Welling on Wall St.

A Journal of Independent Research, Analysis, Opinion and Insight

A Bit Greedy: New Fund GoodHaven's Veteran Managers Finding More Patient Buys

GoodHaven Fund Performance	YTD as of 03/31/2019	One Year Return as of 03/31/2019	Five Year Return as of 03/31/2019	Annualized Since Inception[1] as of 03/31/2019
GoodHaven Fund	**6.31%**	**-0.70%**	**-2.74%**	**3.19%**
S&P 500	13.65%	9.50%	10.91%	12.30%
Morningstar Large Value	11.30%	4.09%	7.03%	9.35%

[1] Inception date is 4/08/2011

Total Annual Fund Operating Expenses: 1.10%

Performance data quoted represents past performance; past performance does not guarantee future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance of the fund may be lower or higher than the performance quoted. Performance data current to the most recent month end may be obtained by calling 1-855-OK-GOODX (1-855-654-6639).

The Fund imposes a 2.00% redemption fee on shares held for less than 60 days. Performance data does not reflect the redemption fee. If it had, return would be reduced. Short term performance, in particular, is not a good indication of the fund's future performance, and an investment should not be made based solely on returns.

Fund holdings and sector weightings are subject to change and are not recommendations to buy or sell any security.

As of February 28, 2019 the top ten holdings of the Fund were: Barrick Gold Corp. (7.9%), Jefferies Financial Group Inc. (6.8%), Alphabet Inc. – Class C (6.7%), WPX Energy, Inc. (6.5%), Berkshire Hathaway Inc. – Class B (6.3%), American Airlines Group Inc. (5.2%), Spectrum Brands Holdings, Inc. (4.5%), Birchcliff Energy Ltd. (4.2%), Federated Investors, Inc. – Class B (3.5%), and Delta Air Lines, Inc. (3.2%) [Total top ten: 54.8%]. Please note that top ten holdings excludes cash, money market funds and Government and Agency Obligations.

The Fund's investment objectives, risks, charges and expenses must be considered carefully before investing. The statutory and summary prospectuses contain this and other important information about the investment company, and may be obtained by calling 1-855-OK-GOODX (1-855-654-6639) or by visiting www.goodhavenfunds.com. Read carefully before investing.

Opinions expressed are subject to change at any time, are not guaranteed and should not be considered investment advice. References to other mutual funds should not be interpreted as an offer of those securities.

Mutual fund investing involves risk. Principal loss is possible. The Fund is non-diversified, meaning it may concentrate its assets in fewer individual holdings than a diversified fund. Therefore, the Fund is more exposed to individual stock volatility than a diversified fund. The Fund invests in mid and smaller capitalization companies, which involve additional risks such as limited liquidity and greater volatility. The Fund may invest in foreign and emerging market securities which involve greater volatility and political, economic and currency risks and differences in accounting methods. The Fund may invest in REIT's, which are subject to additional risks associated with direct ownership of real property including decline in value, economic conditions, operating expenses, and property taxes. Investments in debt securities typically decrease in value when interest rates rise. This risk is usually greater for longer-term debt securities. Investment in lower-rated, non-rated and distressed securities presents a greater risk of loss to principal and interest than higher-rated securities.

While the Fund is no-load, management fees and other expenses will apply. Please refer to the prospectus for further details.

GoodHaven defines free cash flow as the cash a company generates from operations less all expenses necessary to maintain the business in its current position. Book value is defined as net asset value of a company, calculated by subtracting total liabilities from total assets. The Price to Earnings (P/E) Ratio reflects the multiple of earnings at which a stock sells. Return on Equity is calculated by dividing net income by average shareholders' equity. Return on Assets is calculated by dividing a company's annual earnings by its total assets. Portfolio turnover rate is calculated by dividing (1) the lesser of purchases or sales of portfolio securities for the fiscal year by (2) the monthly average of the value of the portfolio securities owned during the fiscal year.

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listeningin

A Bit Greedy

New Fund GoodHaven's Veteran Managers Finding More Patient Buys

Larry Pitkowsky

Keith Trauner

*As **Larry Pitkowsky** and **Keith Trauner** are fond of saying, they've been around the block as investors. More specifically, as long-time opportunistic value managers, they paired up with Bruce Berkowitz in the early days of Fairholme, where they stayed for a decade. A little more than a year ago they set up their own shop, **Goodhaven Capital Management**, and launched a mutual fund called (surprise) Goodhaven, which has been besting its category and, more importantly, generating absolute returns, ever since. In essence, patient investors in the extreme, they couldn't help betraying just a bit of greed when we spoke earlier this week, as speculative appetites shrank, and markets sank, amid the EU's identity crisis. Listen in.*
KMW

You guys are fond of quoting Buffett to the effect that successful investors have to be fearful when others are greedy — and get greedy when others are panicked. So are you greedy yet?

Keith: It's interesting that you ask the greed question because I found myself invoking Warren's rule the other day when I was thinking about editing our fund letter, where I paraphrase his view that successful investing requires a tolerance for temporary price declines, a ruthlessness in avoiding permanent loss, plus a willingness to be fearful when others are greedy, and a sense of greed when others are panicked. There's no question we're getting greedier. I don't know if we're at full blast

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Gosh, I wonder...

Oh yes, Gosh Golly Gee, maybe I forgot to tell you that I have bolted from Weeden and am now publishing my own independent research journal of insight, investment analysis and opinion WELLINGonWALLST. YES, the rumor is true, it ain't free and there is more to the story.

So, you might ask yourself, what is distinct, unique and different about WELLINGonWALLST compared with Welling@Weeden? N-O-T-H-I-N-G, everything is, as it ever was (sound familiar??) except now there is a tangible price attached to this value-added independent research — the very same work you knew you were paying for at Weeden, it just wasn't terribly transparent.

Nothing different about the journal?? NADA. The same insightful, provocative in-depth interviews with the best minds in finance as well as trenchant visionary perspective pieces. Very good stuff. 20 times a year. Want proof?

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Did I forget to mention???

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Probably the very easiest way to take the plunge is to send an email to my junk yard dog of a marketing partner, Pete Arnold at: Pete@WellingonWallSt.com. He will quickly be in touch and promises to make the deal quite painless. You'll be right as rain.

As always, your questions, comments and suggestions are entirely welcome and very gratefully received. Just send me a note at Kate@WellingonWallSt.com or call me at (973) 763 6320. I very much look forward to continuing to work for you from my new, independent, home base.

With warm appreciation for your longstanding support and readership.

Kate

*Noreen Cadigan, (203) 861-7644 or ncadigan@weedenco.com) is your contact for all things Weeden CSA-related.

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greed yet, but we're definitely getting greedier. We've been buying every day. I guess that says something.

It sure does, considering the volume of groaning and complaining I'm hearing from so many money managers in this volatile macro environment.

Keith: We have a few macro thoughts, to give you a sense of who we are, Larry likes to say that there aren't many advantages to not being 25 years old – but experience is one of them. We kind of know what we want to do when we grow up. We've been around the block and we've got lots of experience and lots of perspective.

Larry: We've pretty much done it all before, at least once.

Keith: We're not trying to roll the dice to get big really quickly. We've got too much of our own money on the line. We're in a business and we're trying to earn the best returns in it that we can – that are consistent with preserving capital. I'm sure you played *Monopoly* as a kid, right?

Sure, didn't everyone?

Keith: Well, we never want to get sent back to "GO".

Larry: But we'd like to earn some real returns. We're trying to have our cake and eat it too. We're looking for real returns but we're not looking to have a lot of downside.

You and gazillions of others. But though your firm and fund are relatively new, you guys actually have a record of doing just that.

Keith: As Larry likes to say, "We're a new firm from some not-so-new guys" and the tagline in our logo is "Our Money With Yours." I think those two things say a lot. Our money is on the line in the same things that we own for our clients and shareholders, and we've been around the block. I may have told you before my story about the broker who, when I was just starting out the business, asked me if I wanted to know the secret to Wall Street. He was about 75 years old. I said, "Sure, I'd love to. What's the secret?" He said, "The secret is surviving your first 30 years. He added, "Twenty is not enough. But after 30, you will have seen just about everything."

The internet bubble was this period of fantastic stress for value people all over the world and now it almost feels like history is rhyming again. We're in this tough environment where you've got this fear and an ongoing crisis that's making the headlines every day. When things are tough and when there's lots of volatility is when we should be able to add a lot of value.

Alas, I now know exactly what he meant!

Keith: We know what we're looking for. At this stage in our careers, it's not a question of knowing what to do. It's a question of execution. We were part a team for 10 years that did it before and we think we can do it again. And we're doing it in what we think is the right way – which means we have no marketing staff. We are focused on portfolio management, with the belief that, if we do our job right, people will show up.

Larry: Right. The fund has had a fixed all-in expense ratio from day one, no 12b-1 fee. We'll just worry about the portfolio and we figure if we get that right, the business will take care of itself.

Let's be a little more explicit. Where you did it before was at Fairholme with Bruce Berkowitz. You both were there for quite a while, were you not?

Larry: We were.

Keith: Larry and I showed up shortly after Bruce founded Fairholme. We had both known him in our previous lives through common investments. So we got there close to a year before the funds started. Both of us stepped down from day-to-day responsibilities in 2008 before the real smush.

So if nothing else, your timing was impeccable?
Keith: Well, people can draw whatever conclusions they want. I think we were an integral part of the Fairholme team; it was the three of us working very closely together and we are very proud of our accomplishments during our tenure at Fairholme. We're again in a kind of similar situation marketwise as we were when Fairholme started, which was around the peak of the tech bubble. In a lot of ways it's interesting.

Back then, value managers were almost universally held in contempt, for "not getting it."
Keith: Exactly. It was this period of fantastic stress for value people all over the world and now it almost feels like history is rhyming again. We're in this tough environment where you've got this fear and an ongoing crisis that's making the headlines every day. When things are tough and when there's lots of volatility is when we should be able to add a lot of value.
Larry: The fun thing is that the environment, at the dot.com peak, was one where people were miserable because of envy. And now people are more miserable because of fear. They were really miserable because of envy back then. Truly off-the-charts miserable with envy.

Sure, if you didn't have a portfolio stuffed with pets.com and such you were just hopelessly out of touch.
Larry: Right now, people are miserable with just fear, scared of the volatility, scared of macro events. It's unbelievable. But those are good emotions to have out there when you're looking for bargains.

True enough, and people tend to forget that bargains were also to be had in the midst of the internet bubble — if you were willing to buy "old economy" stocks that were left in the dust as the NASDAQ shot over the moon.
Keith: Yes, and that were relatively unscathed by the crash in the NASDAQ shortly afterwards. Look, we're not blind to the larger world out there but we want to focus primarily on looking at businesses and trying to figure out if the market is mispricing those businesses. We want to find out if we can buy them at a big discount – and if so, we're interested. But with that said, as I noted, we're not blind to what is going on in the world. We wrote about that when we started the fund. Our first letter to investors last spring included a warning about European banks and sovereign debt, in some respects because we didn't really understand what was going on. It looked to us like there were no common-sense actions being taken –
Larry: We think that first letter was greeted with a little bit of a yawn from the world but maybe it looks a little better in retrospect –

Well, common sense still seems to be woefully lacking in the eurozone.
Keith: It seems obvious to us – maybe we're wrong, I don't know – but it seems obvious that the ongoing crisis, which started in '08, is a *debt crisis.* In our first letter, we said something like, "If too much debt is the problem, it should be axiomatic that more debt can't be the solu-

tion." But people aren't behaving that way, at least not in Europe. We really don't expect this whole mess to end, in our minds, until we see real solid debt restructuring or the liquidation of debts in a way that reduces the obligations outstanding. So we don't assume that the outcome of what's going on over there is going to be a neat package or be without volatility. So far, they seem to be stumbling around in a way that doesn't engender a lot of confidence that they can avoid a real crisis. Of course, it's only during a real crisis that hard stuff tends to get done, right?

All too often, that does seem to be the only way folks make the hard choices. Europe is acting like a drunk with a hangover, stumbling around in the morning looking to the hair of the dog that bit him for a cure.
Keith: Right, the only good thing I would say is that a lot of the problem is known today, very well-known, and so probably discounted to some degree.

One certainly hopes so, at this juncture. That would only make sense.
Larry: You are starting to hear the proverbial shoeshine boy discussing these things, which is a bit of a sign that maybe a lot of it is priced in.
Keith: If we can buy a business in the public market at a lot less than what a rational person would pay for the whole business, then whether or not Greece defaults is pretty irrelevant – unless Greece owes that business a lot of money. If Greece doesn't owe you money, it's not that big of a deal if it defaults. Sometimes the headlines and the things that everybody is focused on probably are *not* the things that they should be more concerned about. If Europe gets messy – messier, I should say – there could be a reduction, a short-term reduction in demand. But I don't think it will affect us in a big way, at least over the long term. Could you see some shortfalls in sales and profits and some currency translation issues from Europe as a whole? Sure. But those effects are very likely to be transient, not permanent.
Larry: And we've been expecting that for a while. We're actually surprised that we haven't seen more of a short-term effect on our companies' European businesses to date, but we have factored that in as best as we sensibly could and we've been doing that for months.

Could there be a bright side to all of the sturm und drang in what seems to be the eurozone's impossibly inept and drawn out crisis management style? A method to their madness? All their foot dragging has certainly given people plenty of time to prepare for the inevitable.
Keith: Well, it's not clear that the financial institutions are doing anything more sensible – other than dumping some of their sovereign paper on the European Central Bank. One of the problems, of course, in all of this is that what people – the governments – have done is essentially try to short circuit the long-delayed downturn – which, in the capitalist system, is how you wring excess out of the system, right?

True. But excesses can be fun, to paraphrase Mae West. And wringing them out, isn't.
Right. They are essentially saying, "Well, we really don't want to fire any managers, we really don't want anybody to get hurt financially. We don't want anybody to go bankrupt." But unfortunately that's not how the world works. Somebody has got to eat that bad debt. And so far it seems to be the taxpayers who have been left on the hook. But I would imagine that in most democratic systems eventually the patience of the taxpayers will wear thin. Look, the really positive sign will be when you finally start to get some real discussions about people eating losses and about the absolute levels of debt being reduced.

We haven't had much sign of that yet.
No, we haven't really seen it yet. I mean, what we've seen has been under the surface. Privately, it *has* been going on. Under the surface, you've had write-downs in the banks and reserves added and put-backs of mortgage loans. There is all sorts of stuff going on under the surface that is self-corrective in the way that capital systems normally are. It's just that a big chunk of it has been short circuited by this extraordinary government intervention.
Larry: But this all creates a good backdrop for our search for cheap securities.
Keith: One of the things we have tried not to do is really make big predictions about the macroeconomic environment.
What? You don't have a sideline as a fortune teller?
Keith: We don't think – I haven't met one yet who has been right all the time.
Larry: By the way, it would make life a lot easier if we had one of those.

If I ever manage to find a good one, I'll send her your way.

Larry: It would be really nice to know what long-term rates are going to be in three years, or what GDP growth was going to be.

Keith: Without naming names, how many people can you remember coming across in your career whose prognostications were taken as gospel for some period of time – until they missed a call and that was it, it was over? I can remember at least half a dozen.

Is that all? That's a constant theme on Wall Street, played out in endless serial installments.

Keith: It's really, *really hard* to predict the future. So what we try to do is figure out if we can identify companies that are cheap based on what's going on now, under reasonably conservative assumptions. If it turns out that we're a little too conservative, terrific! We like a big margin of safety. We want things to look inexpensive to us with the world in a mess. So if the world turns out to be in less of a mess, wonderful! They will do even better.

Larry: And this is *not* merely a theoretical exercise. These are the discussions about the portfolio that Keith and I have all day. The principles underlying the ongoing research that we do. If it was just ours and our families' money that we were managing and if we had no clients or shareholders, we'd be having the same discussions and doing the same things. We didn't set out to build an investment management product that somebody might find attractive. We set out to say, "This is how we invest money and we have the desire to build a business around it."

Keith: That's what we're wired to do. We like what we do. We enjoy it. We *enjoy* the process.

And you've actually been officially doing it your way for a little more than a year now? You started last March?

Larry: The fund really launched at the beginning of the second quarter last year.

Keith: Right, we started managing accounts last March.

So congratulations in making it through that tough first year with performance that wasn't only nicely positive (+6.51%) but that bested the market and your Morningstar pigeon hole.

Larry: Well, as we like to say, "So far, so good." But we're not running around the office

Source: Morningstar

high-fiving each other. That's not our style. So far, so good. One thing we're pleased about is that we've done well while holding a chunk of cash and owning cheap securities. We think that all returns should *not* be equally compared. Doing it the way we're doing it and achieving what we've achieved is very different than if we had been rolling the dice and achieved the same numbers.

Keith: After a year, we've probably done better than most hedge funds. We've given people a reasonably favorable experience in an environment where a lot of people haven't done as well.

I imagine your first big client, Tom Gayner, who is the CIO of specialty insurer, Markel, and also chairman of the Davis Funds, is pretty pleased –

Larry: Well, he is our minority partner; he was our first non-family separate account. But he was not an early mutual fund investor of any consequence.

Keith: We've known the Markel guys for years; they know us. Larry and I basically felt, when we decided to start this business, that you never know what conditions will be like in the markets – and we both felt that it was worth having a strong, knowledgeable partner in the business as a start-up. They are a minority partner. Larry and I own by far the biggest part of the firm. They are a completely passive minority partner. But we wanted to make sure that, if the day we opened our doors the market started a two-year, 50% decline, we'd have the staying power to be around to take advantage of it.

Larry: We also knew, from having watched lots of friends in the industry, that we didn't want the pressure, and to have to spend lots of time running around raising money and worrying about the business the early on. We wanted to have the flexibility to really focus on the portfo-

lio. We didn't want to be distracted by having to worry about the P&L constantly in our first year in the business.
Keith: What the Markel minority stake basically afforded us was some comfort – a margin of safety. Larry and I have both seen plenty of examples of guys starting out small and getting a little bit behind the eight ball – and then changing their strategies because they think they've got to catch up.

Or dig a performance pit they'll never climb out of.
Keith: It's the kiss of death. And bringing in Markel basically ensured that we would have staying power.
Larry: Plus, they are wonderful guys and they are great investors. They are really a wonderful minority partner. They knew the three of us when were all together at Fairholme. It didn't hurt to have somebody who knew the three of us well, too.
Keith: You shouldn't be under any illusion. Larry and I both put a significant amount of money into the fund to start it. Our money is at risk. Our tag line, "Our money with yours" isn't just some marketing slogan.

I realize value managers are a contrarian breed, but why did you start *a mutual fund*, of all things, when a hedge fund would have been so much sexier?
Larry: We both decided, "Why not go with the product that has more regulation, higher costs and is less sexy?" What the heck, right?
Keith: Well, the truth is that we thought about it. And we probably could have been happy working out of our bedrooms and wearing bathrobes and managing money. But we felt like we had some currency in the mutual fund world. We had a favorable experience in that world and we thought we understood how to navigate it. It's going through a lot of changes but there will always be demand for somebody who is experienced, can generate results and behaves in a consistent way. There are a bazillion funds out there. I'm very fond of saying that on Wall Street there are many ways to get to heaven.

Or hell —
Keith: Clearly. But neither Larry nor I could ever do what George Soros or Paul Tudor Jones does. They are instinctively great traders and they found their ways to get to heaven. That's not our way, though. We understand a different aspect of the business and we're happy to live in that area.

And how much do you have under management now?
Larry: Oh, call it a little below under $170 million in the mutual fund. And what are the separate accounts now, Keith?
Keith: Close to $100 million.

Still not so big that you have trouble buying the positions you want. But are stocks cheap enough here to tempt you? It's about as easy to start arguments in Wall Street these days by saying stocks are cheap as by saying they're overvalued.
Keith: We don't think it matters. I mean to some degree – when people are talking about the market as a whole – it just doesn't matter.

Because you buy individual securities, not "the market"?
Keith: Right. The question is, can we find a few things? Look, we have a big advantage right now in that we are relatively small. So we can buy big caps, we can buy small caps, we can buy things that are household names and we can buy things that people have never heard of. We can buy debt, we can buy equity. We have a lot of ponds in which to fish, and today, there are a lot ponds that look like they are full of fish. Still, you have to make sure that you are looking at clean water and good fish. But there are lots of ponds out there.

You have a lot of flexibility written into your fund structure. Can short in it, too?
Larry: We can, but one should not expect us to do any real shorting, except maybe in connection with some arbitrage. No one should expect it to be a big part of what we do.

Because low turnover and long-term holdings are more your style?
Keith: It's also because shorting is a very tough business. We will only do it when we really have an axe to grind. When we think we have knowledge that is worth something. But we have the capability in our charter more because, from time to time, we may get involved in arbitrage situations. We were involved in two or three in our first year. Sometimes, the ability to be able to short an acquirer's stock or something can be worthwhile. We are more likely to short in that connection than anything else.
Larry: As a friend of ours likes to joke, we like our mistakes to shrink, not to grow.

No kidding. So what are you looking at?
Keith: Mostly the places that we want to look at are areas where there has been a significant amount of dread, or where there is just about absolute boredom. If the headlines are scary, there is a good chance we are looking at something. If people are talking about something being dead money, there is a good chance we are looking. We may not buy, but we look at a lot of different areas, and we are always trying to figure out what can go wrong. The good news is, when everyone is afraid of something, there are generally fewer things that can go wrong than when everyone thinks the world is great.

Absolutely. When everybody thinks the sky is the limit, it often doesn't take much to disappoint expectations. Now, however, everybody has easy excuses not to invest –
Larry: It's important for us to stay in touch with the mood out there. I mean, you just have to look at fund flows to know that the mood out there is quite pessimistic. But to us that's more of a positive sign than a negative sign, for sure.
Keith: Right. The only place that people are optimistic, by default probably, is in 10-year government bonds –

Despite rates that say they have far more downside than upside –
Larry: I think that is true. It concerns us that a lot of people really are not thinking through what, geez, even a non-cataclysmic move up in rates, would do to the price of a intermediate term bond. It could go down 25% pretty fast.
Keith: Yes, the math on long-term paper is pretty compelling, here. If you have a low coupon on a long-dated bond today, you'd lose somewhere close to 35% or 40% of your principal if interest rates went up by 300 basis points. Which certainly would be the functional equivalent of a crash. Now, in a sense, it is interesting that we're thinking about that – and we do think about it– because it's a *macro* factor. But it also is a risk factor in any business with financing needs, depending on how it finances itself. Depending on whether it generates cash, what its maturity schedules look like, etc. So we think a lot about it. We actually have some things in the portfolio – and it's not necessarily a timing bet – but we own some that will be helped significantly when interest rates go up even modestly. We are not betting that it happens tomorrow, but we *do* think, based on a sense history, that it is unlikely that the Fed holding interest rates at 0% is a permanent condition.

Do you mean things like, for example, money management firms with big exposure to the money market fund business?
Keith: That would be one of them – one of which [**Federated Investment** (FII)], we own.
Larry: So would be property casualty companies that have short-duration bond portfolios.
Keith: Right, companies that are sitting on piles of cash, on which they've been earning nothing, and generating cash. Companies that are in any way, in some form of float business. It could be a securities firm, an insurer, there are others.

Speaking of cash, that reminds me. Are you still holding a fairly large cash position in your fund — keeping dry powder but penalizing performance as you earn practically zilch on it?
Larry: Cash in the fund is lower than it has been since we started, but it's still close to 20%. By the way, it's was a lot higher when we started, because we went slowly. It was as high as 40% - 50% at the beginning and it fell into the area of 30s in the summer/fall of last year, when things got very volatile and we had a chance to buy some bargains. When people were forced sellers, we did a lot of buying. Then, in the first quarter as people were getting a little excited about the world, we probably did less buying. But lately, we've been back to doing a lot more buying. We understand, by the way, why many managers try to avoid the "performance penalty" of holding cash, but we think about it the other way.
Keith: The important thing about our cash

level is not necessarily what it is on average. For instance, in our previous life – in the 10 years we were all together at Fairholme, our average cash level was, I would say, probably 20%. But that doesn't mean that we had 20% cash all of the time.

Far from it.

If things got really stressed we might have gotten down to 5% cash and when things got really ebullient, maybe we had 35% or more cash. We're not trying to make asset allocation decisions. We just like the idea, particularly in a mutual fund structure where people can be prone to panic (although we try to teach them otherwise) of always having some liquidity. That's because it A) allows you to buy when the market or a company is under stress, and B) allows you to better tolerate a stressful period without being forced to liquidate holdings at depressed prices and C) may give your shareholders some comfort that they're not going to get screwed – because there's a cash cushion during that stressful period. So as a general proposition we like always having some liquidity in the fund; we think it's a good business practice and our experience is that *over time on a risk-adjusted basis* it hasn't hurt our returns.

Okay, so tell me about where you find investment ideas. Another advantage of having been "around the block" is that you've probably followed lots of companies in the value universe for quite some time.

Larry: We find ideas in several ways. One, you're right, goes back to us not being 25 years old. There is a long, long list of things that we've looked at and owned, or have considered owning and kept an eye on, or have admired as companies that we keep an eye on. Once in a while, one of those things stumbles or falls out of bed or gets cheap or misses earnings by 2 cents and goes down 15%. That's when we dust off our file and say to ourselves, "Is this still the company we remember? Let's dig in; maybe there's an opportunity here." Second, we can't help but read a lot and we're always attracted to areas that are under stress or under a big cloud or that are hated and despised. So we'll always look there. Third, we do some statistical screening just to make a list of things that might be cheap based on certain metrics that are important to us; it's something to thumb through on a Sunday afternoon. Also, we can't help but notice if somebody we admire owns something. It doesn't mean we'll buy it – but we'll certainly take a look.

Keith: The short answer is that there is no one source of ideas. We have very little ego. I mean, it's always nice to come up with an original idea yourself and you're the architect. But it's a lot more important in this business to recognize a good idea than it is dream one up. And there are lots of smart people out there, so we keep an eye on what other people do as well.

So what sort of research do you do to vet your ideas, wherever they come from?

Keith: We want to try to get to know the things that we're interested in really, *really* well. The first level of our process is we try to make sure we understand the financial statements, obviously. If we have five things we don't understand, we try to get to the bottom of them. If we can't understand them, we stop and we move on.

Larry: That is the key, by the way. The human brain is wired to bypass things in a project that don't make sense; not to stop and say, "Wait, what is that?"

The idea seems so attractive, let's ignore that and keep going?

Larry: Right. My brain says that's no big deal.

Keith: I always call that the "puddle after a thunderstorm in New York City" problem. If you have to cross the street in NYC and there's a big puddle there, you never know if the puddle is two inches deep or six feet deep. But before we cross the street, we want to know how deep that puddle is. If we can't figure it out, we'll let somebody else cross there and we'll walk down the block and cross the road elsewhere. It's important A) to make sure that you understand what you're looking at and B) to get a sense of whether the people running a business are good stewards or not. Are they reasonable capital allocators? For the vast majority of what we do, we want to see managements that have skin in the game, that are incented the right ways; that aren't getting entirely free packages of options but don't own a share – or have never bought a share. We try, also, to talk not just to people in the company but we talk to customers, we talk to suppliers sometimes. We try to understand the businesses we look at. We would rather spend one hour with somebody who's lived in the business for 30 years than spend a week reading Wall Street research.

No question where you can learn more – But that kind of nose-to-the-ground

research is totally out-of-fashion in a world trading at hyper-speed.

Keith: Well, you can't be trading all the time *and* doing research like that.

Larry: Again, this is not a theoretical exercise for us. Thorough research gives us the confidence to take positions and *not* to get shaken out by volatility because we have a deep understanding of what makes the industry or the company tick. And that also allows us to buy under pressure. We're trying to gain the knowledge and the insight to be able to do that because that is how you get bargains – and that is how you end up getting potentially very attractive returns on a risk-adjusted basis.

Keith: It is also part of the reason that we think holding concentrated portfolio positions makes sense. We can't possibly know 200 or 300 securities as well as we can know 25. And we want to understand these things. We will almost never – no, I will say "never" – we will never understand a business as well as the people who have run it for two or three decades. But we can come close sometimes. Our goal is to try to understand the very good businesses that we like better than anybody, other than their managements. That's the goal. We may not get there all the time, but that's our goal.

Larry: We can, of course, be more objective than the managements, too.

If there's one generalization you can make about corporate managements, it's that they're always wrong at turning points. In either direction. But how about illustrating your methods with a few examples?

Keith: Well, sometimes, as Larry mentioned, knowing history helps. As of now, we haven't really made any money on this idea, so it's still interesting, but we bought a stake in **Jefferies** (JEF) in the wake of the MF Global debacle, when a pundit got up on CNBC and said, "These guys are next."

Because?

Keith: Well, we've known the guys who run Jefferies – we've known their largest shareholder – for decades, many years. We understand how they think; we understand their approach to risk. We knew it was *impossible* that they'd be the next to go the way of MF Global. Jefferies' balance sheet is as transparent as you get on Wall Street.

That's not exactly a tough comparison—

Keith: I mean they have only a tiny, tiny fraction of their assets listed as level 3 assets that aren't traded on exchanges. Go ask Goldman or Morgan Stanley to explain *their l*evel 3 assets. It's almost impossible. So in Jefferies you have guys that have a risk-averse culture that have run a sensible business, that have a long history of generating double-digit returns on equity. And we were able to buy a good chunk of its shares at a significant discount to fully diluted tangible book value with the expectation that going forward some things are really playing to Jefferies' advantage. They're *not* a bank and they're not regulated as a bank, one of the few Wall Street firms that isn't now. Its European competitors are all pulling back to deal with troubles at home. Meanwhile, Jefferies has been hiring people and building an infrastructure. One day, when the world is a little bit better than it has been recently, all of the sudden they're going to start *printing* money. So in Jefferies, we got everything together that we wanted. We got management, we got conservative nature and we got shares at the right price – As a result of having a long history of understanding the way that the company behaves because we've followed it for a long time.

Larry: So when the price got smashed by a strange circumstance, we could look at each other and say, "that doesn't sound like it makes sense."

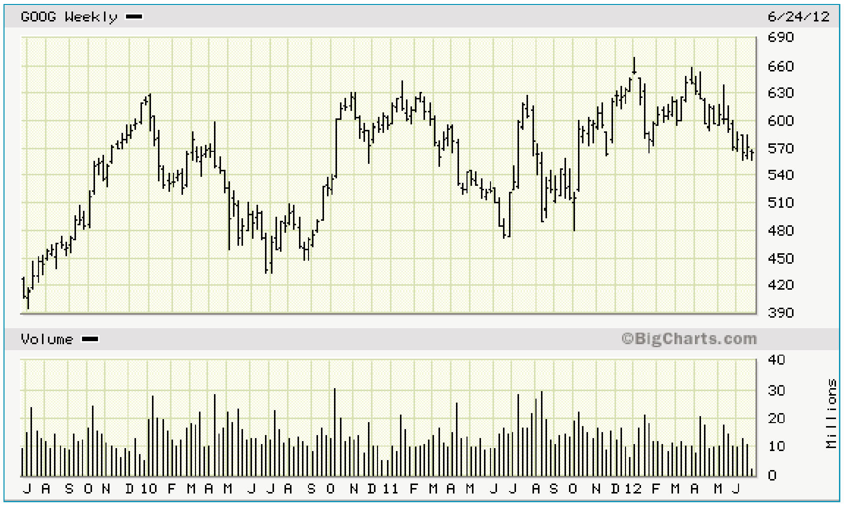
Keith: Yet the stock price is still in the toilet.

Larry: Well, it quickly went up 50%, then it fell right back down.

With most of the Street.

Larry: Well, look at results. It's not a robust environment for either deals, banking or trading, but they're making a couple of dollars.

Keith: In a relatively brutal environment in which they're not earning any float on customer balances or anything like that, they are



trading at 10 times depressed earnings and at a discount to book and being run by very sensible, long-term-growth-oriented people.
Larry: And by the way, a 10% ROE in a horrific environment is hardly tragic!

Do you set out looking for companies clearing specific hurdle rates on ROA, or ROE, or whatever, before you'll dig into them?
Larry: You really can't have across-the-board hurdle rates. Jefferies is in a much different business from a profitability standpoint than, say, **Google** (GOOG).
Keith: Generally our hurdle rates relate more to how big a margin of safety we think we're getting. In other words, how big a discount are we getting to what we think a company's intrinsic value is?

Glad you mentioned that. There are as many definitions of "intrinsic value" in Wall Street as there are overpaid bankers. What does the term mean to you?
Keith: Just a couple of things. One, it's the price that you think a rational and well-informed buyer would be willing to pay for the entire company. It's the amount of cash that you would expect if the company liquidated itself and distributed the proceeds to shareholders. Or it's the present value of the amount of cash that you expect the company to generate over time, discounted back to the present. That's it. And those are all really just different ways of saying the same thing. An intrinsic value is not a point. It changes over time and it's typically a range of values. Our goal is to try to come up with a reasonable value based on what rational people would be willing to pay – and if we can buy something at a big discount to that, something that we like and that has favorable dynamics, great! We're more than happy to do so. So we are constantly trying to appraise businesses. And because if conditions change, the value of a business can change also, we try to be reasonably conservative. But that's not to say that a year from now, something that we think today is worth X, might not be worth 1.5 times X, because conditions have gotten a lot better.
Larry: Or maybe it might only be worth 75% of X because something changed in the wrong way.

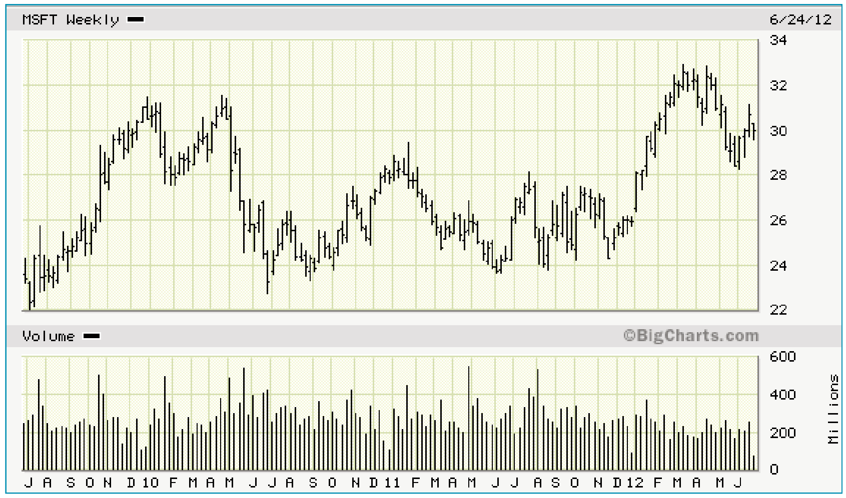
Hence the importance of buying at a discount to intrinsic value and with a margin of safety?
Keith: Right, because you're not going to be right all the time. *Nobody* is going to be right all the time, *ever*. We're going to make mistakes and we can tolerate small mistakes. But our major focus is to make sure that we avoid any big mistakes. And that involves coming in every day and questioning everything. Has anything changed? Is this still playing out the way I expected? Is this still cheap? You just have to have that mentality of trying to disprove your most beloved and cherished ideas. Of course, don't bring those concepts home with you and try to apply them to personal decisions. It won't go well!

Of course not. There's a critical distinction. You're not supposed to be *married* to your stocks, as you were saying. So where else have you been finding bargains?
Larry: Right now, there are three general buckets that we've gravitated towards where securities have gotten interesting. I would say one of those buckets is technology, where the digital economy is doing much better than the regular economy. There's still a tailwind in a lot of these businesses. Even though it's a competitive industry and it can change rapidly there's a certain amount of stability in the infrastructure side of the business. And stock prices are much cheaper than they've been in decades, really. In another bucket is, for the first time in many years, the property casualty insurance business. Then also there's what we like to think of as companies that really are not dependent on a robust economy to do well. They would seem to have pretty good prospects even if things stink for an extended period of time.

You mentioned Google. Is that an example of a tech that's caught your eye. It's pretty atypical for value guys to be into techs.

Larry: Maybe that's true but maybe they should be more open-minded. Cover up the name of the company and just look at the business results and the share price.
Keith: If I'm not mistaken, either this year or last at Berkshire's annual meeting, either Warren Buffett or Charlie Munger said that if they were just starting careers now, they might well decide to become experts in some area of technology rather than the things that they did become expert in. The number of devices with an IP address a decade from now is going to be vastly larger than what exists today. Technology keeps embedding itself further and further into the world. It's gone way beyond desktops. So the pie is expanding. Now, is the more competitive, tougher in some ways to analyze than trying to figure out which candy bar people will eat a decade from now? Yes. But, that doesn't mean that there aren't companies that don't have very strong proprietary positions, that are wallowing in cash. For example, Google. The company is just a cash machine. It may be one of the best financial businesses we've ever looked at and that is obscured in some respects by the fact that they spend heavily on lots of things where nobody knows what the hell they're doing, like driverless cars. I mean one of the interesting things about Google is that they have over 200 venture capital investments that nobody ever ascribes a value to. What are the chances that not even one or two of those turns out to be something big? But what Google really has done in its core business is disintermediate the ad agency model. They have become the ad exchange in the modern world – and that's a gross royalty business which is immensely profitable. We paid a low-teens multiple, and it looks even lower now. YouTube is still growing like a weed; Androids have half of the smartphone market. Wall Street likes to criticize GOOG for lack of focus because they have all of these things going on. But every time we meet with the company, boy, are they focused!
Larry: Scary focused!

Yet the stock has been just drifting for a long time –
Keith: In some respects, people have gotten bored with Google. The stock hit $700 two years ago; it's been wallowing and hasn't done much – we started buying in the high 400's. It's a terrific business run by some really good people.
By the same token, we started to buy **Microsoft** (MSFT) in the low-to-mid-20s when we started the fund. Basically, everyone was calling it dead



money a year ago.
Larry: The criticisms of what they'd done in the last five years were unbelievable. You'd have thought it was Enron! Inept, missed this, missed that, disastrous, it's was unbelievable!
Keith: And yet, since the tech crisis, revenues have more than tripled and they've quadrupled net income, or more. They still have this incredible persistency in the eco-systems of large companies. So, even though everybody talks about the growth in the tablet market, talks about unit sales of tens of millions, the PC market is a 400 million units a year machine market that is not going away. I mean, I can't do what I do on a day-to-day basis on a tablet. Yes, now there are changes taking place with virtualization, etc., and with the amount of technology that goes in the box? But the answer is that these guys are involved in all of that stuff. Microsoft is one of the biggest providers of software for servers out there. And there's the upgrade cycle. I saw some analyst say the other day that the Windows 7 upgrade cycle is over.
Larry: Geez, not from any of the field research we've done!
Keith: Larry and I ask every company that we ever talked to what operating system they're currently using. It was only I think two weeks ago that we had the first company answer "Windows 7." Everybody else is still on XP, which Microsoft won't be supporting in another two years, at all. So the upgrade cycle is also going to have a tailwind; Xbox has a tailwind and a lot of people overlook the fact that Microsoft *expenses* $10 billion of R&D annually. That's $1.25 a share. There's no way that is s maintenance capital. They are spending *HUGE* attempting to enhance the franchise and build the future. Microsoft also has big pile of cash, on which they're earning nothing. In reality, we

were paying probably seven times net income, not even net income adjusted for cash, for a company that is absolutely dominant in several important areas that just generates cash and seems to take an intelligent approach to capital allocation, buying back stock at cheap prices. They're starting to pay dividends; they borrowed a little bit of money. All these things make perfect sense in this environment. So can Microsoft stumble? Yes. Can they get carried off the field? Very, very difficult. Yet it's an example of something where people absolutely got disgusted because the stock price hadn't done anything in a decade? But why was that? Because a decade ago, it was trading at 55 times earnings.

How did you decide that the stock was cheap enough to buy?

Keith: Well, to a lot of people, at 20 times earnings, MSFT looked cheap because it was down from 55 times, but that isn't "cheap" to us. When we looked at it, we compared it to a bond in some respects. Which is something we try to do with everything. So we started to buy Microsoft at a level where we thought we were getting a 12% or 13% earnings yield that was growing. Well, it doesn't take much growth at that kind of starting point to force the stock price up.

Can I assume that you look at some version of cyclically adjusted P/Es and not at multiples of analysts' guestimates for the coming year?

Larry: We look at what we think a company can earn on a consistent basis in an imperfect environment.

Keith: We try to understand what makes sustainable free cash flow. As an owner of the business, what could we put in our pockets at the end of the year? If they were to pay it out. We have no problem with a good company reinvesting money. But, at the end of the day, what could the owners, if they wanted, take out of the business in cash after they'd spent everything needed to maintain the business, the franchise and everything else. What's left over for the shareholders is the number we focus on.

You guys told me a story the other day to explain your confidence in the stickiness of Microsoft's business — about WorldCom.

Larry: Basically, chief information officer-types don't rush to be first movers on switching thousands of employees to an unproven process – not when they've got a well-integrated solution that works well enough.

Keith: The first time we really understood that was when we dug into WorldCom, after its bankruptcy. We bought some debt after it filed, and then ended up buying the new equity when it came out. At the time, it was the biggest accounting fraud, *ever*. But in those days there were only three companies that could supply the telecommunications needs of large multinationals – really only two. There were AT&T, Verizon and Sprint, which was a distant third. So when we surveyed the CIOs of those companies, asking how important it was to them to have multiple bidders to provide those services, they said it was critical. But when we asked how willing they were to switch suppliers for a lower bid, all of the large company telecom types said, "No, no, we don't want to do that. I have 200 offices around the world and if I screw them up, that's my job. We like our suppliers. We just want to make sure they're giving us the right price." We heard it over and over, and the fascinating statistic, if I remember correctly, is that through its entire bankruptcy process, MCI only lost two enterprise customers – and it *gained* one! It was absolutely astonishing considering the awful publicity and turmoil.

So what I would argue is that what's happened in technology, in the 12 years since the internet bubble burst, is a significant consolidation in what we like to call "the plumbing of the digital world." When you pick up a cell phone or you hop onto your PC, or iPad, there is now this enormous under the pavement infrastructure makes all this information at your fingertips happen. It is data farms and server farms and huge storage arrays and the software to run it, etc. That business has consolidated to where there's a relatively small number of large companies in control of a lot of it. Those companies, I believe, have become very difficult to dislodge. Not impossible, but very difficult. It's **EMC** (EMC) in storage and Microsoft in operating systems and server software and Google in the ad business and even **Hewlett-Packard** (HPQ) in business machines to enterprise customers.

Yes, they're entrenched. But so was Kodak, to cite just one example.

Larry: Correct. But it still took quite a while. You do need a culture that is wakes up everyday being a bit paranoid.

Keith: Right, the interesting thing was it took Kodak more than a decade and a lot of bad decisions to destroy their franchise. Look, it's always good to have a culture that tries to upset your own stuff. If you're not willing to do so, you run the risk of watching as someone else does it. That's what happened to Kodak, and to a lot of the newspapers. The good news today is that a lot of that disintermediation process – probably the first and second waves – have already happened.

Let's switch to the property casualty companies. What gives you confidence they're not about to shoot themselves in the foot with competitive price cutting like they do every cycle?

Larry: Well, we're not even in a firm pricing market for them yet, but there are clear signs the environment is improving, and not in an insignificant way.

Keith: What's happening today is a different dynamic in the industry than a typical P/C cycle – partly as a response to the fact that the companies' interest income is running off. The difficulty of replacing higher coupon bonds is becoming insurmountable. Every bond that rolls off is painful to every one of these companies.

Larry: How would you like to be an insurance CFO and watching your income drop by two-thirds every time a bond rolls off?

No, thanks.

Keith: An insurance company generally has just three ways to make money. It can make money on its investments. It can make money on its underwriting or it can make money from an increase in flow. Well, an increase in flow gains them nothing today, because it they earn no interest in the short-term. On the investment side, their income is dropping and there's very little they can do about it right now. So the poorer performers in terms of underwriting are starting to realize that they can no longer continue writing business at the levels that they have been – because they'd lose too much money.

Which tends to tighten the insurance market, considerably because few of them actually underwrite profitably.

Keith: Exactly. Which are the ones that we're focused on of course. But we're starting to see general upwards price pressure across the board in a lot of different lines. It's not dramatic at this point. We're only talking about low- to mid-single-digit increases, but very widespread. The P/C market hasn't seen those kind of conditions in a long time and we think a lot of companies are really starting to get gun shy now, four years into a zero-rate environment. They have two choices. If you're that CFO, you can start to stretch for yield, which some of them are doing, or extend durations. Or you can keep your powder dry on the investment side and raise prices on the underwriting side. So at some point pricing discipline takes hold and our guess is it's going to persist for some time. As it does, and as at some point you do get a little upward movement in interest rates, these guys are going to be able to start investing at higher rates, and you're going to see profits climb significantly. So we're most interested in the companies that we respect not just underwriters but also as investors. We own some **Berkshire** (BERK.A), we own some **Alleghan**y (Y), and we own some **White Mountain** – all of which, except Berkshire, were acquired at significant discounts to book value and Berkshire was acquired close to book value.

Larry: Right, we waited and waited. We've owned Berkshire on and off for decades but we waited to put it in the portfolio in a meaningful way until it got very close to book value which was last fall, right before Mr. Buffett announced the repurchase. We wish he had a little longer. We would have bought a lot more if he'd kept quiet for another month.

Keith: Look, Berkshire is a wonderful business, but it's big and you're not going to get the kind of returns that you got when it was small. So in order to earn the kind of money we want to earn, we needed a pretty good price. So we waited and we got it, and as soon as we got it, we started to buy. Patience and discipline are vastly underrated characteristics in an environment where everybody's focus has gotten so short-term. In some respects it is a competitive advantage, I think.

The third "bucket" you mentioned holds companies that aren't especially sensitive to the economic environment?

Keith: Yes, Jefferies is one. Two others are Spectrum Brands (SPB) and Walter Investment Management (WAC). Spectrum has brands everybody knows but nobody has ever heard of the company. They sell Rayovac batteries and Remington Shavers and Tetra Fish Products and George Foreman and Black & Decker appliances. They are value brands and they have a strategy that really seems to have resonated with both retailers and consumers in an environment where everybody is looking to pinch a penny. Spectrum basically doesn't advertise its brands in any significant way. It effectively passes on those savings to the retailer and so the retailer ends up with what amounts to a branded private label product. That's a little bit of an oxymoron but they get a well-known name like Rayovac with a higher margin than some of the competition. We started buying Spectrum when it came out of a bankruptcy – it didn't go bankrupt because there was anything horribly wrong with the business. It went bankrupt because the previous private equity owner overleveraged the business.

Gee, what a shock!

Keith: After that, they took their best operating executive and put him in the CEO seat. The guy is just a terrific operator. We think he's done a great job. What we focused on was that coming out of the bankruptcy these guys were generating an awful lot of cash in a very consistent business and paying down debt at a fairly rapid clip. So value was accruing pretty rapidly and we bought it starting in the mid-to-high 20s, when we thought cash generation was on the order of $4 a share. Somebody at First Boston put out a report a month or two ago saying they expect free cash flow to be close to $5 a share in 2013. Still, there's very little research coverage. When we started there was none. We think one thing that has held back the stock is that the majority owner is Harbinger Group, which is controlled by Phil Falcone.

Who has a few problems these days.

Paradoxically, those problems might actually be helpful. One of our concerns going in, was although we thought we had some protection, was that we didn't want an owner that could take advantage of us by trying to buy the company back in on the cheap. But now we think it would extraordinarily difficult for him to do a transaction that would have bad optics.

I can't help noticing that you guys haven't mentioned trying to hedge your portfolios with any sort of derivatives or anything.

Larry: The short answer is we're skeptical about a lot of these things. If we can't quantify our exposure, we don't want to be there. Some of the stuff is so complex and in such big size and involves so many inter-tangled parties it's very hard to analyze even with the best of intentions. So we shy away from things that require us to draw conclusions about a lot of these instruments.

Keith: And that really encompasses, for example, all the large financial organizations in the country. We don't have a religious view against owning large financials; we don't have a religious view against owning financials, we own a whole bunch. But we own ones where we've gotten our arms around the critical issues. If we can't, we don't assume that it'll be okay, we just pass. We have no interest in entering into an open-ended commitment where in order to close out one commitment, you have to open a commitment with somebody else – which means it's really not closed out. You now have two commitments. That game is not for us.

Larry: As they say, it's not always the bad ideas that hurt you; it's the good ideas taken to an illogical extreme.

Words to the wise. Thanks, guys.

WOWS interviewee disclosure: Keith Trauner and Larry Pitkowsky are co-founders, managing partners and co-portfolio managers at GoodHaven Capital Management, a registered investment advisor that began accepting new accounts in March, 2011, and managers of the Goodhaven Fund, (GOODX). Goodhaven, This interview was initiated by *WellingonWallSt.* for informational purposes ONLY. Neither *WellingonWallSt.* nor Goodhaven, its principals and employees guarantee the accuracy, validity, timelessness, completeness or suitability of any information or data made available to you through this interview. This interview is published in good faith, and while WOWS and GoodHaven take reasonable steps to ensure its accuracy, they disclaim all warranties, express or implied, including, but not limited to, warranties of title, non-infringement, merchantability or fitness for a particular purpose, for the information provided in this interview. Neither WOWS nor GoodHaven will be liable for any damages or injuries arising out of your use of any such information or data, including without limitation, damages relating to any (i) error, omission, interruption, delay in operation or transmission, (ii) computer virus, worm, malware, spyware, "trojan horse" or "phishing" program (iii) failure or defect in any communication facilities, hardware or software, (iv) theft and destruction or unauthorized access to, alteration of, or use of information, whether resulting in whole or in part from negligence or otherwise. Your use of this information is at your own risk. Nothing in this interview constitutes investment, legal, tax, accounting or other advice and you should not rely upon it in making an investment decision. Nothing in this interview constitutes an offer or an invitation to make an offer to buy or sell securities or to provide investment services of any description. This interview is not directed at you, if we are prohibited by any law of any jurisdiction from making the information in this interview available to you. For further information on Goodhaven and the Goodhaven fund, see www.goodhavenllc.com and www.goodhavenfunds.com.