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Issue XIII

Fall 2011

Lee Cooperman — “Buying Straw Hats in the Winter”



Leon Cooperman

Leon “Lee” Cooperman ’67, CFA, began his post-business school career in 1967 with Goldman Sachs. In addition to holding a number of key positions within the firm, Mr. Cooperman was founder, Chairman and Chief Executive Officer of Goldman’s Asset Management division. In 1991, he left the firm to launch Omega Advisors, Inc., a value-oriented hedge fund which now manages roughly \$5.5 billion. Mr. Cooperman earned his B.A. in Science from Hunter College and his M.B.A. from Columbia Business School. Mr. Cooperman and his wife are signatories of Warren Buffett’s “Giving Pledge”.

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Mario Gabelli — “Think Like an Owner”

Mario Gabelli ’67, CFA, started his career as an automotive and farm equipment analyst at Loeb Rhodes & Co. In 1977 he founded GAMCO Investors (NYSE: GBL), where he is currently Chairman and CEO, as well as a portfolio manager and the company’s largest shareholder. GAMCO now manages roughly \$36 billion dollars across open and closed-end mutual funds, institutional and private wealth management, and investment partnerships. Mr. Gabelli earned his B.S. from Fordham Univer-



Mario Gabelli

sity and his M.B.A. from Columbia Business School.

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Marty Whitman — “Business Skill Critical to Investment Success”

Mr. Whitman founded the predecessor to the Third Avenue Funds in 1986 and M.J. Whitman, a full service broker-dealer affiliated with Third Avenue in 1974. He has managed the flagship Third Avenue Value Fund since its inception in 1990 and was Third Avenue’s Chief Investment Officer from its founding through January 2010.

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Marty Whitman



Pictured: Bruce Greenwald, named the "Guru to Wall Street's Gurus," at the Columbia Student Investment Management Conference in February 2011.



Investor Warren Buffett receives a gift from students on a Heilbrunn-sponsored trip in March 2008.

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Welcome Back to *Graham & Doddsville*

We are pleased to present you with Issue XIII of *Graham & Doddsville*, Columbia Business School's student-led investment newsletter, co-sponsored by the Heilbrunn Center for Graham & Dodd Investing and the Columbia Student Investment Management Association.

This issue features a trio of legendary value investors, who honored us with their time and sage advice. One thing became crystal clear: there is no single "right" way to practice value investing. Each successful value investor adapts the practice to his or her own style, although Graham & Dodd and their famous disciples remain an inspiration to so many of us.

We start off this issue with Lee Cooperman '67, founder, Chairman and CEO of Omega Advisors, Inc. Mr. Cooperman reflects on the path of his incredibly successful career, describes how his firm constructs its portfolio, and outlines the theses behind a few of his top investment ideas.

We also had the privilege of speaking with Gabelli Asset Management (GAMCO Investors) founder, Chairman and CEO Mario Gabelli, well-known value investor and alum of Columbia Business School's class of 1967. Mr. Gabelli provides his approach to security analysis and discusses his interest in BEAM, National Fuel Gas and The Madison Square Garden Company.

Our third interview is with veteran value investor Marty Whitman, Third Avenue Management's Chairman and Portfolio Manager, and an Adjunct Professor of Distress Value Investing at Columbia Business School. Mr. Whitman shares his thoughts on some compelling areas of investment opportunity, discusses his approach to company valuation and describes some of his firm's most successful investments.

Please feel free to contact us if you have comments or ideas about the newsletter. We hope you enjoy reading *Graham & Doddsville* as much as we enjoy putting it together!

- Editors, *Graham & Doddsville*

(Cooperman from page 1)

G&D: After graduating from Columbia Business School, you began your very successful career at Goldman. What drew you to the sell-side following business school?

LC: Something that I should mention, before addressing my time at Columbia and Goldman, was my decision to not pursue a dental education. This was the most difficult decision I had made in my life up to that point. Back in 1963, if you completed your undergraduate major and minor in three years, you could count your first year of den-

tal or medical school toward your fourth year of college and receive a separate degree. I finished my science major in the summer of 1963, which enabled me to enroll in dental school. After being in dental school for about eight days, I wasn't sure that was the direction I wanted to go. This became quite a traumatic situation. I had to go to the dean of the dental school and tell him I wanted to matriculate back into the undergraduate school to complete my fourth undergraduate year unencumbered. The dean put me on a great guilt trip, telling me that I had deprived the 101st applicant of a dental educa-

tion, that the school would be losing revenues for the next four years and that I couldn't possibly know what I wanted to do after eight days. The only person who really appreciated the significance of my decision was the dean of Hunter College. I went back to Hunter and, since I had finished my major during the summer, took 10 elective courses in economics and received 10 A's. That furthered my interest in business. Upon graduation I went to work for Xerox up in Rochester, NY as a quality control engineer.

After about 15 months I

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Lee Cooperman

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decided I wanted to get an MBA to advance my credentials. I wanted to stay in the New York area and I was interested in finance, so Columbia was a natural fit. With great modesty, I would say that I was an attractive package coming out of Columbia Business School. I was Beta Gamma Sigma, had straight A's, a 6 month old child and was a serious person. Wall Street was hiring with abandon, a lot of which had to do with the market cycle. I was interviewing in 1966, which was a year in which the market was peaking, though no one knew that. I accepted an offer with Goldman Sachs, which at the time was not what it would become a decade or two later. This was fortunate because I was able to contribute, in a small way, to the firm's later success.

I got my MBA on January 31, 1967. I had a six month old child and I had no money in the bank so I was not in the position to take the obligatory trip to Hawaii or Australia. I started as an analyst at Goldman the next day. I then spent close to 25 glorious years with the firm.

I had a number of different roles in the company. For example I was made Partner in charge of research in 1976 and, at the same time, I was Chairman of the firm's investment policy committee. For a number of years, I had been telling Goldman

management that we were making a mistake not being in the asset management business. The firm, being a brokerage house, was strongly opposed to what they considered competing with their client base. Every brokerage firm at the time was largely in this business. Once Salomon Brothers and some others announced their launching of an asset management business, Goldman leadership asked me to establish one of their own. I left research at that time and became Chairman and CEO of Goldman Sachs Asset Management.

This was the beginning of my exit from the firm. They wanted to capture as many assets as possible because they wanted to build the business to a scale that would be relevant to a firm like Goldman Sachs. On the other hand, my motivation was the proper performance of the assets in my control. I realized after a short time I didn't want to be on the road every week, introducing a new product and sourcing new funds. I wanted to spend my time visiting companies and finding new mispriced stocks. I wanted to manage money in such a way that my interests and the clients' interests were 100% aligned. I did not want to build a big business like Goldman Sachs wanted me to. I have the highest respect for Goldman, but it was the firm's reluctance to go into the hedge fund business that led to me start Omega.

My last day at Goldman was November 30th, 1991 and I started Omega the very next day. Over the past twenty years I've been raising the money, hiring the people, running the money and setting up the infrastructure. It's kind of been non-stop. I'm getting older but I'm still handling it okay.

G&D: Did anyone or any investing class at Columbia Business School have a particularly significant influence on you?

LC: Yes, there was one person who had a profound influence on me. I even have a letter he sent me in 1977 hanging on my wall. His name was Roger Murray, Benjamin Graham's successor as the professor of security analysis at Columbia and, in fact, a subsequent editor of the book *Security Analysis*. Mario Gabelli, a very dear friend of mine, also studied under him and would probably say the same thing. As our value investing professor, he showed a great deal of excitement for the subject matter. I would also say Warren Buffett influenced me tremendously. I'm an expert in his writings and his views. Finally, Graham and Dodd influenced me as well. Their book *Security Analysis* is sitting right there on my shelf.

G&D: How has your approach to investing changed

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“... there was one person who had a profound influence on me. I even have a letter he sent me in 1977 hanging on my wall. His name was Roger Murray, Benjamin Graham's successor as the professor of security analysis at Columbia and, in fact, a subsequent editor of the book *Security Analysis*.”

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Lee Cooperman



Pictured: Benjamin Graham,
father of value investing.

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since 1991?

LC: Not in an appreciable fashion. The bulk of our portfolio is long-term oriented bets. We do a certain amount of trading - a quarter of our portfolio turns over more actively. I think the major change was a result of the drubbing most of us took in 2008. I did not do a good job of controlling losses. I invested a certain amount of responsibility in my associates and they showed, in the end, an inability to sell. So now I'm more willing to sell when things don't look like they're going in the right direction.

I would sell a security for one of four reasons. The first reason is the highest quality reason. That is when you buy something with a price objective. When it appreciates to that price objective, and you think it's fully valued, you sell it. The second reason is when, based on calls to our companies, their competitors and their suppliers, things are not moving along the originally anticipated lines so you get out before you get murdered. It is very hard in this market, which is choppy and not really going anywhere, to make up for big losses so you have to sell before you get creamed. A third reason we sell is when we find an idea that's more attractive than the idea we're acting on already. So we'll sell something to

buy something that we think has a better risk/reward ratio. Finally, the fourth reason we sell something is when our market outlook changes. Since I don't tend to buy and sell market futures to an appreciable degree, to effect this macro-driven repositioning, I have to sell specific securities.

So I would say the big

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change is my willingness to sell. This is very difficult for a value investor because if, for example, you liked Ford Motor at \$20, you should like it more at \$18 and even more at \$15. But there are times when the market has figured out what's going on before you, the fundamentalist, have figured it out. Let's face it, although not

perfect, the stock market is one of the better leading indicators. Some people are wary of the information the stock market is imparting because, they would say, it has priced in 10 out of the last 7 recessions. In my opinion, however, that's a better record than most economists.

G&D: What about the de facto value investing motto that if something you've liked goes down, buy more and, if it falls further, just buy more?

LC: Well, there are those times when you've made a fundamental mistake - you've misjudged the company's competitive position, you've misjudged the economy, you've misjudged the stock market. I think you just can't afford to say, "I know more than the market". Of course, it depends on the company. There are certain things you can be stubborn on such as when you have a big dividend yield, a big discount to book value, an extremely low valuation. But I think, generally, you have to respect the stock market. If you don't, you're going to get wiped out.

G&D: How do you personally think about valuation? What types of techniques do you use?

LC: There are a lot of different approaches. We use the dividend discount model

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to identify undervalued stocks as a screen. Essentially, I know what the financial statistics are for the S&P and as a value investor, I'm looking for more but for less. I'm looking for more growth at a lower multiple. I'm looking for more yield versus what I can get from the S&P. Or, I'm looking for more asset value.

I'd say a theme that runs throughout a lot of our portfolio holdings is the concept of public market value versus private market value. About 95% of publicly traded companies have two values. One is the auction market value, which is the price you and I would pay for one hundred shares of a company. The other is the so-called private market value, which is the price a strategic or financial investor would pay for the entire business. So one of the approaches I take is to look for a stock in the public market that is selling at a significant discount to private market value where I can identify catalysts for a potential change. In the last year we had four take-overs in the portfolio.

We try to find some set of statistics that motivate us to act. The analogy I have always used is that when you go into the beer section of the supermarket, you see 25 different brands of beer. There's something that makes you reach for one particular brew. In the parlance of the stock market,

there's some combination of return-on-equity, growth rate, P/E ratio, dividend yield, and asset value that makes you act. We have a diversified group here looking for attractive ideas, and different industries get capitalized in different ways. If you want to be a broad-based investor you have to be willing to embrace different approaches. For example, although we are value-orientated investors typi-

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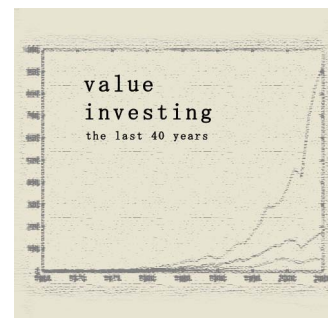
cally looking at the traditional valuation metrics, we do have a technology analyst who is studying things like rate-of-change and following Citrix Systems and Apple, which we own.

G&D: What are the characteristics of a business that you'd want to own for a long period of time?

LC: To me, it's free cash flow *sine qua non* because that gives you the ability to intelligently redeploy your money. If you don't have the free cash flow, you don't have anything. Number two is a business that has a moat around it, where it's competitively insulated to some large degree. There are very few businesses that actually have a monopoly position today. Quality of, and incentives for, management are also very important. We look at management ownership to see whether their interests are aligned with the shareholders' interests and we look for their compensation levels to be reasonable. The compensation levels in corporate America are ridiculous in my opinion, and this is a big problem today. Hedge fund guys are overpaid but the good news about that is, you don't make the money unless you make the money for the investor. In corporate America, you're being paid to fail. A lot of times, guys are kicked out of companies and they leave with \$10, \$15 or \$20 million checks, which I think is ridiculous.

Back to free cash flow; I would obviously weigh-in the growth of the company too. I would love to own a company that has great in-

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Columbia Business School is a leading resource for investment management professionals and the only Ivy League business school in New York City. The School, where value investing originated, is consistently ranked among the top programs for finance in the world.

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Lee Cooperman

“The next big trended opportunity will be being short U.S. government bonds. They don’t belong at 2%. Historically, the ten year U.S. government bond yield has tracked nominal GDP...So if the ten year government bond yield was in that range of 4-6% that would not be unusual.”

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vestment opportunities in which it’s investing a lot of cash. I just want to make sure the money is invested wisely. A company has a number of uses for free cash flow. Management could choose to reinvest in the business through capital expenditures, buy other businesses, reduce debt loads, or pay out dividends. I just want to make sure management is channeling their cash into the right opportunities.

Corporate America has been very busy, particularly in 2008, buying back stock. Most of them have not known what they’re doing. There’s been a large amount of money wasted. I gave a presentation at the Value Investing Congress in 2007 where I said a lot of companies were mispricing what they were buying. I was highly critical and provided many examples of this development.

Analysts tend to be cheerleaders for corporate repurchase programs. In my view, these programs only make sense under one condition – the company is buying back shares that are significantly undervalued. Most management teams have demonstrated the total inability to understand what their businesses are worth. They’re buying back shares when the stock is up, and have no courage to buy when the stock is down.

G&D: Can you talk about

how you construct your portfolio?

LC: My portfolio construction is some combination of top-down and bottoms-up. We try to make money for our investors in a number of different ways. Stocks are high risk financial assets and short term bonds and cash are low risk financial assets. First, we spend a great deal of time trying to figure out whether the market is going up or going down because that will determine both the predominant performance of our portfolio and how much exposure we want to have to risky assets. The second way we try to make money is looking for the undervalued asset class. We look at government bonds versus corporate bonds versus high yield bonds. We think about bonds versus stocks, whether in the U.S. or in Europe. We’re trying to look for the straw hats in the winter. In the winter, people don’t buy straw hats so they’re on sale. We’re basically looking for what’s on sale. In 1993, we made a great deal of money in non-dollar bonds because we made a play on interest rates that was very right. In 1995 through 1997, we made a great deal of money in the debt of Brazil, Turkey and other emerging markets. In 2002, we made a lot of money in high yield bonds, and the same is true for 2009 and 2010. So we’re looking for the right asset class. Any study you’ll read on portfolio returns

will tell you that being in the right asset class is more important than being in any individual stock in any one year. Third, which is the bread and butter business where I spend the bulk of my time, is looking for undervalued stocks on the long side. I have a very value-oriented approach. Fourth, which has not been particularly productive for us, is finding overvalued stocks on the short side. Finally, we take 2-3% of our capital and invest in macro strategies. We might be long or short the dollar, we might be long or short a commodity.

It’s a small part of what we do but I like the macro strategies. The returns are not necessarily correlated to equities and at times you get a trend of opportunity that you can capitalize on. In my own opinion, the next big trended opportunity – though we haven’t put the trade on just yet – is being short U.S. government bonds. They don’t belong at 2%. They’re just way too low. Historically, the ten year U.S. government bond yield has tracked nominal GDP. If you think we’re in a world of 2-3% real growth and 2-3% inflation or potentially more, that would give you nominal GDP of 4-6%. So if the ten year government bond yield was in that range of 4-6% that would not be unusual.

I would also add that, over the years, our portfolio has

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on average been 70% net long, though right now we're about 80% net long. We tend to be more invested than most hedge funds.

G&D: So you're optimistic about the general outlook for the market?

LC: We're more optimistic than most. We don't believe that we're going into a recession but rather an environment of slow growth. We don't think we're another Japan. That's our opinion as well as Jeff Immelt's and Warren Buffett's. Recent auto sales and recent chain store sales suggest a decent economic environment. I also assume that the ECB will do for European financial institutions what the Fed did for U.S. institutions. In the end, they have no choice and I think they'll do it. They need to ring-fence Greece though, and make sure the mess doesn't spread to Spain and Italy.

One of the biggest concerns I have is social unrest. The labor force in America grows 1% per annum. Productivity of the labor force grows 2% per annum. So you need 3% growth to keep the unemployment rate flat and we're not growing at that rate. The global unrest and global demonstrations – "Occupy Wall Street," the demonstrations in Zuccotti Park, the Arab Spring, are all about unemployment. The

frustration over the lack of economic opportunity, particularly by the youth, is understandable. People are looking for a scapegoat. I had hoped that Obama would move more to the center and soften his anti-wealth and anti-business stance. He doesn't seem capable of doing that and his election underscores the unrest I'm referring to. The largest country in the free world chose as its leader a 48-year-old man who was a community organizer and had never worked in the business world. His election was a clear result of the frustration of the populace.

G&D: Is your technique for shorting mostly valuation driven?

LC: It's valuation driven or it's driven by a belief that the company's competitive position is in the process of changing. But if you look at the sources of our returns, short selling has not been an important part. The bulk of our returns have come from undervalued equities on the long side.

G&D: What have you learned from the market collapses of 2000-2001 or 2008-2009?

LC: We made money in 2000 and 2001 because we stuck with value. You only got creamed if you were buying these 100x revenues technology companies. So it was really 2008 that was a rough patch for us and it was very simple. We mis-

judged the significance of Lehman. As I mentioned, 2008 was transformative for me because, at the time, I allowed my people to hold onto their positions when I should've started kicking them out well before we got into the hole. One thing nice about the investment business is that, even though I'm 68, I continue to learn. You learn something every month and every quarter.

G&D: Could you describe the process your team goes through to generate investment ideas at the company level?

LC: When I hire an analyst, we put together a FactSet universe of companies that are within their sphere of expertise and those are the companies they follow. I monitor and judge their performance by how well they do penetrating the opportunities that 'Mr. Market' has presented. The way it works is that the analyst proposes an idea. The stock selection committee, which consists of four or five senior people at the firm, and me, dispose and debate the idea. This process represents about 75% of the activity of the firm. For example, this afternoon, we're discussing an apparel company that my analyst is strongly recommending we buy. He submitted his report for our review this afternoon. I ask these analysts, who are experts in particular areas, to find

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Pictured: Glenn Greenberg at the Security Analysis 75th Anniversary Symposium (Fall 2009), with Bruce Berkowitz (left) and Tom Russo (right).

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Pictured: Heilbrunn Center Director Louisa Serene Schneider at the CSIMA conference in February 2011. Louisa leads the Heilbrunn Center with much skill and grace.

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things that are going to outperform the market. Later, we'll have a meeting about the New York Stock Exchange, which the associated analyst is also recommending. Periodically, we'll operate with a shorter term timeframe because we think we've developed some information that other people don't have and we want to act on it before it becomes commonly known.

G&D: How do you evaluate management teams prior to making an investment?

LC: Benjamin Graham, in *The Intelligent Investor*, said you evaluate management twice in the decision-making process. Once, through the face-to-face interrogation. You ask them questions and they respond and you make a judgment about the quality of their responses. In addition, the quality of management also manifests itself in the numbers: in ROE (absolute and relative to competitors), return on total capital, growth rate, industry position, trend of market share, and profit margins.

G&D: Regarding the importance of management, with the unfortunate passing of Steve Jobs, how do you see Apple - one of your favored picks - impacted going forward?

LC: You can't replace a guy like Steve Jobs. At the end

of the day, they have a pipeline of products already in place that could probably last several years and they generate something like \$15-\$20 billion a year in free

"To me, 'value' means the value proposition that is being offered. A lot of companies Warren Buffett owns would not be considered value in the classical sense. A company can be growing at an extremely high rate but happens to be trading at a very reasonable multiple. Or that same company can be giving you your return through a fat dividend."

cash flow on top of \$80 billion in cash and marketable securities. No rational

person would criticize Jobs but I will criticize the company for their financial management. There is no basis for sitting on \$80 billion in cash and not paying a dividend and not buying back stock. They're projecting, in my opinion, temporary success. They're saying we don't know where the business is heading long term and we want to have this financial powerhouse. I'm told by people close to Jobs that he wanted to do a content acquisition, such as Disney if it had not been in the theme park business. Regrettably, for the world and for him, he's not around to execute that ambition.

I think Apple will do fine for a few years and we'll have to see after that. Right now, the major plus in Apple is the valuation. It seems ridiculously low for a company growing at its rate. Based on all of the checking I do, the users of the equipment at corporations are making purchasing decisions and the users all want iPads. They have a phenomenally high market share of a growing business that has very high profit margins. I'm sure one day, Apple will have issues but for the next few years it looks like clear sailing. Jobs left behind a financial powerhouse. Maybe one change that could be constructive is the better use of their cash. So you think eclectically. Apple has no dividend and no repurchase program but they

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generate gobs of free cash flow and they're in the right business.

G&D: Many in the value investing community say that Apple is not a true "value" stock. How would you respond?

LC: I think their definition of "value" has to be broadened. It's not just about trading below book value. To me, "value" means the value proposition that is being offered. A lot of companies Warren Buffett owns would not be considered value in the classical sense. A company can be growing at an extremely high rate but happens to be trading at a very reasonable multiple. Or that same company can be giving you your return through a fat dividend. My analyst thinks Apple can earn \$40 per share next year, which is 9.4x earnings. When this was printed, the S&P was at 11x earnings. So is Apple a growth company or is it a good value proposition?

What you want is some combination of financial statistics that yell, "Buy me." It could be an unusually high growth rate at a proper multiple or it could be a return upfront with modest growth. I'm very eclectic as an investor. In the '70s, the dominant investing institution was JP Morgan U.S. Trust, which espoused a philosophy of the "nifty fifty". They only wanted to

be in the best growth companies but had no regard for what they paid. They didn't care if they paid 60x or 70x earnings. During the eventual recession which followed a surge in interest rates, the prices of these stocks declined 50% or more. The multiples were all wrong. Their philosophy was "only the right stock at any price" whereas my philosophy is "any stock or bond at the right price."

G&D: It would be great if we could discuss a couple of specific stocks that you find compelling today.

LC: Well, I like KKR Financial (ticker: KFN), where the debt management arm has the ingredients that I look for. Right now their dividend yield is 9.75% in a world of zero interest rates and the dividend is covered twice by earnings. They earn about \$1.50-1.60 per share and they're only paying \$0.72, so they can grow the business over time. The real book value is somewhere around \$10 and the stock is \$7.75. So I'm buying something 20% below book, yielding in the high 9% range – which is competitive with the equity market's return annually, with motivated management that own a decent amount of stock in a decent business. KKR Financial is a mezzanine lender and they have the advantage of being on the KKR platform, which sees a lot of interesting deals.

Another one I like is Sallie Mae (ticker: SLM). Roughly 81% of their loans are guaranteed by the U.S. government and the bulk of the remaining loans are co-signed by the student's parent. So I think the quality of these assets is not bad. I think they'll earn \$1.80 this year and the stock is \$13, so half of the market multiple. The yield is about 3.5% and they're buying back 5% of their stock annually through the repurchase program and we think the assets are worth \$20 per share. The company is a consolidator of FELP loans. FELP loans are shrinking part of all bank balance sheets and therefore will slowly be sold as they're not worth the effort to hold. Sallie Mae is one of the few natural buyers in the market and is able to achieve attractive double digit IRR's on these purchases. In addition, the "sins" of Sallie Mae's past are burning off quickly. The amount of "non-standard" credit entering repayment is dropping very quickly. 2010 had \$572 million enter repayment, 2011 has \$320 million, and next year only \$112 million. With 40-50% loss ratio on these "non-standard" loans, credit at SLM will naturally improve. The company is shareholder friendly. As the FELP portfolio generates cash, we expect the company to complete the previously announced \$300 million repurchase program this

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"What you want is some combination of financial statistics that yell, "Buy me." It could be an unusually high growth rate at a proper multiple or it could be a return upfront with modest growth. I'm very eclectic as an investor ... my philosophy is "any stock or bond at the right price."

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Bruce Greenwald holds the Robert Heilbrunn Professorship of Finance and Asset Management at Columbia Business School and is the academic Director of the Heilbrunn Center for Graham & Dodd Investing. Professor Greenwald is an authority on value investing with additional expertise in productivity and the economics of information.

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year, and repurchase \$500 million in 2012. As financial institutions struggle for asset growth, SLM could become a nice niche acquisition target for any large bank over the next several years in the low \$20s range.

G&D: Could you walk us through other ideas that you find interesting today?

I also like Boston Scientific (ticker: BSX). The company generates \$1 billion a year in free cash flow, so you're getting a free cash flow yield of about 17-18%. They just achieved an investment grade credit rating so they're now in a position to take that cash flow and buy back stock or do tuck-in acquisitions to accelerate growth. Management seems very motivated to follow-through. Of course, the opportunity to buy cheaply is a result of their deal from hell, that being the acquisition of Guidant for nearly \$30 billion. Now we think they're on the way back. Due to the past issues, investors seem unwilling to look at the value of the business objectively. Old management is gone. BSX's private market value is much greater than public market valuation. Financial buyers could easily pay \$9.50/share. If the company was broken up and sold off in pieces or if a strategic buyer were to step in, BSX could fetch \$13/per share based on public comps or transactions done in the

past 24 months. It is a highly regulated business, and as it gets more regulated, it means that the costs of entering these businesses increase. Utilization will continue to increase with demographics and with healthcare reform, we will likely see more people coming into the system. In spite of pricing pressure, margins are still very attractive. The new management is shifting its focus on creating shareholder value in the near term, rightsizing cost struc-

"BSX's private market value is much greater than public market valuation. Financial buyers could easily pay \$9.50/share. If the company was broken up and sold off in pieces or if a strategic buyer were to step in, BSX could fetch \$13/per share based on public comps or transactions done in the past 24 months."

ture, improving profitability, selling non-core assets and buying back stock. Multiple new product cycles are coming in core franchises (stents, defibrillators, women's health), that will drive 500+ bps of operating margin improvement in the next few years.

We also like Transocean (ticker: RIG). The stock is currently around \$50 and we believe there is significant upside to it. RIG is trading at a very low P/E, P/CF, and EV/EBITDA multiples, and at a substantial discount to NAV and Tangible BV. The offshore drilling market is fast improving, especially in the ultra-deep water where RIG has the largest fleet. The overhang of legal issues from the 2010 BP "Macondo" disaster may start to be resolved over the next six months. RIG has a \$3.16 dividend (6.7% current yield) that we believe is sustainable for years, so investors are being paid to wait. Long-term contracts on its deepwater fleet will recover most construction costs and reduce the basic risk of RIG's business. RIG's 2011 EPS reflects low "revenue efficiency": contracted rigs are out of service for replacement of Blow-Out Preventers. This process will continue through 2011 but then end, so "revenue efficiency" will return to historical 90%+ level, from 82% now. Many Wall Street analysts don't have higher "revenue effi-

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Lee Cooperman

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ciency" in their projections. We believe consensus 2012 EPS could rise by \$1.00-\$1.50.

G&D: Which personal attribute has contributed the most to your success over the years?

LC: I would attribute my success to hard work, surrounding myself with good people, and a fair amount of luck. I remind my team of this proverb often: "Every morning in Africa, a gazelle wakes up; it knows it must run faster than the fastest lion or it will be killed.

Every morning a lion wakes up; it knows it must outrun the slowest gazelle or it will starve to death. It doesn't matter whether you are a lion or a gazelle. When the sun comes up, you'd better be running." In the parlance of my business, I like to put this proverb in my own terms. There are roughly 10,000 mutual funds that will manage your money for 1% or less and there are roughly 10,000 hedge funds that have the audacity to ask for 1-2% management fees and 20% of the profits. Our clients have a right to expect more because they're paying more. So what that means is that when the market's high, I have to figure out how I can get hedged and when the market's low, I have to figure out how I can get leveraged to the opportunity. You're constantly on the balls of your feet. There's no relaxing.

"It doesn't matter whether you are a lion or a gazelle.

When the sun comes up, you'd better be

running... Always try to surround yourself with the very best people.

Don't feel threatened by good people. You should feel that having them around is to your advantage.

Lastly, no matter how rich you become, arrogance is not a luxury you can afford. "

You come to work with a total commitment to the clients' interests or you go to work in a different indus-

try.

G&D: What are the most common errors that you see analysts make?

LC: Misjudging a company's competitive position would be one. Making valuation judgments that are wrong is another. Then there are macro mistakes, such as underestimating the degree of discontent with the banks following the credit crisis, which is leading to higher capital charges and an inability for their earnings to grow. In every sector it's different. In technology, you may have overestimated the company's competitive position and underestimated the competitive threat from somebody else. You can't standardize the error.

G&D: Any parting words of wisdom for our readers?

LC: The best advice I can give anyone is exemplified by the following Andrew Carnegie quote: "Here lies a man who was wise enough to bring into his service men who knew more than he." Always try to surround yourself with the very best people. Don't feel threatened by good people. You should feel that having them around is to your advantage. Lastly, no matter how rich you become, arrogance is not a luxury you can afford.

G&D: Thank you very much, Mr. Cooperman.

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Mario Gabelli

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G&D: How did you become interested in investing?

MG: I used to hitch hike from the Bronx and caddy at a country club in Westchester. Later in the afternoon after the market closed the specialists would arrive and talk stocks. The other caddies would go home at 4pm but I would stay and listen to what the specialists were talking about. This was maybe when I was in the 7th grade. I still remember my first stocks, Coca Cola, AT&T, and Beech Aircraft.

G&D: Can you bridge us from those days to business school?

MG: I was always passionately involved in the market and would go into high school and read the *The Wall Street Journal* and *Business Week* religiously. When I went to college at Fordham I had some great professors teaching finance but it wasn't until I had Professor Roger Murray at Columbia that I saw the sun, the moon and the stars align themselves and knew this was what I wanted to do. Reading Graham and Dodd helped me to learn the mechanics for how to evaluate stocks. Their approach to stock analysis and valuation made a lot of sense.

G&D: How would you describe your approach to investing and how it has

evolved over the years?

MG: I left Columbia on a Friday and joined Loeb, Rhoades & Co. next Monday, not taking the 3 months

"It wasn't until I had Professor Roger Murray at Columbia that I saw the sun, the moon and the stars align themselves and knew [investment management] was what I wanted to do."

off like a lot of people do now. I inherited the industries followed by Michael Steinhardt who had left that day. Steinhardt went on to start one of the most successful hedge funds. So I covered farm equipment, conglomerates, auto parts and automotive. Sometime around 1969, one of the analysts who covered the broadcast and entertainment industries left to start his own firm and I walked into my boss's office and said "I quit." He said, "Why, you're doing well?" And I said, "I want to cover the broadcast industry." And he said, "Fine, you got

it." Why did I do that? I knew if I followed ABC, NBC, and CBS, which were in New York, I could convince everyone that I should follow the movie industry. I knew this because they were the program suppliers which would get me to LA. Growing up in the Bronx you don't get a lot of opportunities to go to LA. I later left Loeb, Rhoades and went to William D. Witter which merged with Drexel and 90 days later I started an institutional research firm. This was in 1977, and at that time the market had been at 1,000 and started recovering but then quickly declined. The key question was how was I going to convince individuals and corporations and pension plans that they could make money in the stock market?

At the time, there was a lot of inflation. If you had property, plant and equipment, the replacement cost was significantly higher than what you paid for it. Interest expense was 12% to 15%, and taxes were not predictable. So we came up with the idea: what is the value of the business if someone is trying to take it private? We figured out what was the value of the business today, what it would likely be worth five years hence and how would one finance it. So we came up with the notion of private market value and we did this because we were

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trying to convince individuals and institutions that this was a great time to buy stocks. We wrote a report on a company called Houdaille, and if I recall correctly, the stock was around \$26 or \$28 and Henry Kravis came around and bought the stock at about \$39 or something like that and I took out an ad in the *Wall Street Journal*. I said, "to my friends at Houdaille and KKR, thanks for surfacing the values in the market." So that was in 1979 and that's how I got to meet Henry.

G&D: Can you talk a bit about how your approach differs from the Graham or Buffett methodology?

MG: It's the same thing. The analysts are trained to gather the data and read it carefully. These days you can get the data faster. We array the data in our format. Project the data and then interpret it. Interpret it in a way that assigns a value and then build in a margin of safety. So everything Graham and Dodd taught in the 1930s is still applicable today.

G&D: Would you say that your methodology works better for some industries than others?

MG: Of course. How do you value Facebook or how do you buy Apple with an almost \$400 billion market cap? We had a

rigorous discussion today with the analyst covering Apple. I love Apple's products, and the company sells at about \$400 per share and they've had great numbers but it's hard for me to see how financial engineering or a takeover with a catalyst helps to surface increased value for them, and that's how we look at companies.

G&D: What do you say to people who argue that catalysts are usually already priced into companies?

MG: Nonsense. Let's say there is a company selling at \$10 and you predict it's worth \$20 based on your analysis. Will the discount narrow between the \$10 and \$20 so that you can earn your return? Will the company's value grow to over \$30? Will someone come in and buy it? At the time in the 1970s if there was that sort of gap we would wonder if someone would come in and fire a "thunderbolt" (a tender offer). So the difference between the current stock value and the intrinsic value would lead to an event to unlock the value. Look at what's happened in the last year. Fortune Brands announced that they were breaking up.

G&D: We remember you recommending it on CNBC about two years ago when the stock was trading at about \$20.

MG: Well the reason for

that was not complicated. We are a touchy feely organization so I drink bourbon. It's a business we've been tracking for a long time and the value was there. Nowadays, Sara Lee is splitting into two parts, Kraft is splitting into two parts, and there are so many other examples. Why are all of these companies splitting up? They do so because it is a more tax efficient way to let the value surface and allow someone to buy pieces. But the key is seeing that value ahead of time and knowing the pieces ahead of time so that you can take advantage of it. For example, would Pepsi split the company in two parts so that its snack business and its beverages business can reach a higher publicly traded value? Would CVS do it? There are a lot of candidates that you could identify.

A catalyst could be as simple as a new product introduction. We have been following coffee for 40 years and coffee wasn't growing. And then all of a sudden it was November 1989, the Berlin Wall came down and it really helped open the global marketplace. A lot of the western companies flocked to the Eastern European and CIS countries to sell their products, including coffee. And more recently you had single serve coffee introduced in a number of countries. Another example is oil and gas and shale

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"A catalyst could be as simple as a new product introduction. We have been following coffee for 40 years and coffee wasn't growing. And then all of a sudden it was November 1989, the Berlin Wall came down and it really helped open the global marketplace. ... more recently you had single serve coffee introduced in a number of countries. Another example is oil and gas and shale drilling. So a catalyst can take many forms."

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drilling. So a catalyst can take many forms.

G&D: Conversely, if you have an investment thesis about a company and you've held the company for a long time and the catalyst isn't coming to pass, how long do you wait?

MG: One of our oldest funds, the asset fund, was inceptioned in 1985. The turnover is 7%, so that's what, a 15 year holding period? As in the movie *Waterboy*, if the CEO heads for the wrong goal line, we will try to stop him and if they continue to do it, we will sell. Or, if the stock goes above intrinsic value, we will find better options out there.

G&D: Could you give an example of a company you like and how you valued it?

MG: If you look at the human population there are about seven billion people. One and a half billion people are too young to drink or don't do so for philosophical reasons. My first visit to China was in 1981. Two things were clear: the culture loves to gamble and loves to drink. The important thing to think about is which companies had pricing power. What companies had businesses that required the least amount of capital expenditures to maintain the brand. Could the Japanese and Chinese create a vodka and then sell it at a lower price? Would con-

sumers still be willing to spend a certain amount of their income on a particular product?

The ideal thing is to find businesses people are loyal to, like alcoholic beverages and coffee. You have to look at who the customers are and how postponable is the purchase. So if you look at a business like Cable TV,

"The ideal thing is to find businesses people are loyal to like alcoholic beverages and coffee. You have to look at who the customers are and how postponable is the purchase."

you have subscription revenues that are predictable (albeit with some churn rate) and then you look at what customers are likely to want in the next 10 years, which is probably speed, mobility, video, voice. Then we try to understand who packages it up best and what can go wrong with the pricing power of that service. And how does this business

compare to a company that sells widgets that are hot but who knows how sustainable it is, and based on relative and fundamental analysis, try to come up with an approximate value to put on that business.

G&D: Was it through similar analysis that you found Fortune Brands?

We look at the pricing power of an industry, such as distilled spirits. The global distilled spirits business is about \$250 billion. We know the growth rate for distilled spirits in each sector (vodka, scotch, tequila, etc.). Then we look at the companies consolidating, such as Pernod in Paris, Diageo, Anheuser Busch, etc. We follow the industry globally, and we have an analyst in New York who's a Columbia Business School alum as well as one in Shanghai who is following industries in which we have a core competency, such as beverages. So we were following Fortune Brands and we watched what the company was doing and the changes in management. We could see the potential for Bourbon. It wasn't because we liked Jessica Simpson and Dukes of Hazard. We were seeing what all of the other businesses in Fortune Brands were doing, how management was allocating cash, what the underlying value was and what all the catalysts were. We were buying the stock.

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Then Bill Ackman came along and purchased 11% of the company, and we knew he was going to push them over the goal line. They then announced the split. So now the underlying value of the individual businesses

“We meet with the management and we look at various competitors and we believe five years from now the distilled business of Fortune Brands (ticker: BEAM) is probably between \$80-\$85.”

has surfaced.

We look at what will happen on a reasonably predictable basis over the next five years, we look at the cash flows, we look at the multiple we are paying today based on enterprise value and EBITDA, and try to evaluate the person that will run the business. We meet with the management and we look at various competitors and we believe five years from now the distilled business of Fortune Brands, now traded under the

BEAM ticker, is probably between \$80-\$85. Kevin Dreyer, Associate Portfolio Manager of Gabelli Asset Fund, has done the work on this and we think the company is going to be taken over. There are lots of entities that could do it and Bourbon is a \$6 billion category. The only thing that bothers me is when I watch *Boardwalk Empire* and “prohibition”. The other concern is sin taxes.

G&D: What do you think of Fortune’s other business, the Fortune Brands Home & Security business, that is so tied to the housing industry? How do you approach and value that business?

MG: There are 90 million single family houses in the United States. Starting in 2001 and 2002, Alan Greenspan really wanted to get the economy going and lowered interest rates. Everyone was being sold on the idea they should own a home, and so we built about 1.6 to 1.8 million homes per year and everyone benefited from that and in 2007 that bubble collapsed. Now we are building about 500,000 homes per year. Eventually we will go back to the normalized amount of 1 million per year or so.

So back to Fortune Brands – they have the Moen brand of bathroom and kitchen products. With Moen you go into Home Depot and pay maybe \$200 for a faucet. They also have cabi-

nets, which can be very expensive and postponable in terms of remodeling and also things like windows, which you probably don’t replace unless they break. So we look at these businesses and believe you really need housing to pick up in order for them to do well because most people can put off upgrading their existing home needs. We look at what the earnings power of the company is at 500,000 new homes per year. What about 1,000,000? Then we look at another of their businesses: Master Lock. What is the earnings power for each business, what will the earnings power be in five years under a good environment or a bad environment and whether there is a margin of safety. Can these businesses survive in another economic contraction?

The stock started trading the other day at \$11.10 on 155 million shares so it’s about a \$1.7 billion market cap with about \$500 million in debt so you’re paying around \$2 billion and you’ve got about \$285 million of base EBITDA. The earnings would nearly triple if we get back to 1,000,000 homes. EBITDA could reach \$500 million.

G&D: Could you talk about a few other stocks you like?

MG: When we went public in 1999, the hot groups

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Pictured; Professor Roger Murray and investor Robert Heilbrunn with their wives, Agnes Murray and Harriet Heilbrunn.

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“We’re owners and we know how to think like owners. If you have 80% of the vote and 3% of the economics that bothers us unless it’s something like the 14th generation of a family.”

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were AOL, Yahoo, and other dot-coms. We started a utility fund. As we looked around at the utility world, it was somewhat in shambles. Enron went out and said to the utility world, “You are all dumb: you’ve got to go global, you’ve got to diversify, and you’ve got to do acquisitions.” Bottom line, if you went back and looked at utilities, they were rate-of-return regulated. If inflation was going to stay at 2% or 3%, they were going to do well. A company in Buffalo called National Fuel Gas, which we like today, was a business that sold home heating gas. They have 750,000 customers. It gets cold in Buffalo, so it’s a reason to stay in business. About 80 years ago, they had the McKinsey of their time recommend that they go out and buy land. So they bought a million acres in land mostly from West Virginia to New York. And periodically they would go and drill down and put a gathering system in and get gas. Then when the well was depleted they would use it to store gas. It was a nice little company, paying a growing dividend, etc. Fast forward to now, it is trading around \$55, with 83 million shares and \$4.6 billion market cap with about \$900 million debt. Some of the questions we ask to understand and evaluate the business are the following: What is the utility worth and what would someone

pay to buy it? What is the pipeline worth? What is their midstream business worth? What are some of their oil holdings in California worth? And their raw land? New technology comes along and instead of drilling vertically down in the Marcellus area 10,000 feet below the surface, you have other options. If you put a well down, it costs about \$3 million. If instead you went down and then drill laterally it costs about \$5 million. And then hydraulic fracking is in the mix. And fracking unlocks huge amounts of oil and gas. Now, over the next ten years, who knows what happens with the price of oil and gas? But the company has land in an area of the world that everyone wants because of shale. They’ve got a midstream business that they can transform into an MLP and monetize. They also have an oil business they could sell. So we try to find the value of the business over the next ten years. If gas ever goes to \$6 over that time we make a ton of money, and if your IRR is 25% to 35% and you own the mineral rights as opposed to leasing, you do very well.

G&D: Is there another company that you would like to tell us about?

Another company is right here in New York City. Cablevision spun off Madison Square Garden. There are 75 million shares of

MSG and it’s trading in the low \$20s and there is no debt and they have \$300 million in cash. They are putting their cash towards refurbishing the MSG arena. So when I look at the Cable Network associated with the company, we put a value on it, and when we do that, we see we are getting two sports teams for free: The Knicks and The Rangers. There are always super rich people who want to buy sports teams. I think you could buy those teams for \$20 per share, and so the question is should we own this company to participate in that upside? Now, the questions are: is there going to be an NBA season this year? We don’t know.

G&D: Isn’t there also an issue with the controlling family?

MG: They are owned by the Dolans. I am friends with the Dolans. We voted against Chuck Dolan’s company going private four years ago at \$36 a share because we thought there were hidden assets and that the deal was leaving too much on the table for our clients. They ended up spinning off Cablevision and Madison Square Garden and AMC Cable. Chuck Dolan’s son Jimmy is doing a better job running MSG and is becoming more shareholder friendly and he won’t sell. This is a keeper for him.

G&D: So do you in general

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like those companies that tend to have high insider ownership?

MG: Well, GAMCO Investors did go public, and I have 98% of the vote. So we can't preach against A/B shares. We're owners and we know how to think like owners. If you have 80% of the vote and 3% of the economics that bothers us unless it's something like the 14th generation of a family. But it's hard to paint with one broad brush – it depends on the shareholder.

G&D: You have had a long interest in American Express? What do you think of the competitors Visa and MasterCard? Do you see long term threats to those companies?

MG: Of course. There's always a threat. When I started in the broadcast industry, there was very little spent on capital expenditures. You could focus on some high growth cyclical company with great cash generation and to buy a TV station in a major market you paid 12 or 13 times cash flow. Today a trade just took place at 7 or 8 times cash flow. To buy a major market newspaper you were paying 25 times back in the day, and that's if you could even get one. Now they are trading at five times cash flow due to technological change. Sony Walkman had the only game in town and they stopped

creating. Now if you go back to ten years ago, the only card company we could follow was American Express. We owned it and still own it. More recently MasterCard and Visa went public and Discover spun out. So now we have four companies we can look at and we are certainly interested in the digital wallet. Can AXP adapt quickly? Time will tell.

G&D: You have a history of waging proxy battles with some management teams. What are you looking for in a management teams and what makes you advocate for change?

MG: If you entrust money to us, we want to make a return and also act like surrogate owners. Sometimes management teams will go in the wrong direction. Starting in about 1987, we issued a Magna Carta of shareholder rights and what we would vote for and against for our shareholders. We said, if you try to put in a poison pill, we would vote against it. If it's already in there, we can live with it.

G&D: In the case of a company like Myers Industries, where you've tried to advocate for change for many years, what do you do?

MG: In the case of Myers, I started as an auto analyst and I would go to Ohio religiously to visit with them,

so we knew the company. They tried to go private with Goldman Sachs a few years ago. So we looked at them and told them not to make any more deals and they sort of pushed back. They pushed the owner's son off the board. So we said, "Our clients own 10%, we should get some board seats." And then during that period, Bear Stearns went bust and Lehman collapsed, and the money markets shut down. We ran out of juice in that instance. Are we going to go back? We haven't made a decision yet. Our clients now own 15% and there are two or three other institutions that have been patient and may get involved. Why not add another director who can add some value?

G&D: To what do you credit your success?

MG: I do credit a lot to Columbia and to Roger Murray, my value investing professor.

G&D: What is it that you've done so well that others can't replicate?

MG: A lot of people have replicated what I've done. Chuck Royce has done a terrific job. Henry Kravis has done better than I have in the private world, albeit with some leverage. There's clearly a bias towards success by following value investing. I feel like I'm not working for a living

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"If you entrust money to us, we want to make a return and also act like surrogate owners. Sometimes management teams will go in the wrong direction. Starting in about 1987, we issued a Magna Carta of shareholder rights and what we would vote for and against for our shareholders."

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Pictured: Panelists Mario Gabelli '67, Charles Brandes, Jan Hummel, and David Winters at the "From Graham to Buffett and Beyond" Omaha Dinner in April 2011.

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and have the right northern star.

G&D: What are some of the most common errors that you see young analysts make?

MG: Young analysts – what about me? I still make plenty of errors. We bought Netflix at \$40 and sold it at \$80. It went to \$300.

G&D: What about in terms of assessing the fundamentals of the business?

MG: Sometimes the younger analysts get concerned about Mr. Market and the events of today, the volatility in stocks, especially due to all the new ETFs and high frequency trading and the like. Mr. Market is now more volatile than ever. There were reasons the uptick rule was eliminated. One of the reasons was because it made it easier for electronic trading. And so, there was a group of highly focused organizations and individuals that wanted to dismember regulatory elements that had reduced volatility to a degree. So what happened last year with the flash crash was partially the result of that lobbying group having success at changing the rules of the game. So analysts need to look at intrinsic value and realize that the antics of Mr. Market to the fourth power are creating more volatility than they might have other-

wise become accustomed to.

G&D: Do you have any advice for novice analysts who tend to get lost in the weeds with the wealth of information surrounding each company?

MG: Yes, and that is that you cannot study a company without feedback mechanisms and benchmarks. So the key is to start by getting

“You cannot study a company without feedback mechanisms and benchmarks. So the key is to start by getting to know an industry extremely well. That gives you a great perspective. “

to know an industry extremely well. That gives you a great perspective. For example, we have a conference on the auto parts industry. Start off by reading everything that's happened in the last 20 years in an industry. So you read all the trade info and then you cross check. Then understand how that indus-

try relates to other industries. And then you need to understand the stock. First understand the business and then understand the stock. Those two things don't always go in lockstep.

G&D: When you came to Columbia last year, you provided handouts of Sara Lee. What do you think of their businesses now?

MG: Sara Lee is a company with many products. The CEO, Brenda Barnes parachuted in a few years ago and started looking at the company and trimming it down and selling various businesses such as Hanesbrands. We knew the food business because we have a team that does health and wellness and then we also follow consumer products companies so we knew well the businesses they were involved with. And as we are closely following the company, they came up with the single serve coffee, which really took off in Europe. Then I tried some personally, and it was so easy. Just look at the categories they are in. We watched the company and slowly but surely we're adding to it at times where we could get the appropriate margin of safety. Now we see the company being split up in two parts and then once they split, the question is will one company be sold, or will both be sold? So at \$16.70, I'm still in the camp that I can make 30% on the

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upside and I think that's OK.

G&D: Is there anything you wished you knew when you were getting started in the asset management business?

MG: Even though I could make money for my clients in 1976, I probably structured my business in the wrong way. I should have been in the hedge fund world. You can't be in the business of ignoring overpriced securities; you need to be able to short them. I also don't think I'd ever have gone public. The burdens of regulation are too great.

G&D: What books or publications should aspiring investors be reading?

MG: I read annual reports and reading them constantly is simply the best way to learn about businesses. For example, I got an annual report of a company in Racine, Wisconsin. The company is Twin Disc. I hadn't seen the company in a long time but was just curious about them. And then all of a sudden I noticed they are producing a transmission dedicated to fracking. Meanwhile, I had been sensitized to the dynamics of shale because of National Fuel Gas, and here I see a company producing a critical component. The stock was at \$11. They have approximately 12 million shares, and at the time

a \$130 million market cap. Because we run a micro cap fund we can own it there and also in separate accounts for our private wealth management clients. So we start buying the stock. It went from \$11 to \$40 in a year. It then dropped back to \$28, and now we own about 7% of

"Everyone should go shark fishing. When you go shark fishing, you leave a chum line. The sharks smell the chum line and follow it. So if anything breaks the chum line, you don't have nearly as much success."

the company for our clients. We have an analyst who graduated from Columbia Business School within the last few years following the company. Now, for the last 40 years I've been reading *Variety* and *Billboard* and *Automotive News* and *Farm Income Journal* and all sorts of other things that give you an idea of what's going on around the world. The hard part is to connect all the

dots. In World War II, how did the allies find out where the German V-I bomb base was? An intelligence analyst was reading the social papers and he was wondering why all these German generals were going to this location in the middle of nowhere? And he figured out that's where they were making the bombs and sending them to England. So gather the data, array the data, and then figure out the valuation techniques.

G&D: Is there anything you'd like to leave our readers with?

MG: Everyone should go shark fishing. When you go shark fishing, you leave a chum line. The sharks smell the chum line and follow it. So if anything breaks the chum line, you don't have nearly as much success. So the notion of understanding the first rule of life is important: don't lose money. The best way to learn not to lose money is to lose money. Going through a market like this is a great learning experience, because people realize no matter how smart they are, things change very quickly.

G&D: Thank you for speaking with us, Mr. Gabelli.

"So the notion of understanding the first rule of life is important: don't lose money. The best way to learn not to lose money is to lose money. Going through a market like this is a great learning experience, because people realize no matter how smart they are, things change very quickly."

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Marty Whitman

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Mr. Whitman graduated from Syracuse University and holds a masters degree in Economics from The New School For Social Research. Mr. Whitman is Adjunct Professor of Distressed Value Investing at Columbia Business School.

“I don’t think we can identify high quality securities at discount prices unless we look at things not only as passive investors, but also from the point of view of the corporations and managements. So instead of primacy of the income account, we appraise companies and managements in terms of their capabilities as operators.”

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G&D: Can you talk about your approach and how it compares to the classic G&D approach?

MW: Graham and Dodd, in my mind, had three great contributions to investing. The first is the focus on distinguishing between market price and intrinsic value. This is very important since modern capital theory assumes a price efficiency and ignores intrinsic value. Second, they preached the importance of basing decisions on solid facts. They did this in the 1960s, which was before companies were forced to disclose everything they have to disclose today. Everything about an investment decision should be based on the facts you know and how reliable the facts are. It is much easier to do this type of work today than it was when they were doing it. The third great contribution of Graham and Dodd, in my mind, was their idea of investing with a margin of safety. Everything we do at Third Avenue is based around these tenets of the Graham and Dodd method.

G&D: What about any differences?

I don’t think we can identify high quality securities at discount prices unless we look at things not only as passive investors, but also from the point of view of the corporations, managements, and creditors. So instead of primacy of the income account, we appraise companies and managements in terms of their capabilities as operators. We look at management teams as investors and we look at management as financiers. Between those things we have a balanced approach.

Graham and Dodd placed great emphasis on dividends. In general, companies have three uses of cash. They can expand assets, reduce liabilities, or distribute funds to shareholders. The distribution of funds to shareholders, with one exception, always has to be a residual from the company’s point of view. This distribution can either take the form of stock buybacks or dividends. Both have their advantages and disadvantages. Graham and Dodd had a preference for dividends; we think buybacks can be a much more judicious use of cash some of the time. The one exception to dividends to stockholders being the residual is where a regular increase in dividends improves the company’s access to capital markets compared to the access they

would otherwise have. This avails itself to certain types of institutions – a good example is integrated electric utilities companies.

G&D: How do you think about valuation? What metrics do you tend to focus on?

MW: Earnings are very, very overrated. We can look at the four ways corporate value is created. One is cash flow from operations available for security holders, which is relatively rare. The second is earnings, with earnings being defined as creating wealth while consuming cash. Believe it or not, it’s what most corporations and governments do. In order to have earnings in the long term, you have to remain credit worthy and you have to have access to capital markets to meet cash shortfalls. The third element of creating corporate value is resource conversion, which can be massive changes in assets, massive changes in liabilities, and changes of control. This includes mergers and acquisitions, take-privates, LBOs, MBOs, spinoffs. This is a very important element. The fourth element is having super attractive access to capital markets. Let’s say you own some income-producing real estate. Having access to long-term non-recourse debt to finance 70% or more of your project, that’s a value creator.

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Marty Whitman

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We look at hurdle rates in most of our common stock investments. We want to get in at a substantial discount to readily ascertainable net asset value. We want at least a 25% discount. We don't go into these types of situations unless we think there are very good prospects that, over the next 3-7 years, the company can increase its net asset value by no less than 10% per annum compounded. We are more conscious of growth in readily ascertainable net asset value than we are in earnings per share. This is unlike Graham and Dodd who said value is created by operations. I don't think that's real in today's world, in the 21st century.

G&D: What about some other differences between the Graham & Dodd approach and your approach?

MW: Graham and Dodd loved net-nets. When they invested in them, all they did was look at classified balance sheets. In my opinion, there are real limits to looking at companies like these so far as there are no catalysts. Graham and Dodd wrote about the unimportance of the balance sheet. From our point of view, if you want to predict future earnings, one of the tools you will use is ROE. We don't believe that you can just pay attention to past earnings trends. Unlike

Graham and Dodd, we are not as concerned with past earnings growth.

Taking the balance sheet at face value is often misleading. For example, let's take a mutual fund management company. Assets under management, where persistent, have a ready market value even through they are not a balance sheet asset. There are a lot of liabilities that have equity characteristics. Take deferred income taxes for a going concern. Since the company is going to reinvest cash savings when they aren't paying taxes in assets which give rise to tax deductions, this account is really more like equity than a liability.

G&D: In the past you have criticized how people use GAAP. Could you explain these criticisms to our readers?

MW: I have criticized how people use GAAP, including Graham and Dodd, who thought it was so important to find true earnings. GAAP is essential, but it misleads you as an analyst in some respects. Cash accounting, which is not GAAP, also misleads because it doesn't give you any measure of wealth creation. GAAP misleads because it focuses on wealth creation and buries cash accounting. It is rules based, not principles based. However, GAAP is critical in the USA because it is the only objective benchmark you have. Our

portfolio has a lot of financials, income-producing real estate, and a lot of private equity. With these investments IFRS tends to be more useful than GAAP. Under IFRS, income producing real estate assets are carried at appraised value.

G&D: Can you talk about one of your favorite new investment ideas?

MW: Cheung Kong Holdings, an enormously successful private equity and real estate development company, has a net asset value of around HK\$140 per share. It is the world's largest container port operator with facilities throughout the world, other than the United States. Its real estate operations are centered in Hong Kong and mainland China. Cheung Kong, through its 50%-owned subsidiary Hutchison Whampoa, has interests in a leading integrated oil company in Canada; is one of the largest retail store operators in Europe and mainland China; and also has extensive interests in telephonic communication in various countries; as well as utility operations in the United Kingdom. The stock cratered recently due to fears in Hong Kong regarding the company's huge presence in Europe in ports and retail. There has been a lot of panic selling. One of the things about the Hong Kong stock market is that it is dominated by "short term

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"GAAP is essential, but it misleads you as an analyst in some respects. Cash accounting, which is not GAAP, also misleads because it doesn't give you any measure of wealth creation. GAAP misleads because it focuses on wealth creation and buries cash accounting. It is rules based, not principles based.."

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-ism." I like to say that Hong Kong traders "don't like to buy green bananas."

G&D: Can you go through a few other holdings?

MW: Sure thing. Applied Materials, near \$11, sells around 10x earnings. It has an extremely strong financial position. It is the world's leading producer of chip manufacturing equipment and, through a China-located subsidiary, a leading manufacturer of solar panels.

Capital Southwest trades at \$84, yet has a net asset value around \$140. Investor AB, which trades at 125 Swedish Krona on the Swedish Stock Exchange, has a net asset value of around 189. Both are investment companies with extremely favorable long-term records for growing net asset value and dividends.

Last, I want to mention Hang Lung Group and Wheelock & Company. Hang Lung is the holding company for the leading developer of shopping centers in secondary cities in mainland China, following its huge success in building and operating two shopping centers in Shanghai. Wheelock is a holding company for a huge private equity and real estate developer. Both common stocks sell at substantial discounts from net asset value. Third Avenue has been invested in Cheung Kong, Hang Lung and Wheelock since 2005. Dur-

ing that period, net asset values, after adding back dividends, have increased by more than 15% per year compounded. Results for 2011 will be very strong. 2012 may be a year of moderate recession.

G&D: Can you talk about the characteristics of some of your most successful investments?

MW: Some of my best investments have been in companies that were going through Chapter 11. Kmart was a good example, back in 2003. The first thing we did was buy out a lot of trade claims from creditors. Then we kept averaging down and we went on the official creditors committee. It was there that we met Eddie Lampert, who asked if we would join him in the reorganization, which we did. Eddie ran everything. To find these types of homeruns we really need good partners. We are good investors, but not great managers.

Unfortunately he's tied up with troubles at Sears now. I think Sears is toast. Eddie is very skilled, but I think it will be very hard to turn this thing around. The company has a nice cash position now from realizing the value of the company's real estate. I don't know what's left. I have the greatest respect for Eddie, and if anyone can pull this off, it's he. I'm not as close to the situation as I used to be, as

we sold our position a while ago and I don't really follow the company anymore.

G&D: Can you talk about your investment in Brookfield Asset Management (BAM)?

MW: Brookfield has a net asset value of around \$40, through it trades near \$29 per share. It has ownership in a large number of Class A office buildings in Manhattan, Toronto, Calgary and Washington, D.C. Equally important are its hydroelectric investments in Canada, the U.S. and Brazil. Brookfield controls General Growth Properties and has huge infrastructure, real estate and agricultural investments in Brazil and Australia. Finally, Brookfield is the general partner in highly successful hedge fund investments.

G&D: How do you think about the macro when you invest?

MW: I think the reason that such a high percentage of our holdings are in the Far East is that the region has better prospects for NAV growth than any other part of the world. For us, the key investment criteria are a super strong financial position, buying at a discount, and getting comprehensive disclosure so we can understand the business. I think these things are relatively easy to find, but figuring out the macro is very

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"For us, the key investment criteria are a super strong financial position, buying at a discount, and getting comprehensive disclosure so we can understand the business."

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hard. The real thing investors should be thinking about is creditworthiness. Creditworthiness, for any economic entity that has to borrow, is a function of three things – the amount of debt, the interest rate on the debt, and how productive is the use of proceeds. I don't know why everyone doesn't wake up to the fact that in the aggregate, debt is almost never repaid, and doesn't have to be. Provided the entity can remain creditworthy, it can refinance, expand the amount of debt and continue the process forever. As long as the assets are used productively, you can't call it a Ponzi scheme.

G&D: Would you shy away from the equity market given what's going on in Europe right now?

MW: First off, it's not going on in Europe, it's going on in parts of Europe. They are very happy in Scandinavia. I'm not smart enough to figure out if I can buy things cheaper than I have. If I can buy these well capitalized businesses at big discounts, I'm not worried about the market. I just think there are fantastic opportunities in 363s (emergency sale of a company in bankruptcy) and in capital infusions. You could do very well making capital infusions like Warren Buffett has in recent years.

G&D: What industries are you inclined to invest in and why?

MW: We like to go where there are readily ascertainable asset values at a huge discount. 'Readily ascertainable' is not rocket science – it includes income-producing real estate, securities and private equity. I like technology companies. Microsoft (MSFT), Intel (INTC) and AVX (AVX) are companies that have cash well in excess of book liabilities. These are very profitable businesses generating a lot of cash, and they have large cash balances. As such, I feel confident that they will not burn the cash that serves as a sizeable portion of the asset value. I think retail is often very prone to distress. Between the banks, the landlords, the bondholders, and the trade, companies are very dangerously financed. It's often hard to call a bottom on retailers. I remember what one of my college professors used to say – "Everything is unpredictable, especially the future."

G&D: What is the best approach to find new ideas that finding companies trading at a substantial discount to NAV, but also have a quality business, a quality management team, and growth prospects for NAV?

MW: We usually tend to be in bed with managements who don't really need the capital markets. In 2010 and 2011 these managements were willing to sacrifice return on equity for the safety and opportunism of a

strong financial position. We really lucked out. We've dealt with terrific managements throughout the world.

These discounts would never exist if there were catalysts, especially prospects for change of control. Once that existed, they wouldn't sell at these discounts. If there are no prospects for change of control, there is no reason security prices ever have to be rational. What we do is Graham and Dodd on steroids. We are looking for growth in NAV if there are no readily apparent catalysts. One of the reasons for the huge discounts for securities on the Hong Kong stock exchange is because the rules for change-of-control that make it almost impossible for companies to go private or do a cash merger. You need a shareholder vote of 90% of the outside shareholders to approve a going private transaction. We've gone to the Hong Kong Stock Exchange to try to get them to change the rule so that companies can go private with a simple majority. If something like this were to happen, the discounts would not be as ludicrous as they are right now. Meanwhile, the companies we are invested in have insiders who continue to make open market purchases of their stock, despite not being able to do a full transaction. The absence of potential changes in control really hurts an

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"If I can buy these well capitalized businesses at big discounts, I'm not worried about the market. I just think there are fantastic opportunities in 363s (emergency sale of a company in bankruptcy) and in capital infusions. You could do very well making capital infusions like Warren Buffett has in recent years."

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economy. It breeds management teams that don't use resources well. Japan seems a good example of this.

On a different note, a good example of our being disciplined in finding bargains, was not chasing things during the dotcom boom. We never really suffered during the period. We had criteria when looking at tech companies in those days. Cash had to be well in excess of book liabilities. We would never pay more than 2x annual revenue and never pay more than 10x peak earnings. We could meet these criteria with large blue chips, such as Intel (INTC), AVX (AVX), and Applied Materials (AMAT).

G&D: How do you get comfortable investing in Japan and Hong Kong when the catalyst may never actualize?

MW: I'm absolutely comfortable in most things when I can find discounts to NAV of 40%. I was a limited partner in Jim Grant's Nippon Partners. They went out and bought 20 net-nets in Japan in 1999. On this stuff, I have to hope they have the growth in NAV and that the discount doesn't widen. A real shortcoming of what we are doing now, and what we were doing then, is a lack of a catalyst.

G&D: How do you get comfortable that there is a sufficient margin of safety in

an investment?

MW: You can be wrong about anything. One of the things that is very important to understand is that diversification is only a surrogate, and usually a poor surrogate, for knowledge, control, and price consciousness. As a non-control investor you have to have a moderate amount of diversification, which is not true as much for control investors. It is very hard to make guarantees. A margin of safety usually comes from buying high quality securities at a discount. Secondly, if you are a passive investor you need a moderate amount of diversification. This is really a probability business, not a certainty business. As an outside passive investor, you can be wrong about anything.

G&D: If an analyst comes into your office with a new idea, what are the first few things you would want to know?

MW: What I want to do is understand the business. I want to know the estimate of NAV, and can we buy it at a sizeable discount from this. We guard against investment risk, but we pretty much ignore market risk, which is different from Graham and Dodd, who were very conscious of how much you suffer when the price goes down. We try and train our people that to be successful, you need to guard against investment

risk. Market risk is just a random walk. Without catalysts, any near-term market prices are a random walk.

G&D: Who else in the industry do you have a lot of respect for?

MW: There is a great tendency for the best people in value investing to graduate and to do control investing and distressed investing. There are a lot of very successful people who will never make a passive investment. Take my friend Sam Zell for example – he never makes an investment where he doesn't have control. Warren Buffett is a control investor and also is very much a distressed investor. Bill Ackman, David Einhorn, and Mario Gabelli come from the Graham and Dodd school of passive investing and are all investors I respect.

G&D: What do you think has made you a successful investor?

MW: I can spell that out. L...U...C...K. It's been more business skill than investment skill that has helped me throughout my career.

G&D: We appreciate you sharing your thoughts with us, Mr. Whitman. Thank you.



Bill Ackman and David Einhorn at the G&D Breakfast, 2010.

“One of the things that is very important to understand is that diversification is only a surrogate, and usually a poor surrogate, for knowledge, control, and price consciousness... It's been more business skill than investment skill that has helped me throughout my career.”

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Columbia Business School Alumni Profile: Eli Rabinowich

G&D: Tell us a little about your background and your current firm?

ER: I did not know what I wanted to do after business school, but I knew Columbia was famous for its value investing tradition, and when deciding on schools, I thought that at a minimum I wanted to go to a great business school and learn how to invest my own money. I took all of the classes on value investing, and after the first semester figured out that this was what I wanted to do. I started the 'Profiles in Investing' column at Columbia where I would interview different value investors. One of the investors I profiled was Rich Pzena, and I started working at Pzena Investment Management when I graduated.

I am now a portfolio manager for Pzena Investment Management, where I co-manage our mid-cap U.S. portfolio.

When I first started I covered property & casualty insurance, followed by pharmaceuticals, medical devices, chemicals and housing. We rotate sector coverage here every 3 to 4 years. The rotating coverage model is employed because it gives the analyst exposure to different business models. From an investment standpoint, it allows the firm to get different perspectives on a given industry.

G&D: How did your edu-

cation at Columbia shape you and how did you develop as an investor post-graduation?

ER: Columbia is great in the sense that it is almost a practical application on how to invest. There are a lot of real world practitioners who come in and say 'here is what we do'. The big difference in what happens at Columbia and what happens at other schools is that Columbia really shapes the temperament in terms of buying cheap stocks – at Columbia they really drill that into you. But in terms of how to really think about a business, such as what the critical drivers are, and how to deal with the emotional volatility of the market, I really learned all of that after school.

G&D: The most difficult part of investing is often just generating an idea and finding mispriced securities – what is your search process and how do you go about it?

ER: I fundamentally disagree that finding new ideas is the hardest part of investing. I think ideas are all over the place and there are many places to look for ideas such as new stocks hitting 52-week lows, looking at insider buying trends, etc. There certainly are a lot of statistically cheap stocks most of the time. The hard part is separating what is permanently cheap and what is cheap for a temporary reason.

We utilize a proprietary screening system that identifies stocks that are cheap on price-to-normalized earnings. The screen takes the last 10 years of history (revenue growth, returns on capital, and margins) and extrapolates future normalized earnings five years out. For example we will run the screen for our large cap portfolio, where the pool of companies is the 500 largest companies in the U.S. We will then fish in the cheapest quintile. The analysts spend their time doing deep dives into the companies that the screen identifies and then we will ultimately invest in 30-40 of those 100 names.

G&D: What are some of the biggest challenges in investing?

ER: The most challenging thing is having confidence in your earnings estimates when the market moves against you. What we do is we constantly reevaluate our normal earnings and position sizes. We do it on every major news event and on every quarterly report. The analyst will write up what happened and the estimated impact on normalized earnings. Theoretically, once we have locked in normalized earnings, stock price moves should not impact the normalized earnings of a company.

We have a morning meeting every day where analysts report on material news, where the analysts will give an update on their compa-

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nies. We generally will not react to stock prices movements, though if something happened at the operational level, we will sit down and discuss whether or not something has changed that fundamentally changes our view of the company and its normalized earnings power. For example, if management decided to make a large dilutive acquisition that was not in our forecast, we may then have to reduce our normal earnings.

G&D: What is your typical holding period, and how do you decide when to sell?

ER: Our typical holding period is about three years, but our horizon is five years, really ten years. Our sell process is fairly mechanical. We buy names in the cheapest quintile, and we sell when a name reaches the midpoint of fair value. Today, the average stock in the universe is trading at approximately 11x our normalized earnings estimate and we are currently buying names that are trading for 5-7x normalized earnings. We will sell when the name trades at an average multiple. A lot of our holdings are depressed and it takes time for things to work out. Some are facing some sort of problem and others are just disfavored by the market. On average it takes a few years for the market to come around to our point of view about a stock's valuation.

G&D: What questions do analysts have to answer in order to figure out if a particular business is a good business?

ER: The critical element is understanding what the sustainable level of earnings for a company is. We start with 'what has the company historically done', and then 'is the future likely to be like the history or different from the history?' Where we spend a lot of time is trying to understand what has changed to make a stock cheap. Typically you have a company that was going along and everything was fine, and then somehow it ended up being a cheap company. For example, we are finding a lot of opportunities in housing-related stocks. Housing stocks are cheap because the macro environment for housing stinks. -We used to make 1.5 million houses a year and now we are building fewer than 600 thousand houses. The questions then becomes 'what is the sustainable level of housing construction?', and 'are these the same companies with the same characteristics and same return profile that they have historically had, but are now just operating in a difficult environment?' Other companies could have had a change in the competitive structure, and then we want to understand the competitive dynamics of an industry, and see if they are the same as before or if they have gotten

worse.

G&D: Could you talk about a recent investment?

ER: Mohawk Industries (MHK) is an interesting idea. Mohawk is the second largest manufacturer of carpet in the country. The company has cyclically depressed revenue because the business is related to housing. Mohawk has three businesses, each of which is about a third of the total company's business. These businesses are carpet, ceramic tiles, and laminate flooring. In carpet the big players are Mohawk and Berkshire Hathaway, which together control roughly 80% of the market. The business is characterized by high returns on capital, good margins, and very stable market share. In ceramic tiles, Mohawk is the undisputed leader with roughly 35% market share and is the only integrated manufacturer and distributor in the ceramic space. In laminate tiling it has dominated positioning in Europe. Currently the stock has a double digit free cash flow yield and then there is a lot of room to improve as the macro environment gets better. Here is a business that has a dominant franchise in each of its businesses, currently generating good investment returns, with very good long-term prospects, trading at a cyclically depressed valuation.

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Pictured: Steve Eisman at the Columbia Investment Management Conference in February 2011.

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G&D: How much do you think about the macro environment? Is it more of an opportunity to buy cheap stocks, or is also something you look at to try forecast?

“The most challenging thing is having confidence in your earnings’ estimates when the market moves against you.”

ER: We do not spend much time forecasting the macro. For a company like Mohawk, you can look at the level of housing starts, which is the number of houses we create each year in this country. Household formation each year is a little over 1 million per year. At a minimum we need to have a level of housing starts that is commensurate with household formation, plus a little extra when you factor in teardowns, second homes and migration patterns. The majority, more than 2/3 of sustainable demand, comes from household formation. While we overbuilt during the boom we are now building below a sustainable level. At some point all of these households are going to need a place to live. What we have seen in the recession is that household formations have collapsed - people have been living with their parents

longer, not getting divorced, etc. At some point there is going to be a need for housing. This is a macro call on housing starts as opposed to call on the general economy.

We are not sitting here saying GDP is going to be up a certain amount, nor do we necessarily want to be positioned cyclically or non-cyclically – we care about what stocks are the cheapest. In the current environment people are more scared and that generally means cyclical stocks are probably cheaper right now. What we want to own are companies that have the wherewithal to make it to the other side and do well. What’s great about Mohawk is that if the economy gets worse, Mohawk actually throws off cash because its working capital needs get reduced. It then needs cash as it is coming out, but that’s a good thing and almost anyone would be willing to lend to them.

G&D: Do you think that there could be a secular trend toward less carpet and more hardwood?

ER: Clearly there is a trend away from carpet and toward other surfacing, and it’s been going on for the last 20 years. Mohawk has seen this, and it is part of the reason that the company moved into ceramic tile and laminate flooring. The share shift away from carpet has

been very slow. About 15 years ago, carpet was 70% of square footage and since then it has trended down to 60% of square footage.

G&D: So where do you think the intrinsic value of Mohawk is?

ER: At ~6x our normalized earnings estimate of \$7.50 we find the stock very attractive.

“The critical element is understanding what the sustainable level of earnings for a company is. We start with ‘what has the company historically done’, and then ‘is the future likely to be like the history?’ ”

G&D: Can you tell us about another investment idea?

ER: Abbot Labs (ABT) is a diversified healthcare company. It has some very large pharmaceutical products. The company has one product that the market is very scared about right now. Humira, an injectable drug used to treat autoimmune disorders, accounts for \$6.5 billion of the company’s \$30 billion in revenues. The

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company also has leading businesses in stents, nutrition, and cardiovascular. There is a lot of value in these businesses, but the market is discounting this right now. The most imminent threat to Humira comes from potential alternative therapies, such as Pfizer's Tofacitinib. The value proposition of these treatments is easy to understand as they are oral therapies that will be competing in a category dominated by injectable products. Based on our analysis, however, we believe the market is vastly overestimating the potential impact of Tofacitinib, and we think that Humira's sales will likely persist for years. There are a lot of hurdles for Tofacitinib. The drug still needs to be approved by the FDA. Compliance can be a major factor for twice a day oral treatments, vs. a once in two week injection for Humira. In addition, Tofacitinib may not be as successful as Humira in certain indications, for example, a recent clinical data released in May 2011 indicated that Tofacitinib failed to meet the primary endpoint in a Crohn's disease study.

G&D: What is one thing students should know before entering the investment world?

ER: The Applied Value Investing program at Columbia gives you a great preparation, but you still have a lot to learn. When you come in,

don't think you are going to tell your boss 'that is not how I would do it'. You should really be very responsive to how your boss

"In the current environment people are more scared and that generally means cyclical stocks are probably cheaper right now. What we want to own are companies that have the wherewithal to make it to the other side and do well."

thinks about things. Even within value investing there are many different ways to slice it. You could look at a range of value investors and their portfolios will look completely different. It is important to realize how your firm values companies and to think about how they evaluate businesses.

G&D: What advice do you have for newly graduating business school students looking for jobs in value investing?

ER: When I was interviewing for positions it stood out to me how the style, pace of investing, and temperament varied across dif-

ferent value investing firms. It's important to find the place where your temperament and the temperament of the firm are in tune. For me personally, I was looking for low position turnover and low personnel turnover.

G&D: What do you think separates successful value investors from less successful ones?

ER: The ability to understand the odds of their recommendations. Every investment is essentially a bet on, or a prediction of, the future. Being able to make bets in such a way that you make money on the upside but don't lose much on the downside is biggest thing an investor needs to be successful. What I have found is that people who are intrinsically motivated to find good investments tend to be better long-term performers in the industry. Over time these people will separate from others who are just in the industry because it is a lucrative field to be in. There will be a lot of times when the stress level can get pretty high when positions start to move against you, so if you don't really enjoy it you are in for a tough time.

G&D: Thank you very much, Mr. Rabinowich.

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Philip is a second year MBA student concentrating in Finance & Economics. He spent the summer interning with a private equity fund in New York City. Prior to enrolling at Columbia Business School, he spent four years in investment banking and private equity

Great Lakes Dredge and Dock (GLDD) - Winner of 2011 Sonkin Prize

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Great Lakes Dredge and Dock Capitalization		GLDD		Long, Price Target of \$6.55 (Based on Earnings Power Value with WACC of 8%)		Returns	
				Multiples			
Price Per Share (10/19/2011)	\$4.91			LTM		LTM 3-yr avg.	
Diluted shares	59.2			TEV / Sales		ROA	
Market Capitalization	\$290.6			TEV / EBITDA		ROIC	
Plus Debt	257.6			TEV / (EBITDA - Maint. CapEx)		ROE	
Plus Non-Controlling Interest (NCI)	0.3			EPS		Growth	
Less Cash	(96.0)			LTM 6/30/11		LTM 3-year CAGR	
Enterprise Value	\$452.5			2011E		Revenue	
Operating Statistics		LTM		2012E		EBITDA	
Revenue	655.7			2013E		Net Income	
EBITDA	89.9			Other		EPS	
Net Income (excl. restruc charges & 1x's)	23.1			Short Interest			
FCF (EBITDA - Maintenance CapEx)	72.4			Insider ownership			
				Dividend Yield			

Investment Thesis

I recommend purchasing shares of Great Lakes Dredge and Dock Corporation ("GLDD" or the "Company") with a price target of \$6.55. GLDD is a business with a 80% margin of safety on an asset reproduction basis at current price levels, a conservative valuation on an earnings power value or free cash flow basis, impressive barriers to entry and a dominant market position, recurring revenue from that smoothes over fluctuations in capital spending project demand and a demonstrated ability to make acquisitions at attractive prices.

Margin of Safety on an Asset Reproduction Basis: The book value dramatically understates (by over \$1 billion) the fair market value of the Company's vessel assets. In addition, the Company has real estate holdings with significant underlying value that is not reflected on its balance sheet due to GAAP accounting conventions. I estimate that the Company's net asset reproduction cost would be roughly \$24.31 per share. At the company's current stock price of \$4.91, this implies an 80% margin of safety on the basis of asset value alone.

Trading Significantly Below Conservative Estimate of Earnings Power Value: GLDD exhibits upside of roughly 33% of its current share price based on a conservative estimate of its earnings power value (following page). Historically, talented, private-equity backed management teams have actually been able to achieve EBIT margins of 11% over the course of several consecutive years (e.g. 1999-2002). If management could improve cost discipline to get back to those levels, then the upside from current price levels would be approximately 94% from the current share price (implied price target of \$9.53).

Significant Barriers to Entry: The combination of the Foreign Dredging Act of 1906 and Merchant Marine Act of 1920 prohibits foreign competition in domestic U.S. dredging operations. The Company owns and operates the only two hydraulic dredgers in the U.S., which are particularly important for dredging the Port of Houston and the deepwater ports along the California coast. The Company has a dominant market position with an estimated 46% of the domestic dredging bid market from 2008-2010, so GLDD is several times the size of its nearest competitors, giving it unique advantages in bidding on large contracts. Finally, the Company estimates the reproduction cost of its fleet at over \$1.5 billion versus a book value of \$315 million, so any potential entrant would face unattractively high upfront capital expenditures.

Demonstrated Ability to Make Acquisitions at Attractive Prices: GLDD's acquisition of Matteson was done at ~3.0x EBITDA versus a GLDD trading multiple of 5.0x 2011 EBITDA. Significant synergies will likely result in following years as well, as headcount can be removed from the G&A expenditure line (G&A has historically been roughly 7.5% of sales).

Management: The GLDD management team has industry experience and a record of managing the business prudently. Management has also been disciplined in making acquisitions in the past with only one major acquisition in the last ten years, and that one was at an accretive multiple. I would note however, that management's incentives are not perfectly aligned with shareholders, since the company's executives are expected to target EBITDA for its dredging segment alone rather than consolidated EBITDA—giving management incentive to shift overhead costs between segments.

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Great Lakes Dredge and Dock (Continued from previous page)

Cash Flow

On an enterprise basis, GLDD generates substantial free cash flow and has low, manageable levels of leverage at 1.8x net debt / 2011E Consensus EBITDA, which is down significantly from 3.7x as of the end of 2008. At a multiple of only 6.3x TEV / (EBITDA—Maintenance CapEx), GLDD represents a unique opportunity to buy a business with a substantial cash flow yield even at a cyclical trough for the industry, with substantial asset coverage buttressing the cashflow valuation.

Business Description

GLDD is the largest provider of dredging services in the United States. GLDD provides dredging services in the East, West and Gulf Coasts of the United States and worldwide. The Company also owns a majority interest in NASDI, a demolition services provider in the Boston, MA area. The Company has a 50% interest in Amboy Aggregates, a sand mining operation in NJ. GLDD earned 89% of its FY2010 revenue and 103% of its FY2010 operating income from dredging operations and 11% of its FY2010 revenue and (3%) of its operating income from demolition operations.

Valuation

GLDD is an asset intensive business with significant swings in margins, primarily tied to swings in the capital project dredging cycle and the overall economy. Therefore, I don't consider this a franchise business and have omitted a discussion of growth from our valuation here, since it is unlikely to be growth within the franchise. Instead, I looked at the earnings power of the business using average EBIT margins over the cycle and adjusting for excess depreciation. Based on my calculations the earnings power of the business, conservatively valued, provides a 33% upside to the current share price. While I took the cyclical average margins for the company's earnings power value, 2011 consensus revenue estimates are relatively depressed due to a cyclical lull in the level of capital dredging projects, especially abroad. In the past, talented private equity-backed management teams have raised EBIT margins to 11% over several consecutive years, suggesting that there is significant potential upside from our earnings power estimates.

(US\$ m)	
2011 Consensus Revenue	\$651.8
Average EBIT margin (1999-2010)	7.5%
Sustainable EBIT	\$48.9
Average tax rate	38.0%
Normalized NOPAT	\$30.3
Excess depreciation after tax	13.6
Normalized Earnings	\$43.9
WACC	8.0%
Earnings Power Value	\$549.0
Net debt	(161.5)
EPV Equity	\$387.4
Current market capitalization	\$290.6
Upside to current price	33.3%

“GLDD represents a unique opportunity to buy a business with a substantial cash flow yield even at a cyclical trough for the industry, with substantial asset coverage buttressing the cashflow valuation.”

Investment Risks/Considerations

Economic Slowdown: Although the Company doesn't break out its margins by contract type, the capital project (29% of 1H2011 Revenue) dredging margins are significantly higher than the maintenance and nourishment dredging margins and would be especially vulnerable to an economic slowdown.

Labor Costs: GLDD, including Matteson, had 39% of its 2010 employees on salary and the remaining 61% on hourly wages that are largely determined by a handful of union contracts. Union contracts representing over 43% of the Company's hourly workforce will reset in 2012.

Bahrain Unrest: Foreign dredging revenue, comprised primarily of revenue derived from contracts in Bahrain, contributed 14% of contract dredging revenue in the first half of 2011. The Company carries insurance on property and personnel but not lost revenue. A significant spike in the unrest against the government of Bahrain could lead to a significant loss of revenue and operating profit.

Contract Risk: The Company faces competitive bidding on most of its government contracts. Contracts from the U.S. Government's Army Corps of Engineers accounted for 54% of 2010 revenues, although it was spread over 47 contracts.

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Madison Square Garden Inc. (MSG) - Winner of 2011 Sonkin Prize

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Madison Square Garden, Inc. (Nasdaq:MSG)		FYE 12/31					
(\$ in millions except per share)		FY Ends June 30	2009A	2010A	2011A	2012E(2)	2013E
Share Price as of 10/21/11	\$25.07	Projections					
Basic Shares Outstanding	76	Revenue	\$1,062	\$1,157	\$1,188	\$1,151	\$1,270
Options / RSUs	2	%YoY Growth	6%	9%	3%	(3%)	10%
Total Shares Outstanding	78	EBITDA	\$106	\$217	\$208	\$191	\$346
Market Capitalization	\$1,961	% Margin	10%	19%	18%	17%	27%
Cash and Equivalents	\$305	EBITDA Multiple	15.6x	7.6x	8.0x	8.7x	4.8x
Capital Lease	\$4	PF for Renovation EBITDA Mult.	22.0x	10.7x	11.2x	12.2x	6.8x
Enterprise Value	\$1,660	FCF	\$29	\$96	\$91	\$81	\$177
MSG Renovation Cap Ex (1)	\$675	FCF Yield	1%	4%	4%	3%	8%
PF Enterprise Value	\$2,335	Implied Valuation Using FY2013E EV/EBITDA Multiple PF for Renovation					
% of Insider Ownership	21%	EBITDA Multiple	8.0x	9.0x	10.0x	11.0x	12.0x
52-Week Low-High	\$20.28-\$30.21	Market Capitalization	\$2,391	\$2,737	\$3,082	\$3,428	\$3,774
Avg. Daily Volume (MM)	0.3	Implied Price Per Share	\$30.57	\$34.99	\$39.40	\$43.82	\$48.24
Shares Sold Short (MM)	1.0	Implied Annualized Return	12%	22%	31%	39%	47%

(1) Analysis treats the \$710M remaining cap ex to be used to renovate the Garden over the next three years as debt, discounted to present value at 3%
(2) All 2012 projections assume NBA misses half the 2011-2012 season

Investment Thesis:

I recommend purchasing shares of Madison Square Garden ("MSG"). MSG is poised to benefit from improvement in its core business segments and the unrecognized upside in the renovation of the Garden. The new Garden will boost earnings, allowing MSG to better harvest returns from an underutilized asset. Shares for the entire company, including the Knicks, Rangers and Madison Square Garden Arena, are trading at 4.8x projected 2013 EBITDA while lesser regional sports networks ("RSN") without the irreplaceable assets listed above have typically been sold in the 15x-25x EBITDA range. Applying a 10x EBITDA multiple gives a target price of \$40 per share or a 30% annualized return. A sum of the parts valuation discussed on the next page, which reflects the private market value of MSG's unique assets, yields a target price of \$50 per share, although a breakup is unlikely. Buying Highly Profitable Regional Sports Network at a Steep Discount to Peers: RSNs are a must-have for cable providers whose subscriber base demands local sports content. Cable providers pay a premium fee of \$3.50 per sub with 5% yearly escalators for the MSG Networks. Sports hit key male demographics and are typically watched live with advertisements. MSG and MSG+ are arguably the most valuable RSNs given that they serve the largest market in the US (16M subs), operate at a higher margin due to vertical integration and have teams with dedicated fan bases. RSNs do not trade publicly but have historically been acquired in the 15x - 25x range, with an average of 18x for the 37 transactions analyzed from 1994-2009 in DTV's S-4 filed on 6/08/09.

Garden Renovation provides Attractive Opportunity: MSG has undertaken a four year ~\$850M renovation of Madison Square Garden. The Garden will be closed for three consecutive summers from 2011-2013. The new Garden will increase the number of suites from 89 to 111 and will result in general admission price increases throughout the stadium (prices haven't increased for most seats in 8 years but will increase 49% and 23% this year for the Knicks and Rangers, respectively). Renovation execution is critical but the market is unduly skeptical of ROI. Garden improvements should yield \$75M in incremental EBITDA in 2013. MSG has guided to the renovation costing \$850MM-\$1B. However, Forest City Ratner, the builder of the Barclay Center in Brooklyn that will be home to the Nets has estimated the cost to be \$800M for building the new Center from the ground up. Clearly, new construction requires significantly more raw material while the same unions are employed on both projects. If the NBA returns from its lockout and the Knicks continue to improve (potential Chris Paul acquisition in 2012) there is a lot of upside to ticket prices driving incremental EBITDA beyond 2013.

NBA Lock Out Creates Buying Opportunity: The lockout creates a near term catalyst for the stock price upon the work stoppage's resolution. Currently, the players and owners have little incentive to negotiate in good faith given that neither side feels the impact financially prior to the start of the season. In my opinion, this lockout will follow the pattern of the previous one in 1998 when half a season was missed. Like the previous lockout, owners should prevail and gain better economics that will benefit MSG long-term, while investors can take advantage of the short-term uncertainty.

Business Description: Madison Square Garden, Inc. was spun off from Cablevision, owned by the Dolan family, on 2/9/10. MSG business segments include the Knicks and Rangers sports teams, Madison Square Garden arena, the MSG regional sports networks, and a series of smaller entertainment businesses, including the Christmas Spectacular at Radio City Music Hall, the Beacon Theatre, Chicago Theatre and Wang Theatre in Boston.

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Madison Square Garden (Continued from previous page)

Business Segment Overview: Substantial Value in the Sum of the Parts

A sum of the parts/breakup analysis shows significant upside to the current stock price but should not be considered viable given the interlocking nature of the businesses. A potential breakup scenario is the Dolan's purchase the entire company and strip away non-core assets, like Fuse, and the MSG entertainment business. Minority shareholders would insure full value is reached given the Dolan's track record for unsuccessful takeover offers. The Dolan Family owns 70% of the total voting power of the stock.

MSG Media: Provides almost the entirety of EBITDA currently and is a strong cash generator with exclusive access to programming for the Knicks, Rangers, NJ Devils, Buffalo Sabres, Liberty and Wolfpack, along with college sporting events (ACC, Big East, Pac-10). MSG Media showcases these teams on MSG and MSG+. RSNs command premium subscriber fees because many cable subscribers view local sports as a necessary feature in any cable package. MSG's RSNs warrant a premium valuation due to their 35% EBITDA margin and top-tier market presence. By way of comparison, Liberty Sports Group's RSNs sold for 13x EBITDA and had 22% EBITDA margins, generated just \$45M (vs. MSG's \$230M) and had far less iconic content. A 12x 2011 EBITDA multiple was used for the sum of the parts valuation.

MSG Entertainment: Primary value is the Radio City Christmas Spectacular, which generates \$125M in revenue and is viewed by 2M people annually. The Spectacular was renovated in 2008 for arena tours, which resulted in a decline in EBITDA of \$25M. The segment has historically been profitable but operating profit dipped due to cost associated with the renovation and the economic downturn. Peak EBITDA was in 2007 at \$50M, so assuming that it returns to 50% of that level, applying a 5x multiple (Live Nation trades at 6.3x), the business is worth \$125M, plus another \$25 for the other theaters.

MSG Sports: The Knicks and Rangers were purchased in 1997 for \$300M and \$195M, respectively, and are accounted for at historical cost on the balance sheet. The Knicks were valued at \$655M in January 2011 by Forbes and the Rangers were value at \$416M in 2009. While neither team can be sold for two years post spinout, both teams are significantly undervalued on the balance sheet. Prior to last season, the Knicks had missed the playoffs for 6 straight seasons, but were ranked #2 in the league in gate receipts. The signings of Carmelo Anthony and Amare Stoudemire have rejuvenated the fan base and the possibility of signing another big player in 2012 (Chris Paul?) will drive the Knicks to greater success in the future. Any improvement with the sports teams has a multiplying effect on earnings throughout the company – better teams mean playoff ticket sales, more tickets sold in general, higher ticket prices, more merchandise and concession revenue and better per-sub affiliate fees and advertising rates for MSG and MSG+. Ticket prices will be raised for the first time (if there is a season, see below) but demand still greatly exceeds supply. The renovated lower suite level is already sold out and a 10 year sponsorship deal with JP Morgan for \$300M gives visibility into ROI. This analysis ascribes no value to the Liberty or the Wolfpack and the presentation rights for live sporting events that take place at the Garden, which clearly have value. The sports teams are part of the cultural fabric of New York with very loyal fan bases.

Air Rights and Venues: MSG owns the land and the buildings on which Madison Square Garden rests and it also possesses the air rights. Gabelli estimates that the air rights are worth \$250M at a 50% discount to the 4.5M capacity of MSG at \$110 per square foot. The sum of the parts does not consider the value of their other tier 1 entertainment venues, which is highly conservative, and values its Live Nation stock at its market price.

Investment Risks/Considerations

NBA Lockout: In June, the NBA players were locked out after the Collective Bargaining Agreement (CBA) between the players and owners expired. The negotiations are ongoing and the crux of the disagreements revolves around the split of Basketball Related Income ("BRI") between players and owners and a "hard" salary cap that cannot be exceeded. Under the old agreement, players received 57% of BRI and there was a "soft" cap that allowed owners to exceed the salary cap but pay a penalty. The work-stoppage could have a significant impact on MSG in the near-term. By my calculations, a loss of the whole season could result in a loss of ~\$170M in revenue and \$85M in incremental EBITDA. Although it is my opinion that the entire season won't be lost, the uncertainty is priced into the stock and the negotiations will be a net positive for MSG's profitability and investors with a longer time horizon.

Overhang on Stock Due to Dolan Family Control: The "Dolan Discount" will erode over time as the Dolan's look to earn on their \$400M position in the common stock. The Dolans have exhibited shareholder friendly activity in the last two years with the spin out of MSG and AMC Networks and the dividend and share repurchase at Cablevision. The typically 10%-20% discount associated with insider control is warranted but the significant discount likely associated with Dolan control is excessive. The Dolan's have offered investors in Cablevision numerous potential liquidity events over the years and there has been plenty of speculation that James Dolan would like to take MSG private. I view the Dolan ownership as a 'put' that offers investors downside protection.

Sum of the Parts Summary	
MSG Media	
MSG/MSG+	
EBITDA	\$228
Multiple	12x
Value	\$2,736
Fuse	
Subscribers	49
Per Sub	\$1
Value	\$49
MSG Entertainment	
Xmas Spec. / Theaters	\$150
MSG Sports	
Knicks	\$655
Rangers	\$400
Other Assets/Liabilities	
MSG Air Rights	\$250
Live Nation Stake	\$34
Less: Corp. Cost	\$108
Total SOTP	\$4,166
Plus: Net Cash	\$301
Less: Renovation NPV	\$675
SOTP Value	\$3,793
Price Per Share	\$48.49
Implied Ann. Return	48%

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Graham & Doddsville 2012 / 2013 Editors



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