DISCOVERING VALUE
WHITNEY TILSON
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Bargain Hunter Blues

In *The Little Book That Beats the Market*, published in 2005, star money manager Joel Greenblatt describes a "magic formula" for success that ranks stocks based on only two factors: share price relative to a firm's earnings and return on capital. His formula looks for companies with a great combination of quality (reflected by a high return on capital) and a bargain price (reflected by a low price-earnings ratio). Back-tested over the 17 years before the book's publication, Greenblatt's formula produced a stunning annualized return of 31%, compared with a mere 12% for Standard & Poor's 500-stock index.

Why value investing is hard. After reading his book, we asked Greenblatt if widespread adoption of his simple plan might undermine its effectiveness. He was unconcerned: "Value investing strategies have worked for years and everyone's known about them. They continue to work because it's hard for people to do, for two main reasons. First, the companies that show up on value screens can be scary and not doing so well, so people find them hard to buy. Second, there can be one-, two- or three-year periods when a strategy like this doesn't work. Most people aren't capable of sticking it out through that."

What Greenblatt is describing is a central challenge of value investing, which is rooted in the notion that to perform better than the crowd you have to deviate from it by making contrarian bets. But investing this way also means that you will almost certainly go through some periods during which you appear to be clueless.

For a real-time example, look no further than Fairholme Fund's Bruce Berkowitz, who just months ago was basking in the glow of having been named Morningstar's Fund Manager of the Decade. But Fairholme is having a dreadful 2011 (down 8.7% through July 8) because of its high allocation to financial stocks. In June, *Fortune* reported from Morningstar's annual investment conference that some investors were suggesting that Berkowitz is toast. Really? We doubt it. But Berkowitz's uncomfortable position underscores why most active managers don't stray far from the composition of their benchmark indexes.

Our portfolio today has more than its share of stocks that, in our humble opinion, the market has been maddeningly slow to recognize as having a wide gap between the value we see and the price at which the shares trade. **MICROSOFT (SYMBOL MSFT)** continues to report stellar profit growth and is improving its positions in Web search, gaming and cloud computing. But the stock, which closed at $27 on July 8, trades at only ten times estimated earnings for the year that ends June 2012. A P/E that low is usually associated with cyclical businesses or those in permanent decline, neither of which applies to Microsoft.

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The market has also been shunning **INTEL (INTC)**. Investors worry that Intel hasn't been a leader in chips for mobile devices, but ignore the extent to which the company benefits from the proliferation of mobile computing and the attendant need for servers and network equipment—packed with Intel chips—to help manage all the new traffic. Intel is a powerhouse that is unlikely to remain a stepchild in any core business in which it chooses to compete. Moreover, the firm reduced its operating costs significantly during the recession, meaning that its already sky-high profit margins can actually expand.

So here's a market leader, in an expanding market, that generated 30% earnings growth in the first quarter. But at $23, the stock trades at just ten times the average of analysts' 2011 earnings estimates of $2.29 per share, a figure we consider conservative. Could Intel shares get even cheaper? Of course. But as long as the *value* of the company—from higher earnings and cash flow—continues to increase, we'll take our chances on looking out of touch for a while. ■

FUNDS CO-MANAGED BY WHITNEY TILSON OWN SHARES OF MICROSOFT AND LONG-TERM CALL OPTIONS ON INTEL.

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