Value Investor INSIGHT

The Leading Authority on Value Investing

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The following excerpt, reprinted with permission, is from a feature interview with Larry Pitkowsky and Keith Trauner that appeared in the October 31, 2014 issue of *Value Investor Insight*.

INVESTOR INSIGHT

Larry Pitkowsky (*l*), Keith Trauner (*r*)
GoodHaven Capital

"Sometimes you smell smoke and most people want to run. We're wired to walk toward the smell and check it out."

Editor's Note: *The Fairholme Fund became one of the great mutual fund success stories of the 2000s, but things didn't get off to a rousing start when Larry Pitkowsky and Keith Trauner teamed with Bruce Berkowitz to launch the fund in 1999. "It was a brutal period for value investors," says Trauner. "We were completely out of sync with the market until the bubble burst." Things went more smoothly for Pitkowsky and Trauner when they went out on their own in 2011 to launch GoodHaven Capital and its flagship GoodHaven Fund. They've chosen not to tinker with success, following the same basic strategy they employed at Fairholme. "The simple goal is to compound money as fast as we can without taking a lot of risk," says Pitkowsky. "That's the whole plan."*

Your bona fides as contrarians are well intact. What's the philosophy behind that?

Keith Trauner: The analogy we use is that sometimes you smell smoke and most people want to run, thinking there's a fire. We're wired to walk toward the smell and check it out. Maybe it's a fire, maybe not. Maybe we go into the building, maybe we don't. But we'll definitely take a look. The basic idea is that if you're looking for bargains, you're far more likely to find them among the unloved or unknown.

One of our first big purchases after starting GoodHaven was Microsoft [MSFT], when the stock was in the low- to mid-$20s and trading at 8-9x earnings. We play a game sometimes and pull out a *Value Line* sheet or something similar and cover up the name and say, "What would you pay for this?" If you did that with Microsoft, which had tripled revenue and more than quadrupled profits over the previous decade, you wouldn't come up with 8-9x earnings. But everyone had given up and thought it was dead money. Those are situations that interest us.

Larry Pitkowsky: Our goal is to put money into situations where we feel there's a lot of upside and very little downside. Risk can be greatly attenuated if you pay a low price and if expectations are already so low that the remaining downside is limited. That's clearly not the case with ideas everyone loves and knows about.

Give an "unknown" example.

LP: We bought into Spectrum Brands [SPB], which has a broad portfolio of consumer brands, not long after it emerged from bankruptcy in 2009. The company had gone bankrupt not because there was anything horribly wrong with the business, but because its private-equity owners had loaded it down with too much leverage. As we looked into it, we found a decent set of businesses, with capable new management, and a stock trading at 5x free cash flow. There was little Wall Street coverage, and the financials were off-putting because of a number of extraordinary charges. We thought it was a real gem and while it's done very well, we still own it and think it trades at a modest valuation.

Before talking about an idea or two, describe how you think about holding cash.

KT: There are two rules of thought on Wall Street about the future. The one most people follow is to try to decide what the world is going to look like going forward and on that basis make judgments on the industries and companies they buy.

The other school of thought, which we follow, says you respond opportunistically to what actually happens. It's not that we ignore the earnings power of a business or its competitive dynamics over time, but we're more interested in reacting to turmoil in the market that can cause forced selling. The best way to take advantage of that is to have cash available. If you look at public companies that have been run by great capital allocators – Berkshire Hathaway, Leucadia, Liberty Media – most of the time they have a fair amount of cash. When markets get rocky, they spend it on bargains and use that liquidity to great advantage. Eventually the stresses pass and

cash starts to build up again. We've tried to take that lesson to heart.

In an up market the liquidity looks like it's hurting you, but when prices on average are high, people don't think about the optionality value of cash. That value reflects what cash can buy in the future versus what it can buy today. Sometimes the difference can be enormous.

At Fairholme our level of cash varied from maybe 5% to 40%, probably averaging 20% over time. The level of cash in our current fund is in the mid-20s, down recently from the low-30s. It wouldn't surprise us to average around 20% in cash over time, and our experience tells us it doesn't have to hurt returns.

Why do you consider the optionality value in WPX Energy [WPX] so high?

LP: WPX was spun out of Williams Companies in January 2012 and pro-forma some already announced transactions will have more than four trillion cubic feet equivalent of proved reserves – mostly in the Piceance, San Juan and Williston basins in the U.S. – about 70% of which is natural gas, with the balance split between crude oil and gas liquids.

We were attracted to WPX because of the size and composition of its asset base and its extremely cheap stock price, but we kept our position small because the company struck us as undermanaged. Our view started changing in May when Rick Muncrief was named CEO. He recently worked for Continental Resources, but most of his experience was at Burlington Resources from 1980 until shortly after it was sold to ConocoPhillips in 2006. Burlington was one of the few oil and gas companies to combine a strong capital-allocation and bottom-line focus with engineering and operational excellence. That is not the industry norm, and it's not surprising that Burlington has turned out a number of strong CEOs, including Randy Limbacher at Samson Resources and Tom Nusz at Oasis Petroleum.

We spoke with as many people who had worked with Rick Muncrief as we could, and what came back was that he is a strong leader that people get behind, he's an excellent operator, he's a smart capital allocator, and he underpromises and overdelivers. He came in and has put his money where his mouth is, buying shares on the open market in June at $21.71 per share and in September at just over $26.

On October 9th he laid out a plan for WPX that calls by 2020 for a five-fold increase in oil production, to 81,000 barrels a day. He plans to increase domestic cash-flow margins on an energy-equivalent basis three-fold from today. Using only assets now on the balance sheet, he's looking to triple the market cap by 2020, translating into a share price of around $60. So you have a credible guy lay out a specific, credible plan to unlock value and then all the market cares about is falling oil prices. The stock today is off 14% since he made the presentation.

What are the key components of the thus far ignored plan?

LP: They're pruning some non-core assets, but the key initiatives revolve around allocating capital to higher-return reserves, mostly oil, improving drilling costs, making the supply chain more efficient, reduc-

INVESTMENT SNAPSHOT

WPX Energy
(NYSE: WPX)

Business: Exploration and production of natural gas and oil reserves that are located primarily in the Piceance, Williston and San Juan basins of the United States.

Share Information
(@10/30/14):

Price	**18.54**
52-Week Range	16.04 – 26.79
Dividend Yield	0.0%
Market Cap	$3.76 billion

Financials (TTM):

Revenue	$3.44 billion
Operating Profit Margin	(-16.5%)
Net Profit Margin	(-35.0%)

Valuation Metrics
(@10/30/14):

	WPX	S&P 500
P/E (TTM)	n/a	18.4
Forward P/E (Est.)	24.1	16.2
EV/EBITDA (TTM)	8.2	

Largest Institutional Owners
(@6/30/14):

Company	% Owned
T. Rowe Price	12.8%
Donald Smith & Co	6.2%
BlackRock	5.9%
Vanguard Group	5.9%
Millennium Mgmt	4.6%

Short Interest (as of 10/15/14):

Shares Short/Float	3.5%

WPX PRICE HISTORY

THE BOTTOM LINE

Because of falling oil prices the market seems to be ignoring the ambitious and credible plan the company's new CEO recently laid out to create shareholder value, says Larry Pitkowsky. That plan targets a tripling of the stock within five years, while Pitkowsky's "back-of-the-envelope" valuation pegs today's fair value at twice the current share price.

Sources: Company reports, other publicly available information

ing transportation costs as old contracts roll off, and reducing headcount. It's blocking and tackling from a management that knows how to block and tackle.

How are you valuing the shares, now trading at $18.50?

LP: We're always in the Buffett camp, much preferring to be roughly right than precisely wrong. When we go through the proved reserves, assess their quality, and assign values to them based on comparable transactions, we come to a back-of-the-envelope intrinsic value that is twice the current market value. That was before we had the new CEO, whose plan to us makes eminent good sense.

We also agree with the company's expectation for gas prices in the medium term to be in the $3.50 to $4.50 per BTU range, and for oil over that time to normalize at $80 to $100 per barrel. WPX has hedged 50% of its price exposure for the balance of this year as well as for next year. We don't at all need a perfect commodity-price environment for this to work. The company has a lot of flexibility in what it does and when and where it does it. You may see some delay of game based on lower energy prices for a time, but it's not going to change the basic math.

The shares of non-bank mortgage servicers like Walter Investment [WAC] have had a terrible run. Why are you bullish on its prospects?

KT: Walter and the other big players in the market, Ocwen Financial [OCN] and Nationstar [NSM], benefited from sort of a land rush after the financial crisis when large banks made the decision – sometimes voluntarily, sometimes not – to outsource a big chunk of their mortgage-servicing operations, primarily involving less-than-prime loans. In simple terms, Walter collects payments, works with delinquent borrowers and tries to maximize the cash flow to the loans' owners. It and other non-bank servicers claimed they'd have better outcomes than the large banks and have, over time, provided more value to both borrowers and investors. It was all like water running downhill. Walter now services around $250 billion in mortgages – as measured by the unpaid principal balance – up from less than $40 billion at the end of 2010.

Walter's stock has declined over most of the past two years due to a slowdown in outsourcing and a fairly weak housing market. Another significant issue has been an increase in regulatory risk, after New York regulators blocked the sale of a large Wells Fargo loan-servicing portfolio to Ocwen, and as the Consumer Financial Protection Bureau and other regulators have stepped up their scrutiny of the mortgage-servicing business.

In terms of market potential, we don't think the game is over for non-bank servicers. Roughly 20% of all residential mortgages are serviced by companies like Walter, but the addressable market of less-than-prime borrowers is probably one-and-a-half to two times that. There's no question growth will be lumpy, but that means there are an additional $1-2 trillion in mortgages out of $10 trillion in total that can make their way over time to non-bank servicers. Don't forget that anyone who was delinquent, defaulted, or went

INVESTMENT SNAPSHOT

Walter Investment
(NYSE: WAC)

Business: Manages and services residential mortgage loans, with primarily focus on less-than-prime loans originally made in the United States by FDIC-insured banks.

Share Information
(@10/30/14):

Price	**22.61**
52-Week Range	20.02 – 40.12
Dividend Yield	0.0%
Market Cap	$852.5 million

Financials (TTM):

Revenue	$1.37 billion
Operating Profit Margin	14.4%
Net Profit Margin	6.3%

Valuation Metrics
(@10/30/14):

	WAC	Russell 2000
P/E (TTM)	10.0	71.7
Forward P/E (Est.)	4.6	18.5
EV/EBITDA (TTM)	n/a	

Largest Institutional Owners
(@6/30/14):

Company	% Owned
Select Equity Group	13.8%
Birch Run Capital	11.3%
Baker Street Capital	11.3%
NewSouth Capital	10.0%
Amici Capital	7.2%

Short Interest (as of 10/15/14):

Shares Short/Float	22.7%

WAC PRICE HISTORY

THE BOTTOM LINE

Keith Trauner believes the big concerns weighing on the company's shares – the threat of tougher regulation and headwinds to even maintaining its current book of business – have been significantly overdone. Based on either a sum-of-the-parts net asset value or a multiple of normalized earnings, he thinks the shares are worth closer to the mid-$30s.

Sources: Company reports, other publicly available information

through a bankruptcy in the last few years is going to be viewed as a non-prime customer for a while, and large banks show little inclination to deal with less-than-prime customers on a servicing basis.

On the regulatory front, we believe Ocwen's problem with New York is specific to it and that other regulatory issues will be resolved in ways that may increase attendant costs, but won't alter the fundamental conduct of the business. Intensified regulation should actually prove to be an enormous competitive barrier to entry, benefitting companies in good regulatory standing, of which we have every reason to believe Walter will be one. In the end, regulators want to ensure that borrowers are treated fairly and that the outcomes for all involved are as good as possible. Walter to us furthers those goals rather than detracts from them.

At a recent $22.60, how cheap do you consider Walter's shares?

KT: The company essentially has four lines of business: mortgage servicing, mortgage origination – which it has stepped up considerably as big banks have pulled back on less-than-prime lending – reverse mortgages and asset management. The GAAP financial statements are complicated by accounting issues around mortgages and mortgage-servicing rights, so it's very important to strip that all away and understand the margin the company should earn on its base servicing and origination businesses. When we do that and use conservative assumptions, we conclude that on its $250 billion in mortgages today, Walter can earn normalized free cash flow of $3 to $4 per share. That assumes no growth and no increase in interest rates, which would make servicing more valuable because pre-pay rates would decline.

If $3 to $4 per share is the steady state, what yield would you require to own that "bond"? You'd arguably take less than 10%, but even at 10% the share price would be $30 to $40. That's consistent as well with the net asset value of $35 we get when valuing each business line on a sum-of-the-parts basis.

Are you counting on big new portfolio purchases to replace paid-off or defaulted mortgages?

KT: Our best estimate is that Walter will have to replace $25-30 billion in unpaid principal balance per year. Even in a tepid market, they've been originating $15-20 billion in mortgages through their own platform, so that leaves only $10-15 billion that they'll have to acquire from other sources. That shouldn't be a big number for them.

Is leverage a concern here?

KT: The company is financially leveraged, but generates significant cash and high returns on capital deployed. It recently formed a joint venture with a partner that will allow Walter to pursue new deals to acquire mortgage-servicing rights without employing its own balance sheet, which should bring leverage down fairly quickly as new business is added that requires little or no capital.

The biggest nagging concern is probably that the new CFPB and the states become not just zealous, but punitive. Anything is possible, but we'd argue that would be counter to the interests of the mortgage market overall – which also seems to be the view of the government mortgage agencies and their regulator.

You mentioned earlier that your portfolio's cash balance has been coming down. Do you expect there to be more bargains on the way?

KT: One of the difficulties of the last twelve months or so has been that there has been very little stress, very little fear and very little volatility. That doesn't play to our strengths and has hurt our recent relative performance. But for value investors running fairly concentrated portfolios, you have to be able to psychologically accept that there are going to be times when you are completely out of sync with the rest of the world. If we're right on valuations, eventually we should be right on returns.

Volatility from time to time helps us immensely. We don't know how long it might last, but volatility like we've had in the past few weeks should continue to create opportunity. VII

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 it may be obtained by calling 1-855-OK-GOODX or by visiting www.goodhavenfunds.com. Read carefully before investing.

Fund holdings and or/sector allocations are subject to change at any time and are not recommendations to buy or sell any security.

As of August 31, 2016 the top ten holdings of the Fund were: WPX Energy, Inc.* (12.3%), Barrick Gold Corp. (11.2%), Alphabet, Inc. – Class A and Class C (5.9%), Birchcliff Energy Ltd. (4.2%), White Mountains Insurance Group (4.1%), Spectrum Brands Holdings Inc. (3.7%), Federated Investors Inc. – Class B (3.5%), Hewlett Packard Enterprise Co. (3.5%), Leucadia National Corp. (3.4%), and Alleghany Corp. (3.1%). [Total top ten: 54.9%]. Please note that top ten holdings excludes cash, money market funds and Government and Agency Obligations. * Total for issuer; includes common stock and corporate bonds.

Mutual fund investing involves risk. Principal loss is possible.

References to other mutual funds should not be interpreted as an offer of these securities.

Earnings growth is not a measure of the Fund's future performance.

Diversification does not guarantee a profit or protect from loss in a declining market.

It is not possible to invest directly in an index.

The Securities and Exchange Commission (SEC) does not approve or disapprove of any investment.

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Russell Midcap Index-- The Russell Midcap Index measures the performance of the mid-cap segment of the U.S. equity universe. The Russell Midcap Index is a subset of the Russell 1000® Index. It includes approximately 800 of the smallest securities based on a combination of their market cap and current index membership.

Return on equity-- The amount of net income returned as a percentage of shareholders equity. Return on equity measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.

Cash flow-- Earnings before depreciation, amortization, and non-cash charges.

Free cash flow-- A measure of financial performance calculated as operating cash flow minus capital expenditures. Free cash flow (FCF) represents the cash that a company is able to generate after laying out the money required to maintain or expand its asset base.

Price-to-book value-- A ratio used to compare a stock's market value to its book value. It is calculated by dividing the current closing price of the stock by the latest quarter's book value per share.

Basis points-- A unit of measure used in finance to describe the percentage change in the value or rate of a financial instrument.

Dividend yield-- A financial ratio that shows how much a company pays out in dividends each year relative to its share price.

Market capitalization-- The total dollar market value of all of a company's outstanding shares.

Price-to-earnings-- A valuation ratio of a company's current share price compared to its per-share earnings.

Forward price-to-earnings-- A measure of the price-to-earnings ratio (P/E) using forecasted earnings for the P/E calculation.

EBITDA—Earnings before interest, taxes, depreciation, and amortization.

EV/EBITDA—A comparison of enterprise value and earnings before interest, taxes, depreciation and amortization.

Architecture Billings Index-- A leading economic indicator of demand for commercial and industrial building activity.

S&P 500 Index-- A capitalization weighted index of 500 large capitalization stocks which is designed to measure broad domestic securities markets.

Sum of the parts-- Valuing a company by determining what its divisions would be worth if it was broken up and spun off or acquired by another company.

Russell 2000 Index-- The Russell 2000 Index measures the performance of the small-cap segment of the U.S. equity universe and is a subset of the Russell 3000® Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.

EU-- European Union
ECB-- European Central Bank
BTU-- British thermal unit
OEM-- Office of Emergency Management
CDO-- Collateralized Debt Obligation
CLO-- Collateralized Loan Obligation
NOL-- Net Operating Loss
CFPB-- Consumer Finance Protection Bureau

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