be as present as they were before. We love to find jewels buried amid the rubble after that kind of explosion occurs.

*David Nierenberg, 7.28.06*

There are characteristics that have been proven over long periods to be

associated with above-average rates of return: low P/Es, discounts to book value, low debt/equity ratios, stocks with recent significant price declines, companies with patterns of insider buying and – something we're paying a lot more attention to – stocks with high dividend yields.

*Will Browne, 9.29.06*

Our experience shows there's a positive correlation between improvements in a company's return on invested capital and its stock performance. More than anything, we're looking for inflections in businesses where some sort of structural change will drive returns on invested capital to be materially higher.

*Joe Wolf, 4.30.07*

Our favorite way to get paid is to find companies with below-normal margins for reasons that are fixable and in their control, and to which the market is not giving the benefit of the doubt. In those, you get paid two ways – if you're right, both the earnings and the multiple improve.

*Stephen Roseman, 9.29.06*

I'm looking for steady cash flows, reinvested on owners' behalf by honest and able management. Steady cash flows come from businesses that, for one reason or another, enjoy the perception of indispensability for their products.

*Thomas Russo, 6.30.06*

I've always had an affinity for companies that actually make things. We favor companies with transparent businesses that we can understand fairly quickly and those that have large and recurring maintenance, repair and overhaul revenues from an installed base, such as elevator companies or aerospace-parts firms.

*Alexander Roepers, 2.28.07*

There is something inevitable to me about "positional" goods. Once you've

provided for your basic needs, you start to march up the consumption curve and it is often the more traditional brands that attract the consumer as he reaches a new position in life. The more you prosper, the more narrow the universe of items through which you can express your prosperity.

*Thomas Russo, 6.30.06*

We use a lot of grapevine ideas, asking people what they've finished buying that might be interesting. Why wouldn't you look at what other great investors have found?

*Bruce Berkowitz, 4.28.06*

We learn a lot from other investors. I go to idea dinners and regularly talk to a lot of people I respect in the business. I'm not afraid of ideas owned by other people, but you obviously need to do your own work and make sure they fit what you do.

*Ricky Sandler, 8.25.06*

## THE CRAFT OF INVESTING

In studying the common traits of those most successful at games of skill – across disciplines – researchers have found a clear tendency to focus more on process than individual outcomes. Poker legend Amarillo Slim has described it this way: "The result of one particular game doesn't mean a damn thing, and that's why one of my mantras has always been 'Decisions, not results.' Do the right thing enough times and the results will take care of themselves in the long run."

*VII, 1.31.06*

There's a virtuous cycle when people have to defend challenges to their ideas. Any gaps in thinking or analysis become clear pretty quickly when smart people ask good, logical questions. You can't be a good value investor without being an independent thinker – you're seeing valuations that the market is not appreciat-