



The PM's Perspective

Colin Morris on Finding Inefficiencies in Large-Cap U.S. Equities

Colin Morris on Finding Inefficiencies in Large-Cap U.S. Equities is the second issue of *The PM's Perspective*, a series of interviews with senior members of First Eagle's investment teams. As a firm with a long tradition of independent thinking, we invite you to read market views and strategic insights that come straight from our investors. Whatever your viewpoint, we believe you'll find them of interest.

Q: How do you integrate top-down and bottom-up elements in your investment process?

We choose stocks on the basis of a bottom-up process. We have a very disciplined methodology for estimating a company's future cash flows, and we seek to purchase those cash flows at a price that gives us a margin of safety. But, at the same time, we are also very interested in how macro events could impact a company's results, and we derive many of our investment ideas from a top-down analysis of these events. For example, we have a thesis that it will become less and less acceptable for countries with cheap currencies and cheap input costs to manufacture goods domestically and dump them on world markets. China is starting to bump up against not just political and currency and transport costs, but also environmental costs. At the end of the day, we believe that this macro event will restore some pricing power to U.S. manufacturers, which have been largely unable to raise prices in recent years.

Q: In addition to macro events, you also look at a lot of corporate-specific events—restructurings, management changes, M&A, spinoffs. Tell us about one you've been involved with recently.

A corporate event is often the catalyst that unlocks a company's inherent value. Ford is a good case in point. U.S. automakers had been given up for dead by the rest of the world and by most U.S. investors, but the restructuring that took place in the

U.S. auto market was very dramatic. The cost-cutting at Ford—the restructuring of employee-based compensation—could never have been achieved in a normal world. It could only be done under the threat of going out of business and losing everything. And Ford did it without going through a bankruptcy.

We put that cost equation on top of the company's ability to bring out better products on a global platform that allowed it to amortize costs on a worldwide basis. Ford was taking market share. When we saw that second-hand Fords were trading at a premium to equivalent second-hand Toyotas, we knew how strongly consumers were responding to Ford's quality improvements.

In short, the profound restructuring at Ford created a lot of value. We initiated a position at prices we thought reflected a significant discount to the value being created by the restructuring, and exited when we thought the valuation fully captured that value.

Q: What other kinds of opportunities are especially interesting to you now?

Recently, we've been more focused on companies selling to the domestic U.S. market rather than to markets abroad. This reflects our macro concern about high food and energy prices around the world—particularly in developing countries where inflation in these costs can create serious burdens for consumers and provoke social instability. In the aggregate, S&P 500 companies derive some 45–50% of their revenues from outside the United States, but more recently we've been making a conscious effort to emphasize those businesses that have domestic end-markets.

For example, we recently bought a company with a lot of U.S. timberland. The event that triggered our interest was the company's transformation from a corporation into a REIT. We like the tax efficiency of the REIT structure, and we also like the company's long-term prospects. Today, there are some 525,000 housing builds a year in the United States, but normal housing demand is in the vicinity of 1.5 to 1.6 million homes. If you look at the demographic growth in this country, you realize that once we work through the current excess housing inventory and return to anything half-way like a normalized environment, in our opinion, it is going to provide a boost to the dividend yield that this REIT will pay, based upon its cash flow from the timber business. Additionally, timberlands may see their value increase further as sources of carbon sequestration if global warming regulations and related emissions trading credits take hold. In the meantime, this REIT is operating profitably in a very depressed housing market and providing a 3% dividend yield, which is taxed as a long-term capital gain. In other words, we believe we're getting paid reasonably well to wait for the housing market to turn.

We also managed to purchase some U.S. natural gas power assets with 10–12% free cash flow yields. Any improvement in U.S. power demand and gas demand is going to provide upside potential to these companies, just as an improvement in housing will provide upside potential to our timber company. We also foresee increasing demand for gas-fired electricity as a cheap and clean alternative to coal-fired electricity, which produces mercury and other emissions.

Opportunistically, we've also taken positions in a couple of large U.S. regional banks that have low-cost deposit franchises and great distribution. These banks weathered the credit storm better than most of their peers, which is a reflection of their underwriting discipline. They generate capital at attractive rates. And they were able to strengthen

their franchise through the acquisition of distressed competitors at very distressed prices. We think they're likely to return capital to shareholders through dividend hikes in the near-term, and share repurchases further down the line.

Q: You invest in the U.S. equity market, but you also keep an eye on other markets. Why are they important to you?

You have to look outside the box of U.S. equities in order to understand what the risk/reward in the equity market really is. In the case of Ford's restructuring, for example, the benefits first flowed to its bonds. We had a healthy and honest recognition that, at that point, the risk/reward ratio for Ford's bonds was more attractive than for its stock. Afterwards, we recognized that the improving economics would roll to the equity market, as opposed to the bond market. At that point, we were able to participate in the stock story. Because we're arbitrageurs, we look at our market, the U.S. equity market, in the context of other markets.

We also keep an eye on commodity prices and on the emerging markets. We like to own hard assets as a potential hedge against inflation. Today, many investors are flocking overseas to get all these emerging market opportunities and hard assets, but we can buy U.S. oil and gas companies that, if put up for sale, have the potential to be bought at a premium by international mega-cap companies eager to get that oil and gas out of the ground. And you can invest in these hard assets in a liquid, U.S. dollar-based market, with all the laws and regulations that protect equity investors here, free from many of the risks of social unrest, political instability and expropriation that are endemic in many offshore markets. That's another kind of arbitrage.

Q: Today, investing in large-cap U.S. equities makes you a kind of contrarian.

In the last two years, investors have been saying, "There's no value to be created in the large-cap equity space in the United States. We'd rather put our money in ETFs and passive strategies and put it overseas because there's a lot more value there." This is creating opportunities for people who are independent, strategic thinkers. But it's also true that these valuation gaps—once recognized—can contract very fast. Our strong track record in evaluating corporate change allows us to act swiftly, and this is a key competitive advantage.

Q: Are you bullish on the U.S. economy?

We do not take a view on the future. That being said, there's a lot that could go wrong here. Government debt continues to rise, unemployment remains too high, the Fed's ability to stimulate the economy may be waning. At this moment, I think the U.S. equity market is a good place to allocate capital because it's basically the least-bad alternative. U.S. producers have strong balance sheets and I believe there's at least a decent chance that they'll regain some pricing power in the coming years. I believe what's happened to the U.S. auto industry could be just the beginning in terms of U.S. corporations exerting themselves on a world stage and competing successfully out there.

I feel that a lot of the companies we own, like the timberland, the oil and gas in the ground, the healthy banks that are going to take market share and expand their loan portfolios when the economy eventually grows—I think that there's a reasonable possibility that all these companies will continue to generate good free cash flows and that these valuations will provide investors with very solid returns over the next five years.

Q: How would you summarize your approach?

When there are dislocations within the overall market or an industry or a specific stock—whether because of a macro-influenced event or a company-specific event—we analyze the risk/reward in seeking to provide excess return to our clients, above and beyond those of passive funds. Thanks to the depth of our experience working together as a team, we can decide very quickly whether or not in our view an event is being appropriately reflected in a company's share price. When it is not, we try to capitalize on it quickly.

At the end of the day, the portfolio is constructed by end-market risk and opportunity, but it's concentrated in about 25 positions in U.S. companies that we believe are number one or two in their respective industries.

Colin Morris, Portfolio Manager

Colin is the lead Portfolio Manager of the First Eagle Investment Management U.S. Equity strategy. He joined First Eagle in July 1992 as a Senior Vice President, becoming the Portfolio Manager of an event-driven arbitrage fund in January 1993. As of January 1996, Colin assumed portfolio management responsibility of the Firm's U.S. Equity strategy. He came to First Eagle from Mabon Securities, where he was a partner responsible for arbitrage investments from July 1988 to July 1992. Prior to that, he was a senior analyst in Mabon's arbitrage department in 1986 and 1987. Before Mabon, Colin was an analyst at Mitchell and Associates, a boutique mergers and acquisitions investment company. He holds a BS degree in Engineering from the University of Cape Town and an MBA in Finance and Economics from Columbia University.

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