Columbia Business School

Graham and Doddsville

An investment newsletter from the students of Columbia Business School

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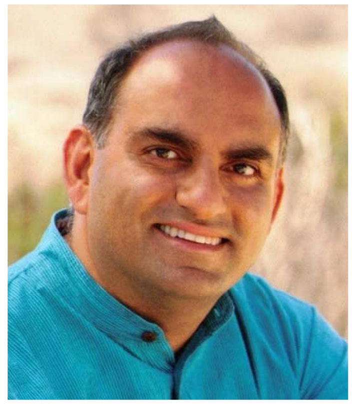
Making Heads and Tails of Mohnish Pabrai

Mohnish Pabrai launched Pabrai Funds in 1999. Less than a decade later, Mr. Pabrai's name is often mentioned in the same breath as legendary value investors who have been in the business for decades. The Pabrai Funds annual shareholder meeting has become a stop on a value investing tour that includes the annual meetings of Berkshire Hathaway, Wesco, and The Sequoia Fund. He is also a frequent guest of Bloomberg, CNBC, and The Value Investing Congress.

In 2007, Mr. Pabrai published his second book, *The Dhandho Investor*, which is quickly becoming a 'must read' for all value investors. Last year, along with Guy Spier, manager of Aquamarine Fund, Mr. Pabrai was the highest bidder in an eBay auction for lunch with Warren Buffett. With his daughters sitting on either side of Buffett, Mr. Pabrai, Mr. Spier and their families spent the afternoon of July 25 with their mentor.



Mohnish Pabrai—Pabrai Funds

In April, Mohnish made his first appearance at Columbia Business School where he appeared as the guest lecturer in Professor Bruce Greenwald's Value Investing Seminar. Mr. Pabrai's investment style has not only been influenced by Benjamin Graham, Warren Buffett, and other value investors, but also by the Indian approach called Dhandho. When asked about his investment philosophy, he often repeats the mantra "Heads I win, tails I don't lose that much." *Graham and Doddsville* was lucky enough to sit down and delve deeper into Mohnish Pabrai's investment philosophy.

Question: How did you get started with value investing?

Until I was 30 years old, frankly, I had never heard of Mr. Buffett. I had never heard of value investing. This was 1994 and I was vacationing in London with my wife. I was looking for something to read on the flight back to Chicago, and I picked up one of Peter Lynch's books. I am an engineer by training, so this was a different field for me. I read that book on the flight and I loved it. It made all the sense in the world to me, in

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Graham and Doddsville Celebrates the 75th Anniversary of Graham and Dodd's Classic

Welcome back to Graham and Doddsville! The summer has come to an end, and a new school year has begun amidst the largest shake-up on Wall Street since the Great Depression. While the times have changed, the original tenets of Columbia Business School Professors Benjamin Graham and David Dodd remain the same.

Along with the new school year, September also marks the publication of the sixth edition of *Security Analysis*. This edition comes as we celebrate the 75th anniversary of the first edition, published in 1934. Professor Bruce Greenwald continues Columbia's rich tradition of value investing as co-editor of the new edition along with Jim Grant and Seth Klarman.

Graham and Doddsville strives to bring you insight and information from the current generation of investors who follow the framework set forth by Graham and Dodd. This issue is no exception, and we are especially pleased to present an interview with Mohnish Pabrai of Pabrai Funds.

Inside you will learn from investors such as Warren Buffett, Joel Greenblatt, Bill Ackman, Rich Pzena, Daniel Loeb, and many others. We are also

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Graham And Doddsville Celebrates… (continued from page 1)

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proud to feature Shilpa Marda's winning pitch from The First Annual Pershing Square Challenge.

This year promises to be an exciting one for all investors. We will continue to bring you insights from some of the most prominent citizens of Graham and Doddsville. If you have any comments or suggestions, e-mail us at: newsletter@grahamanddodd.com.

Go online to find this and past issues of Graham and Doddsville, as well as other resources from CIMA:

http://www0.gsb.columbia.edu/students/organizations/cima

Erin Bellissimo, co-director of the Heilbrunn Center, and professor Dan Kruger, Professor of Distressed Value Investing catch up at the 11th Annual CIMA Conference

Mohnish Pabrai (continued from page 1)

"The thing that I found very strange was that if there is such a thing as the laws of investing, Warren Buffett has pretty much laid them out."

terms of how to and how not to invest. I thought this was an interesting area and I wanted to know more about it, so I found that Peter Lynch had another book and I read that one too. I wanted to learn even more, but I ran out of Peter Lynch books to read. I remembered that in one of the books, Peter Lynch mentioned Warren Buffett and told a story of how Buffett had called him to get his permission to use a quote. This was the first time I had ever heard of Warren Buffett. I figured since Lynch was talking to Buffett, I should learn more about who Buffett is. I looked around, and found the first two biographies that had just been published: Lowenstein's *The Making of an American Capitalist* and Hagstrom's *The Warren Buffett Way*. I read those books and I just had an epiphany. They resonated strongly with me.

The thing that I found very strange was that if there is such a thing as the laws of investing, Warren Buffett has pretty much laid them out. What I couldn't understand was that when I looked at the entire mutual fund industry at the time, which were the professional managers that I had exposure to, I saw that these guys not only did not follow the fundamental laws of investing, but most of them didn't even know what they were. At the same time, their results reflected sub-par performance. So I thought there must be a correlation between these guys not following the rules and having poor performance.

The second thing I found very strange was how you can have an entire industry which does not function with a solid framework. To me, it is like people doing brain surgery by just 'winging it'. That is how I saw mutual funds work – they were just winging it, or they come up with any nuance or 'flavor of the day' they want to pursue. I had a thought that if novices like me simply adopted Buffett's approach and invested in the equity markets with a concentrated portfolio, etc. that I was likely to do better than most of the industry professionals. So I said it was worth testing this hypothesis out. I was lucky at the time in 1994; I had about $1 million in cash. I had just sold some assets of my business and I decided to go ahead and manage that in a Buffett-style concentrated portfolio, buying things I understood, etc. That is how I got into value investing.

Question: You have managed Pabrai Funds since 1999. That must have

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Mohnish Pabrai (continued from page 2)

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been quite a time to open a value fund.

Actually, 1999 was very interesting. I think it was a great time to start as a value investor because the market in 1999 and 2000 had segregated. As a matter of fact, on the day that the NASDAQ hit its peak, Berkshire hit its 52-week low. What happened is that a lot of money had gone into these frothy dot-com type stocks, but effectively it had come out of brick-and-mortar, normal businesses. A lot of brick-and-mortar, real-world businesses were trading really cheap. So it was actually a great time to go into the equity markets as long as you didn't drink the same Kool Aid that everyone else was drinking. In fact, after Pabrai Funds' first year, in June 2000, we were up approximately 38% after fees. Then the second year we were up by mid- 30% after fees. We did really well in the year when everything crashed and burned, for that reason.

Question: Over the past 10 years, how have you seen the value investing landscape change?

There isn't much of a change. The good news is that there is now more of a community with things like Whitney's newsletter (Value Investor Insight), conferences, and the Columbia Value Investing Program. Clearly there is now more interest. However, if you look at all of the people involved with investing in the equity markets worldwide, the percentage of them that focus on true value investing is still a very, very miniscule percentage. I think that, in general, the opportunity to do value investing is almost as good as it was 10, 20 or even 30 years ago.

Question: Where do you hunt for your ideas?

When I look for ideas, I look in places like the 52-week-low list, *Value Line*, as well as stocks with low P/E ratios, low P/B ratios, or large discount-to-book value. Now I have Joel Greenblatt's Magic Formula; I look at that on a daily basis as well. I also subscribe to *Portfolio Reports*, published by *Outstanding Investor Digest*, which gives a listing of all the buying of major value investors every few weeks. I also look at 13F filings of the usual suspects such as the Fairholme Fund, Marty Whitman, Einhorn, and all of those folks. That is basically where I go fishing.

Question: What are characteristics of the companies that attract you?

In general, I look for industries with a slow rate of change, companies with some type of moat, and companies with hard assets. I look to buy businesses where I can rest my hat on the hard assets of the business. Other times, I look at businesses that have more of a franchise value, so the intrinsic value is made up more of intangibles such as brand, etc. Basically, what I'm trying to do is find businesses that I can buy well below what they are worth. I usually try to make one bet per industry, and I typically put 10% of the fund's assets into each idea. An ideal portfolio would be comprised of 10 positions from 10 different industries all priced at a discount to what they are worth. In terms of what exactly I focus on is determined by what is on sale.

Question: Once you identify a potential investment idea, what is your process for determining whether it is in fact a good investment?

After I identify an interesting company, I begin to drill down reading the 10K's and 10Q's. When I first come across a business, I generally ask myself within the first few minutes: Is this something I understand well? Is this a relatively straight-forward business to understand? If I am not getting a clear idea in my head of how the business works and how it makes money, then I will generally stop and move on to the next business. In fact, I often move on if I can't answer that question right way. So the first question you have to ask yourself is: In general, is this a business I can understand? I made an investment in 2001 in a company called Stewart Enterprises which is in the funeral services business. I can understand that business. You bury people, cremate them, you get paid, etc. Then you can start to think about understanding the finer points, such as the brand, and what people think about the community of funeral service providers. It is not a business where a competitor can open up overnight with cheaper pricing and just take your business away. Then, there is the fact that it is rare for someone to aspire to go into the funeral business. In general, it is not an attractive business for a 25-year-old to think about entering, so it keeps the number of new entrants down. Finally, all humans eventually die. They may live longer, but eventually we die, so you also have a steady stream of customers coming in.

So these are the kinds of things to think about when you start thinking about a business. If they all make sense, then you can begin to look further into

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"What I couldn't understand was that when I looked at the entire mutual fund industry at the time… I saw that these guys not only did not follow the fundamental laws of investing, but most of them didn't even know what they were. At the same time, their results reflected sub-par performance. So I thought there must be a correlation between these guys not following the rules and having poor performance."

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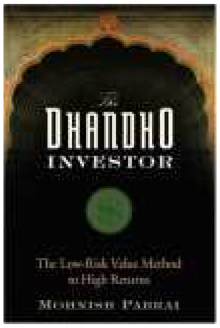
Mohnish Pabrai (continued from page 3)



In 2007, Mohnish Pabrai published his second book, *The Dhandho Investor*

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the business at things like value, why it is trading where it's trading, what it is really worth and so forth and so on.

Question: You have often said that you look for dollar bills that are selling for much less than a dollar, then you need to have the strength to be patient and wait for the rest of the world to realize it is worth a dollar. As MBA students, we are often asked for stock ideas when we interview for summer internships or full-time positions. The first question that we are often asked is "what is the catalyst for your idea to reach its intrinsic value?" How do you think about catalysts when you are making an investment?

I don't focus on catalysts. I have always felt that value is its own catalyst and that eventually the stock market becomes a weighing machine and will weigh stocks correctly. I recently bought into a European company that trades at about 1/3 of its hard asset liquidation value. I can't see any real catalyst in that business. I couldn't tell you when or what event will make that value converge, but if something is trading at 1/3 of what it's worth, I think that if you are just patient for a few years, it is highly likely that you will make money and it is highly unlikely that you will lose money.

Question: How do you think about downside risk?

At Pabrai Funds, I have made several mistakes in the past and I'm sure I'll make several more in the future. You always need to protect the downside risk. I think margin of safety is one of the most important tenets that Ben Graham talked about. You always want to ask yourself "What is my downside?" You also want to get some comfort that you have some protection. In some cases, you can get that comfort from liquidation value or hard assets minus liabilities. In other cases, you may get comfort from somewhere else. For example, if you look at a company like Moody's or American Express, you couldn't invest in these based on liquidation value. If their brands were permanently impaired, you would probably be losing money. However, as long as the brand continues to grow in value, you can end up making a lot of money. When you are looking at the margin of safety you can look at it in terms of hard assets like Ben Graham used to, or you can look at it in terms of more intangible assets which can be very valuable.

"I have always felt that value is its own catalyst and that eventually the stock market becomes a weighing machine and will weigh stocks correctly."

Question: As a value investor, you have mentioned you look out over the 3- to 5-year period. Wall Street obviously has a much shorter horizon. How do you maintain the temperament to hold a security the time it takes to realize its value?

I'm very blessed with the investors I have at Pabrai Funds. I have about 400 families across the five funds I manage at Pabrai Funds with over $550 million in assets and on a typical day, I never hear from any of them. I have an annual shareholder meeting that many of my investors show up to. It is a great group of investors. Even recently, with the market turmoil, I really haven't had many e-mails or calls. I love to partner up with these types of folks. So I don't really face much pressure from the investor base.

Second, I generally don't discuss the existing portfolio positions. That keeps a lot of the noise down. Third, I think the temperament or patience comes in part from the way we are wired or the way we can learn, or not learn, from Ben Graham, Warren Buffett, etc. You know, Warren Buffett has said many times that people either get value investing in five minutes or they won't get it in five years. So, there is something in the human wiring of our brain that, for some of us, makes all the difference in the world right away and the patience that it requires is part of that wiring process. For others, they may buy into the concept completely, but they temperamentally just don't have the patience.

Question: When do you

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Mohnish Pabrai (continued from page 4)

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think about selling an investment?

I typically try to buy things for fifty cents or less and I start to think about selling them when they get to be worth ninety cents or more. When things are above ninety percent of intrinsic value, they become candidates to be sold. Of course I factor into the decision things such as long-term vs. short-term gains or what other opportunities there are for the money. When things go to one hundred percent of intrinsic value, I would be looking hard for replacements or thinking about going to cash.

Question: In the past, what were some of the signs that made you realize you had made a mistake?

At all times, you have to be asking yourself the question "What is the business worth?" and "What is the intrinsic value of the business?" A couple of things can happen. First, you could have made a mistake on what you thought the business was worth and you could later have realized that it isn't worth what you thought it was. In this case, you should look at the current stock price. The algorithm I use is to ask whether the current worth of the business is less than the current stock price. If the answer is yes, there is no question that the stock ought to be sold. On the other hand, even if I made a mistake, but the current value of the business is still above the current stock price, then I will typically wait for two or three years from the time I bought before I would think about selling. I'll give the market some time to try to close that gap.

Question: Several value-oriented hedge fund managers that have spoken to our class this year talked about the advantage they have to go both long and short the market. I know that you have different opinions about shorting stocks.

I think that Charlie Munger expressed it really well at this year's Berkshire Hathaway Annual Meeting when he said that they made most of their money going long on a few great businesses. Buffett has ventured into all kinds of derivatives or pair trades, or shorting, etc., but clearly he has made most of his money by being long on great businesses. I think that the math on shorting is very bad.

"I think the temperament or patience comes in part from the way we are wired or the way we can learn, or not learn, from Ben Graham, Warren Buffett, etc."

First of all, in general, over very long periods of time, markets go up in value. So the starting point of a short bet is to have head-winds against you. That is the first problem.

The second issue is that the maximum you can make if you short a stock and it goes to zero is double your money. The maximum you can lose is infinite, because a stock can keep going up, but can only go down to zero, so you don't have a symmetrical risk-reward relationship. The maximum you can make is two times your investment; the maximum you can lose is everything. It is a poor bet to have those types of odds on any bet you are making.

Third, I think it is so much easier temperamentally to go long on a business. If you short a business, you either have to put up stop-losses, or end up on a leash glued to a monitor all hours the market is open. I don't believe that is a very productive way to live your life. I'm usually drooling on my pillow on the West Coast when the markets are opening. So it certainly wouldn't work for me since I generally don't look at the market until several hours of the trading day have passed.

Question: I know you are a big proponent of Charlie Munger's Latticework of Mental Models approach. How have you applied this thought process to investing?

Well, I think that Munger's mental models approach is a very powerful construct. First of all, he talks about the notion of worldly wisdom. He encourages folks to read and learn about things that are outside of the theme of value

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Professor Bruce Greenwald and Dean Glenn Hubbard

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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Professor Bruce Greenwald

Bruce C. N. 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. Described by the New York Times as "a guru to Wall Street's gurus," Greenwald is an authority on value investing with additional expertise in productivity and the economics of information.

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investing or might not seem to have a connection to value investing, but I think it is very useful to know the way the world works. Reading books on science, economics, or other different disciplines and to have a basic understanding of all of these different disciplines is useful to the investing process. I think investing in general is one of the broadest disciplines that one can go into, because any stock you look at is affected by so many different variables. Many of these variables touch on subjects that are outside of investing and finance. So it is very useful to have a broad set of frameworks and tools to draw on. I think it is very useful to basically become a person who is strong on worldly wisdom.

Question: You are a frequent speaker at many events, such as the Value Investing Congress, where you get to hear many investors pitch their favorite ideas. What are some of the biggest mistakes you see investors, especially younger investors, making?

Many times, when I hear about a stock idea from another investor, the idea being presented does not seem to have the margin of safety tenets. I generally find margin of safety to be the weakest part of most ideas. There is a very important thing about Ben Graham's idea of margin of safety which is that the higher the margin of safety, the lower the risk, which is obvious. The second tenet is that the higher the margin of safety, the greater the return. If you are buying something that is a 70 cent dollar, not only do you not have much downside protection, but you don't have much of an upside either. Both ways you are a loser. Most of the times that I see people pitching an idea, I usually see them talking about 65 – 75 cent dollars and I think that those ideas tend to be lacking on two fronts: There isn't enough of a margin of safety and there isn't enough of an upside.

"Many times, when I hear about a stock idea from another investor, the idea being presented does not seem to have the margin of safety tenets. I generally find margin of safety to be the weakest part of most ideas. "

Question: We were fortunate to have heard you speak in Professor Greenwald's Value Investing Seminar, where you used an analogy about smoke-filled theaters and spectacular waterfalls. Can you discuss this concept?

I was recently discussing this concept with a bunch of value investors and they all said they never heard Buffett use this analogy, but I could swear that I heard it from Buffett. So for now, I will continue to say that I got it from Warren Buffett.

Here is the basic concept. Let's say you go to see a movie and you pay $10 to buy a ticket. Every seat in the theater is occupied – the house is full. Suddenly, the smoke alarm goes off in the middle of the movie and as smoke begins to fill the theater, people run for the exit. Now, this movie theater has special rules, and the rule is that you can only leave the theater as long as you find someone from outside the theater who will take your ticket and seat. You must enter into some type of transaction where that person pays you for your ticket. So the question that comes up is at what price will that $10 ticket sell for now that there is this alarm and smoke in the theater, and the answer is that it probably doesn't sell for very much, or you might have to give it away for free, or you may even have to pay the guy to take it off of your hands. That theater is the New York Stock Exchange, because on the stock exchange every share of any business is owned by someone at all times. If there is an event which is a distressing event for a company which leads people to say I no longer want to own the stock, that is like the smoke in the theater and people wanting to exit the theater. The person who you want to sell the stock to, which is the person who wants to enter the theater, has access to the exact same information that you do. He also knows there is smoke in the theater. Therefore, for him to still be willing to buy it, the price at which the transaction takes place, is likely to be a significant discount at what the stock was trading at before the smoke. If you enter selected smoke-filled theaters, and you later find that the smoke is really nothing to

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Mohnish Pabrai (continued from page 6)

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worry about, or it has been put out, then there is a chance you have gotten a great investment and you can do quite well with it.

The second part of this is when you have smoke in theaters, you are going to have these huge collapses in stock prices. If you look at the stock's chart, these will look like a waterfall. So what this means is that smoke-filled theaters are likely to lead to spectacular waterfalls. As a value investor, you don't want to enter every smoke-filled theater. What you want to do is carefully analyze these smoke-filled theaters to try to find one where the smoke is not real, or the fire alarm is not real, it went off for no reason, and then buy those tickets at hugely discounted prices, then sit back and watch the rest of the movie.

I think this is a good way to summarize the framework. One example I spoke about at Columbia was Wellcare (NYSE: WCG). I generally don't talk about stocks that I own, but I felt that Wellcare was such a pure textbook example. I couldn't come up with a better example, even looking at the history of stocks. I also think people learn a lot more with Ben Graham's technique of talking about current stocks since they can relate better. Here is an event that is still playing out; there is still some smoke in the theater.

Wellcare is a situation where you have a company that is trading at over $120 a share when 200 federal agents show up at their doorstep, unannounced, holding search warrants. The stock is halted and when it resumes trading, there is no data other than news of the 200 agents. That is clearly a theater with an alarm going off, with all kinds of smoke in it. The people sitting watching the movie had signed up for this high-growth, high-momentum stock, and they had signed up to see a certain kind of movie. When the federal agents showed up, they could clearly see that this is not the kind of movie they want to see. They don't want to be hanging around with all the smoke and they want to leave. When they try to leave the theater, they needed to sell those tickets to someone else and the clearing price that they exchanged their Wellcare tickets for was $20 a share. This was 50% of just the cash on their balance sheet. Forget about the business, the earnings engine, and everything else; people were not even willing to pay for the hard assets of the business at that point – not even the liquid assets of the business at that point. So you got a very spectacular, real-world case of logic going out the window, just because of the stampede out of the theater.

Question: What importance do you place on assessing management when you make an investment?

The jockeys are very important. It depends on the situation. I think that the ideal situation is to have a business that is a great business, which is going to grow a lot in the future and not require much capital. The best example of something like that is Moody's – a great business, growing a lot, that you can buy at a very cheap price – well below its worth and run by a spectacular manager. That is utopia, and that is what you always want to try and look for.

The real world usually is not that accommodating. You may have to look at situations, like Ben Graham did, where he focused more on the hard assets, and not much on management, etc. So, I have had some very successful investments in businesses where the bet was based on hard liquidation value, and I did not spend a lot of time assessing the quality of management, other than that they were competent.

There are other businesses where the quality of management is more critical, because of the nature of the business. I was recently looking at the stocks I've held the longest at Pabrai Funds. There are some stocks that I have held now for 5 or 6 years. I looked at these stocks and I asked what about these companies has kept me in these businesses for so long. In many cases they are up two, three, or even four times where I bought them and I still believe they are undervalued, and still hold onto them. The reason is, universally, because of the quality of management.

What I have learned to appreciate, when I looked back at that nuance - historically, I have not paid that much attention to the jockey. But I have learned, sometimes very painfully, that jockeys are much more important than I had given them credit for in the past. So going forward I care a lot more about jockeys. I'm not always able to find great jockeys along with great businesses that are also undervalued, but I have learned to appreciate the importance of jockeys.

One thing I would say is that if you take a look at three classic value managers: Longleaf Part-

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"As a value investor, you don't want to enter every smoke-filled theater. What you want to do is carefully analyze these smoke-filled theaters to try to find one where the smoke is not real, or the fire alarm is not real, it went off for no reason, and then buy those tickets at hugely discounted prices, then sit back and watch the rest of the movie."

Mohnish Pabrai (continued from page 7)

Mohnish Pabrai, Warren Buffett ('51), and Guy Spier

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ners, Third Avenue, and Fairholme - all three are value managers, but all three have very different styles. Marty Whitman of Third Avenue cares very much about hard assets and he doesn't care as much about things like franchise value, or moats or even management. He cares the most about hard assets. If you look at someone like Longleaf, they care a lot about the franchise. They focus on the enduring moat, franchise, etc. One time they mentioned that they thought that Coke bottlers were a great business, and they went looking around the world making a list of every Coke bottler on the planet, trying to see which ones they could invest in at decent prices. In general, they focus on the business and the valuation, but not as much on the management. Their focus is more on moats and franchise value, which is what you will see if you look at Longleaf's portfolio. Then, if you look at someone like Fairholme, they are all about jockey bets. Most of their portfolio is invested in people who are great jockeys. They have large positions in Leucadia, Berkshire Hathaway, and Canadian Natural Resources. If you start to look at why they bought these businesses, it is all about the jockey.

When I look at Pabrai Funds, I think of it as a blend of the three, because I have made many investments which are very much Third Avenue-type bets – pure hard-asset plays. I have also made investments where it is about the franchise value, moats, brands and so on – a Longleaf play. I have also made several jockey bets, like Fairholme. I would say that over the past 12 months, I have learned to appreciate and spend more time analyzing the jockeys and put more weight on it.

Question: What advice would you give to MBA students who aspire to a career in investing?

I think that the best thing to do is to actually set up a small portfolio of your own and start making real investment bets. Don't run these virtual portfolios – take real money that you actually have, and invest it like you would invest a $5 million portfolio. Be rigorous about it because I think you learn when you make mistakes that actually cost you money. From my point of view, that is the best way to learn.

Going to Columbia is a great idea! If you are already at Columbia, follow Buffett's advice and try to find a shop that is run by people you admire and have principles you believe in, and try to convince them to bring you on board without focusing on compensation.

Thank you, Mr. Pabrai.

-G&Dsville

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Annual Alumni Reunion with Joel Greenblatt

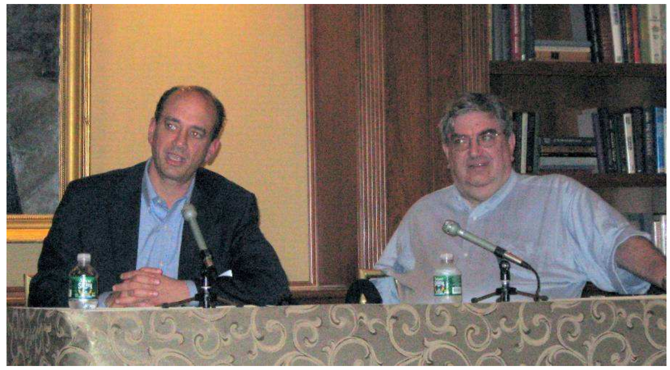
On April 28, 2008, current students and alumni of the Value Investing Program were invited to the annual spring reunion at the Columbia Club in Manhattan. In his introduction, Professor Bruce Greenwald proclaimed that speaker Joel Greenblatt has achieved "the trifecta: he is a terrific investor, he has written terrific books, and he is a terrific teacher in the Value Investing Program."

After reading his first book, *You Can be a Stock Market Genius,* one might naturally wonder if things were different when Professor Greenblatt began as a professional investor. "Was it more of the Wild West 25 years ago?" asked Greenblatt. "Now we keep producing all these smart guys out of MBA schools who are doing all this research and maybe those efficient market guys were right. There are no opportunities left…" However, Professor Greenblatt pointed out several reasons to be optimistic. First, the internet bubble wasn't so long ago. Second, in 2002 – 2003 there were some of the best bargains in the market that he had seen in many years. Third, credit markets, which are much bigger than the stock market, were insane just about a year ago. All this points to a market that is not efficient.

The longer Greenblatt has been in the business, the more institutionalized he has seen it become. "Money managers have different directives – and now people only care how you did last month. If you beat the benchmark this month or next month, and more people become focused on that, then less people can focus on what normal earnings power should be in a normal environment two to three years out, and what multiple does that lead you to? What multiple does a company deserve in normal times and what kind of a discount does that mean a stock is currently at?" Greenblatt's bet is that a turn in the market will come, he just doesn't know when. By focusing on normal earnings, an investor can create what Bill Miller calls Time-Horizon Arbitrage. "There are guys who can trade short-term, and bang out huge returns every month, but (a) I'm not one of them; and (b) you are likely not one of them either!" quipped Greenblatt.

Professor Greenblatt suggests that investors focus on finding areas that are ripe for mispricing. When economic forecasts are bleak, people worry, and in turn, misprice securities. "Their outlook may be right," says Greenblatt, "but this isn't where I focus when investing. I focus on normal earnings power and a long-term normal environment." According to Greenblatt there are a lot of opportunities right now.

Next, investors should be trying to figure out what the companies they are looking at are likely to earn in a normal environment. Whether that normal environment returns next year, or a few years from now is unknown; but investors need to make sure that whatever they are buying is at a big discount to that value. But how should an investor think about normalizing earnings, on a long term basis going forward, when the last 8 years or so of backward data for many industries might be inflated? One thing to look for is whether margins were higher over the past few years than they were on a long-term basis. That analysis would go into your normalized number. According to Professor Greenblatt, the concepts of value investing aren't very complicated; however, they are difficult to put into practice. It is imperative that one maintain discipline in the face of everything going on. Assumptions may have been too optimistic over the past few years, but investors need to adjust their valuations based on what they think normalized is now.



Professor Bruce Greenwald moderates a Q&A with Professor Joel Greenblatt at the Columbia Club.

Professor Greenblatt suggested that "…the best thing to differentiate yourself in the process is not just by doing the good work, but by having the discipline to *not* buy something just because you did the good work." Investors need the discipline to recognize when a company they have been working on is not selling for the same discount as they have seen in the past and pass even if it is just a 'little bit' cheap. "If you are extremely disciplined, only buy when you have a large margin of safety, and are willing to stick it out for two or three years - then I think you have the right process."

"I wait for easy ones," admitted Greenblatt. "I wait for ones where I say 'hey, if someone would have looked at it this way, it is clearly cheap'." This

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"The concepts of value investing aren't very complicated; however, they are difficult to put into practice…"

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Annual Pilgrimage: CBS Students Meet With The Oracle Of Omaha

CIMA Co-Presidents Del Anderson ('08) and Matt Loesch ('08) pose with Mr. Buffett

"This is a difficult market. Recently I heard the story of an investment banker who had to tell his wife that there would be no bonus this year. He says, 'We're going to have to cut back. If you could learn to cook, then we could fire our chef.' To which she replied, 'If you could learn to make love, then we could fire the gardener!'"

And so began Warren Buffett's opening remarks to a group of students from Columbia Business School and the University of Texas A&M on March 21st at the Omaha Field Club in Omaha, Nebraska.

The trek to see the Oracle began early the night before with nearly 120 of Professor Greenwald's students meeting at 116th and Broadway at 3:30 am. From there, two buses arrived and brought us to JFK airport, where we boarded a chartered Jet Blue plane at 6 am.

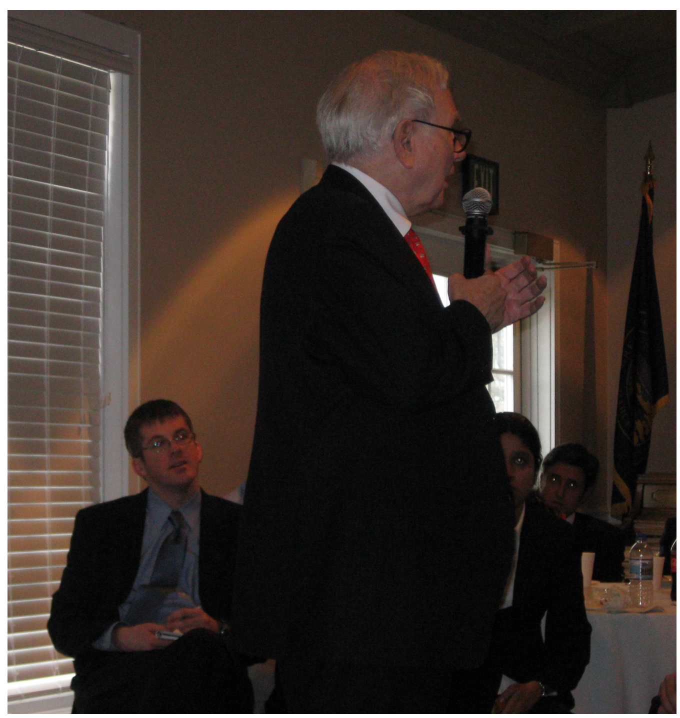
The group arrived in Omaha at 9 am and proceeded to a Berkshire-owned subsidiary, the Nebraska Furniture Mart, where we were greeted by Bob Batt. Mr. Batt, the CEO of Nebraska Furniture, is the third generation of his family to run the company, which was founded by Rose Blumkin in 1937. The purchase of Nebraska Furniture Mart is the stuff of Berkshire legend. And though Nebraska Furniture may not contribute as much as Geico to the bottom line, there is no question that this business is a quintessential WEB investment. It is a business that is run by honest, hardworking people who could quit at any time, but don't because they love their jobs.

By noon, we had taken the full tour of Nebraska Furniture and were ready to pepper Mr. Buffett with as many questions as he'd let us ask. The Q&A session lasted for over two hours and began with a question about Mr. Buffett's thoughts on derivates.

Financial weapons of mass destruction

Although he has been warning the markets about the dangers of derivatives and structured products for years, Mr. Buffett appeared to experience no joy in his recent vindication. He noted that his primary concerns about derivatives involve the leverage they allow participants to employ, and the opaqueness around their true value.

On the plus side, Mr. Buffett noted that there are often significant mispricings in derivatives which create opportunities to profit. On the minus side, "derivatives present big opportunities for financial mischief. When we purchased Gen Re, there were 24,000 contracts on the books. One contract went out 100 years!" said Buffett.



Adam Lindsay ('09) listens as Warren Buffett ('51) answers questions posed by students of Professor Greenwald's Value Investing Seminar

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Annual Pilgrimage: (continued from page 10)

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It was in this context that he remarked "the CEO should also be the head of risk management for any major financial institution. I personally handle all of our derivative contracts. However, it is now obvious to all of us that most banks, insurance companies, and asset managers are not run this way. Back when we were running Salomon, my partner Charlie found a large number of mistakes in one of the derivatives contracts. We paid Arthur Andersen millions of dollars to review the contracts for us, and yet they had missed it. These things are designed to fool. They fooled the accountants, but they didn't fool Charlie!"

Salomon Brothers

Mr. Buffett's discussion of derivatives at Salomon Brothers provided a nice segue for a question about the famous deal in which Berkshire purchased $700 million of preferred convertible stock. The question, akin to asking a chess grandmaster what moves he would use on himself, asked whether he would have done the deal had he been in Salomon's shoes. Mr. Buffett's answer highlighted the benefits and pitfalls that he experiences as a long-term investor, and as one considered by many to be the greatest of all time.

Initially, Buffett explained, Ronald Perelman had indicated interest in buying Salomon – but John Gutfreund was unhappy with the prospect of selling to someone with a reputation for financial engineering. Berkshire clearly had no interest in buying it, levering it up, and selling – so the firm became a very attractive candidate. Second, it has been argued that Buffett received exceedingly favorable terms in the deal. Buffett countered this point with the following observation: Just as stocks often pop when people find that Berkshire is buying, they also fall when Berkshire is selling. Would you buy a stock that Mr. Buffett didn't want? To make up for the discount Berkshire receives when selling—and to compensate for the long-term commitment it makes—Berkshire often needs to demand excellent terms to justify a deal. It is also worth noting that Mr. Buffett received a salary of $1 and is widely credited for keeping Salomon out of bankruptcy. As he said, "I think they got their money's worth."

U.S. trade deficit

Mr. Buffett described our trade deficit as the U.S. force feeding the world $2 billion in U.S. paper every day. "It is kind of like eating an extra roll for dinner every night – it's not like you get up from the table and suddenly people say, 'Oh my god, you've gotten fat!' But over time, of course, it has consequences."

He also noted that accompanying our deficit are some policy decisions that could prove problematic. China has accumulated foreign exchange reserves of $1.5 trillion. Yet when they tried to take some of those funds and purchase a third-tier oil company, Unocal, "Congress went ape." Forcing other countries to take our money and then not allowing them to spend it as they wish does not seem sustainable, Buffett claimed.

Valuation of international companies

A Q&A session with Mr. Buffett would not be complete without someone asking how he values a company. This visit would be no different – but the question focused on the valuation of international companies in particular. The Oracle compared the valuation of companies to how he used to handicap horses. "At the race track, the first thing you want to do , all things equal, is determine each horse's chance of winning the race. Then you figure out which one has the best odds relative to its chance of winning." This is the exact approach he took to valuing PetroChina. Mr. Buffett remarked that when he first looked at the company he thought it was worth about $100 billion. But it was only selling for $35 billion in the market at the time. As he said: "That got my attention." While he freely acknowledged that investing in China is not quite like investing in the U.S., Buffett maintained that PetroChina seemed to be trading at a "significant discount for one of the world's largest oil companies." In such a way, Berkshire was able to scoop up shares of PetroChina with a significant margin of safety. In general, Mr. Buffett explained that he takes the same approach to evaluating foreign companies as he does domestic ones, but he requires an extra

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Columbia Business School Professors Michael Johannes and Tano Santos along with Mr. Buffett

Annual Pilgrimage: (continued from page 11)

Students present Mr. Buffett with a Yankees Jersey bearing the year he graduated from Columbia Business School

"Banks got into trouble by passing around this toxic Kool-Aid, like Jim Jones. And then they drank a couple of gallons themselves."

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measure of undervaluation to compensate him for potential unknowns.

Of course, as any value investor will tell you, a huge component of valuation is understanding competitive advantage. When asked about how he assesses a company's competitive advantage, Mr. Buffett walked us through numerous examples including See's Candy, Coca Cola, and Snickers. This discussion can be summarized succinctly with Buffett's first eight words: "If it isn't obvious, I don't buy it."

Banks and the financial crisis

Not surprisingly, the current turmoil in the financial markets spurred one student to ask Mr. Buffett his thoughts on Citigroup and the other money-center banks. Acknowledging all of our concerns, he remarked that "Citi will be around in the future. You have to think that when the Fed steps in to save number five Bear Stearns, they will print money if they have to in order to get the big banks through." More interesting, perhaps, was how Mr. Buffett betrayed his financial sophistication when discussing the possibility of bankruptcy in the financial markets. Although decrying the abuse of derivatives, Mr. Buffett is unquestionably savvy and will look just about anywhere for mispricings. "It is interesting if you look at the credit default swap market, which is essentially the cost of insurance against Citigroup defaulting on its bond obligations, it is implying a 3.4% likelihood of default. I think that is wrong."

Showcasing his knack for evocative analogies and imagery even an MBA could understand, Mr. Buffett described the financial crisis in the following way: "Banks got into trouble by passing around this toxic Kool - Aid, like Jim Jones. And then they drank a couple of gallons themselves."

Other people's money

One CBS student displayed an interest in starting his own firm one day and asked Mr. Buffett how he knew he was ready to manage other people's money at such a young age. Mr. Buffett recalled that he left Columbia when he was 20 years old and became a stock broker in Omaha. His first call was to his Aunt Alice, to whom he sold 100 shares of Geico. Buffett remarked that some of the other calls weren't so easy. "I was always comfortable doing things with my own money – that was never a problem. But I was bothered when others bristled at the price action on a stock or investment I had recommended. It was difficult for me. People would worry if Geico lost 50 percent, but I would just buy more."

Acknowledging Ben Graham's influence on him, he said that "after I met Graham, I felt 100 percent confident that I was doing the right thing. So the key was getting my investors to agree to the partnership rules, and they did." Mr. Buffett went on to describe how he used to comb through the giant securities manuals published by Moody's or Standard & Poor's looking for value. Recently he tried a similar tact when he bought a manual for securities and companies in Korea where he quickly found dozens of companies selling for two and three times earnings: "I had never heard of any of these companies, and had never been to Korea. Management could be crooks for all I know, but if you buy 10 or 20 of these companies, you can't lose money. You can find these investments today, but you may have to look in places like Korea."

Lesson from past crises

On the topic of managing money, a student asked about Mr. Buffett's thoughts on lessons learned from past crises such as 1973-1974 and 1989-1990. Mr. Buffett reminded us that the "stock market is there to serve you, not to instruct you. The volatility in a stock is your best friend! I love it when companies' prices jump up by 100 percent or down by 50 percent in the same year. Volatility in stocks is what has made me rich!" He further instructed us to be "detached from the market emotionally, but pay attention to opportunities as they arise."

A turnabout on turnarounds

Some of us in the audience apparently are not patient enough to wait around for the market to throw them a "fat pitch." One student asked about Mr. Buffett's thoughts on turnaround situations and noted that Buffett had been involved in quite a few when he was younger. Mr. Buffett expressed a different sentiment now perhaps because of Berkshire's current size or because of the evolution in his investment philosophy. "If you are good at turnarounds," he said, "you are probably just a good manager. Go join a good business and you will probably do a lot better. Why try to swim against the tide? If you want to build a good reputation, buy a good business. I can't think of

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Annual Pilgrimage: (continued from page 12)

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one person who has been repeatedly successful at turnarounds. Capitalism can be brutal when you are up against competition that has some advantage over you."

Professor Bruce Greenwald and Warren Buffett ('51)

Students, managers, and investors

The conversation took its final turn toward three constituencies in which Mr. Buffett has a lot of interest: students, managers, and investors. Commenting first on his advice for students, Mr. Buffett highlighted the cultivation of accounting and communication skills. "Get as much accounting as you can," he explained, "it is the language of business." In addition to accounting, he stressed the importance of written and verbal skills and pointed out that "the only diploma I have hanging up in my office is from the Dale Carnegie School for public speaking. I joined 30 people every week to work on public speaking. It changed the course of my life. Also, I think writing is extremely important. If you can get ideas across to other people, you will stand out anywhere you go."

Although he discussed what he looks for in a manager in some detail, it boils down to one word: "passion – they've got to want to do the job." In perhaps his most colorful analogy of the day, Mr. Buffett described the type of managers he'd buy a business from: "We don't do auctions. Owners who auction their business don't care about what happens to them. They don't think of it like a painting. When you sell your business, you have two options. Sell to Berkshire and it is like selling your painting to the Metropolitan Museum of Art. We will put up a wing for it. Otherwise you can sell to a private equity shop, which is like selling to a porn shop. They will buy the company and they will want to adjust a few things, make the boobs bigger, and so forth… It will sit on the shelf for a couple of months, and then some guy in a trench coat will come along and buy it from them."

Once the laughter in the crowd settled down, we left Buffett with a final question: "which investors would you recommend today?" Although he was able to tick off a few names, such as Greg Alexander at Ruane, Cunniff & Goldfarb and Seth Klarman at Baupost, Mr. Buffett focused more on how we should think about finding these great investors. When he closed his partnership in 1969, he recommended Sandy Gottesman and Bill Ruane. He knew them well, knew their temperaments, and knew they would pursue sound strategies (for more on this topic, see Buffett's article: "The Superinvestors of Graham and Doddesville). He also noted that, "I wouldn't pick the person who has the best track record. You need to spot great investors when they are young and unknown." Nevertheless, as great as it is to find investors before they are famous, he reminded us of the difficulties in managing large sums of money. Although he thinks funds like Sequoia and Baupost will do better than average, these funds will struggle to do as well as they did when they were smaller.

Striking a pose

After a few concluding remarks, Mr. Buffett accompanied us outside where we partook in yet another Buffett trip tradition: pictures with the Oracle himself! It is quite a sight to behold to see 120 professional and successful adults swarm around Mr. Buffett like so many fifteen-year-old girls at a Justin Timberlake concert. But Warren took it all in stride and patiently took photos until every camera had run out of memory

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Squaring Off Against a Hedge Fund Master

Judges of the 2008 Pershing Square Challenge included (l to r): Professor Bruce Greenwald, Danilo Santiago, Bill Ackman, Ali Namvar, and Ken Shubin-Stein

Announcing the 2nd Annual Pershing Square Value Investing and Philanthropy Challenge

For many investment professionals, making money in the stock and bond markets is the ultimate challenge. For those who succeed, an additional (arguably no less formidable) challenge can be finding meaningful and effective philanthropic activities. Bill Ackman, Founder of Pershing Square Capital Management, noted this "high-class problem" in his introductory remarks for the first annual Pershing Square Value Investing and Philanthropy Challenge, which took place in Uris Hall on April 25th 2008.

Ackman's own experience with business school, he reflected, was "a lesson in due diligence." He followed in his father's footsteps and attended Harvard Business School, which – much to his chagrin – did not offer classes in investment management. To provide additional training opportunities for students of investing, Ackman worked with Columbia's Heilbrunn Center to create the Pershing Square Challenge, which has two objectives: to teach students how to develop and pitch investment ideas, and to give students exposure to charitable giving. As an added incentive, Ackman pledged to donate $25,000 to Columbia Business School on behalf of the student with the most promising investment thesis.

Students spent months preparing for the contest. After a series of five training sessions spanning February to April, students submitted two-page summaries of their investment ideas to a selection committee, which consisted of recent graduates from Columbia's Applied Value Investing program. Five finalists – '09ers Amy Chen, Vikas Jain, Adam Lindsay, Shilpa Marda, and Stephen Walker – were selected to present their ideas to a star-studded panel of judges:

- Bill Ackman – Founder and Portfolio Manager, Pershing Square
- Ali Namvar – Senior Analyst, Pershing Square
- Danilo Santiago – Founder and Portfolio Manager, Rational Asset Management
- Prof. Bruce Greenwald - Robert Heilbrunn Professor of Finance and Asset Management
- Ken Shubin-Stein - Value Investing Program Adjunct Professor

The final presentations began on Friday morning, April 25th. First, Amy Chen presented her thesis on retailer Limited Brands. After a brisk five-minute presentation, the judges began peppering Chen with questions, starting with the balance sheet. Chen explained that the Limited had recently restructured; debt was at a manageable level. The judges pressed further: "Do they own or lease their stores? How much do they pay in rent?" In each case, Chen responded calmly with an impressive command of the facts, and the panelists offered suggestions for how she could improve her thesis.

Next, Vikas Jain shared his views on database marketing firm Acxiom Corporation, which he believed is "a good business run badly." Jain presented a series of steps management could take to increase the firm's stock price. Again, the judges asked questions to better understand the risks and assumptions behind Jain's thesis, inquiring about whether their technology was proprietary and about the presence of a competitive advantage.

Adam Lindsay continued the challenge by advocating a long position in used car retailer CARMAX. His comments demonstrated a thorough understanding of the business, emphasizing its strong competitive position and potential expansion opportunities. In the Q&A portion, the panelists asked a series of detailed questions about the company's financing business and receivables. One judge suggested that a sensitivity analysis of customer default rates would be helpful. The judges also inquired about potential threats from nontraditional competitors, such as eBay.

Shilpa Marda made a compelling case for NutriSystem, the weight management system. Her pitch included primary research on potential competitive threats and a sensitivity analysis of the firm's marketing

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Squaring Off… (continued from page 14)

spending. One of the judges complimented her research on competitors but pushed for more detail on the company's track record of returning cash to shareholders. Marda responded with an easy command of the relevant facts. Another panelist observed that Marda's valuation was very conservative—she could go slightly higher and remain conservative. In response to one judge's question on the impact of a consumer recession, Ackman interjected, "it costs $10 per day – that's less than McDonalds! You can save money *and* fit in your old clothes."

Finally, Stephen Walker pitched CSX, a provider of rail-based transportation services. In his opening remarks, Walker pointed out that CSX benefits from a combination of growing demand and tight capacity for coal, which "has to go by rail." As a former employee, Walker displayed a wealth of knowledge about the business. Questions focused on a number of key issues from regulatory pressure that could arise in a tough economy, competition from the trucking industry, and a potential shift away from coal given a new presidential administration's emphasis on new energy sources.

After these spirited discussions, the panel adjourned for several minutes to debate the merits of each idea and select a winner. In the end, the judges selected Shilpa Marda's NutriSystem pitch. At a lunch reception that followed, Ackman presented the check for $25,000 to Columbia Business School on Marda's behalf and lingered in order to chat with students.

Attention future hedge fund impresarios: do not miss this year's Pershing Square Value Investing and Philanthropy Challenge! The first training event – Competition Analysis and Valuation I – begins on September 26th at 10:00am in Uris 301. For more information, please contact Sean McDonald (smcdonald09@gsb.columbia.edu) or Priyanka Agnihotri (pagnihotri09@gsb.columbia.edu), VPs of education and mentoring for the Columbia Investment Management Association.

-G&Dsville

Amy Wu, David Krasne, and Stephen Walker, members of the Class of 2009, enjoyed the after reception where the winner of the 2008 Pershing Square Challenge was announced. See Shilpa Marda's winning pitch on the next page.

Joel Greenblatt (continued from page 9)

(Continued from page 9)

way, Greenblatt does not have to make much in the way of predictions or have to base his whole thesis on normalized earnings. "I look for something any idiot would buy if they were looking at it in the same way that I was."

Professor Greenblatt thinks young managers will always have an advantage in the business, whether it is value or special situations, because the investors who have success in these areas make a lot of money and become too big for some of the smaller situations. This is where younger investors can excel. One piece of advice he would give to investors who are just starting out, especially if they are starting their own fund, is to avoid investing "like you are running $20 billion if you are running $20 million… Look at some of the situations that some of the bigger guys aren't looking at. Do your own work. You don't have to be as smart as guys that have been doing this for twenty years, because there are situations the older guys just can't look at anymore."

Addressing the 2009 graduates of the Value Investing Program, Professor Greenblatt agreed that for those who have not yet found a job, the economic situation sounds like bad news; "but you don't really want to start working at a time when things are at all-time highs," Greenblatt asserts. This is actually a much better environment, if you can find a job., he says, concluding that "it is a harder time to find a job and a better time to get one!"

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The Winning Pitch: NutriSystem Inc.

Shilpa Marda
smarda09@gsb.columbia.edu

The following section includes a reproduction of Shilpa Marda's winning investment pitch from the Pershing Square Philanthropy and Investment Challenge. Please note this information is dated.

NutriSystem Inc.
(NASDAQ: NTRI)

Price: $18.93
Shrs Out: 29.56M
Market Cap: 559.60M

PE: 9.14
Yield: 3.7%
52wk Hi: $50.33
52wk Lo: $12.55

52 Week Chart:

(data as of 09/25/2008)

Investment Thesis

NutriSystem Inc. is a provider of a weight management system based on a portion-controlled, prepared-meal program. NutriSystem utilizes a direct-to-consumer sales and distribution approach and outsources the bulk of production and distribution of its meals. This results in a business model with low capital requirements, high financial returns (ROA 53%), solid free cash flow, and high margins (gross margin 53% and operating margin 21%). Sales have experienced tremendous growth in the past few years: 68% in 2004, 459% in 2005, 167% in 2006 and 37% in 2007. NutriSystem is primarily a sales and marketing organization with a highly scaleable business (revenue per employee increased from $268k in 2002 to $836k in 2006). Since July 2007, the stock price has fallen from about $72 to $20 per share (current) due to a 3rd quarter and 4th quarter earnings miss and new competitive threat from Alli, which is the first FDA approved OTC weight-loss drug, introduced in June 2007. However, this competitive threat has been misunderstood by the market and I believe NutriSystem will maintain its pricing power (implemented 15%, 3%, 4%, 2% price increases between 2003-2006) and benefit from a growing industry, proven product efficacy, untapped markets and a strong fundamental business model.

Investment Catalysts

- **Impact of Alli** – Introduced by GlaxoSmithKline, Alli restricts the absorption of fat in the body, and has severe side-effects including increased bowel movement and oily spotting. Alli had 2M customers in 2007 since its introduction, resulting in NTRI falling short of new customer acquisitions by 40K in Q3. However, I believe this is a short-term shift in the competitive landscape, as Alli is not sustainable. Initially many people tried it, but did not continue to use it due to severe side effects, and weight gains after they stopped using the product. Alli sales according to GlaxoSmithKline (in British Pounds) were 76M in Q2 (with just 2-weeks of being on the market) 34M in Q3, 40M in Q4 and 9M Q1 2008, indicating the 'faddish' nature of this new drug. Before Alli was introduced, NTRI was trading at a P/E of 30X around June 2007.
- **Growth in Market Share** – NTRI is positioned for growth in a number of areas: *a) Men's Diet Market* – Implemented in July 2006 and represented 30% of the business at the end of 2006. NTRI provides a simple and private weight-loss solution, ideal for the men's market. *b) International market* – Business model facilitates easy expansion through local partners/distribution. Canada launched in Q1 2008 and Japan, Australia, Germany and UK expected to launch in 2009. *c) Seniors* – Launched NutriSystem Silver in December 2006. Provides a simple solution to seniors with minimum hassle. *d) Domestic* – Only represented 1.9% share of diet market in 2007. Innovative product launches such as NutriSystem Advanced in 2008 (omega 3's and heart-healthy meal program) will help increase share.
- **Stable Business with a Scaleable Model –** As NTRI's client base increases, customer reactivations (purchases made outside of the 9-month initial diet cycle) have gone up and in 2007 are expected to represent over 12% of sales. Reactivations yield a net profit margin of 31% vs. new customers, who yield 15%. In 2007, new customers yielded gross margins of $373/customer and CAC of $173, yielding a profit margin per customer of $200.
- **Management buyback of stock and Acquisition Target –** Management has board approval to buy back up to $200M of stock. Management also alluded to receiving calls from potential acquirers.

Industry Landscape and Competitive Advantage

- In 2006, there were 62M dieters in the U.S. divided into the commercial weight loss market (approximately 10%) and self-directed (79%). This is expected to grow to 81M dieters in 2010 (30% increase).
- The international diet market is on the rise with the spread of fast-food chains, increase in wealth and shift to less physically intensive work. According to WHO, in 2005, 1.1B people were overweight.

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NutriSystem Inc. (Continued from previous page)

- Increasingly busy lifestyles and growing use of the internet are conducive to NTRI's model of a convenient web-based weight loss solution.
- Also, in addition to diet due to health risks, U.S. consumers are prone to images in media, fashion, and entertainment that depict thin as the ideal body type.
- Main competitors are WeightWatchers (center-based), Medifast, Jenny Craig (center and direct), eDiets.com (direct – caters to a less price sensitive customer), and self-administered products such as Atkins and South Beach diet and medically-supervised programs.
- NTRI targets the price-sensitive consumer who wants a simple-to-use weight-loss program, but is also used by customers that would not be considered price-sensitive. This is a large market as the majority of overweight people are in the less affluent segment of society.
- While barriers to entry appear to be low, it is interesting to note that other entrants into the online diet market have not been successful. This indicates that NTRI does enjoy barriers to entry, including customer captivity and cost efficiencies.

Bill Ackman and Shilpa Marda ('09)

Primary Research

- Surveyed doctors and pharmacists as a potential Alli consumer. 80% told me they would not recommend the drug, and 20% were neutral, focusing more on the medical aspects. They said the side-effects are very extreme and involve changing your lifestyle to adapt to them. They also said the "results are not that good anyways, if you read the small print." One pharmacy had to send back their stock of Alli as inventory levels were too high due to weak demand.
- Spoke with people in healthcare field about weight-loss drugs and found out that typically there is an initial hype with weight-loss drugs, and then demand tailors off as side-effects occur and weight comes back.
- After reading internet diet blogs and surveying people who had actually used or tasted NTRI, I got very positive feedback. People thought it was an extremely simple system that works. They liked the taste of most of the foods and enjoyed the variety. The major drawback was that people wanted to eat out occasionally and other similarly minor issues.

Valuation

- Average P/E of peer group is approximately 14x earnings. In my base case scenario, I have assumed multiple expansion to 13X and an EPS of $3.41 (NTRI repurchased 10% of shares O/S in Q1 2008) (15% YoY growth). This results in a price target of $45.
- A discounted cash flow analysis with conservative sales growth estimates and terminal growth of 3% and WACC of 13% also yields an intrinsic value of close to $45.
- Employing an Earning Power Value approach, and adjusting for normalized 2007 earnings, depreciation and capex with no growth, yields a price of $28, which represents an estimate of downside risk. NTRI requires very few assets to generate revenue. I came up with a net balance sheet reproduction value for NTRI, including marketing expenses incurred over the past few years as though they were capitalized at $365M. This indicates the existence of a franchise, as the normalized EPV of the firm is $895M. I believe NTRI enjoys barriers to entry and will be able to grow profitably within its franchise over the next few years.

Risks

- NutriSystem may be subject to fluctuations in demand due to the diet industry's vulnerability to changing fads
- Increasing customer acquisition costs and weak consumer discretionary environment
- Extended impact of Alli due to strong marketing efforts by GlaxoSmithKline

The 11th Annual CIMA Conference

Panelists (l to r) Professor Bruce Greenwald, Bill Miller (Legg Mason), Lisa Hess (Lowes Corp) and David Winters (Wintergreen Fund)

Heilbrunn Center for Graham & Dodd Investing

cima Columbia Investment Management Association

On February 1, 2008, the Columbia Investment Management Association, in conjunction with The Heilbrunn Center for Graham & Dodd Investing, sponsored the 11th annual Columbia Investment Management Conference. With students, faculty, alumni, investors, and press in a packed Lerner Hall Auditorium, the conference did not disappoint.

Dean Hubbard opened the conference with a few remarks. He first noted that "great investing is important for dynamic economies" and expressed his conviction that Columbia Business School is at the vanguard of the next generation of great investors. Finally, he was sure to thank the conference organizers Jon Salinas, Qie Zhang, and Puneet Kakar.

Richard Pzena, founder of the highly regarded Pzena Investment Management, which was recently taken public, delivered the morning's keynote address. His speech was directed toward the question all value investors will have to deal with: "How do you make it through the bad periods?"

He discussed three types of investors: momentum investors (who "ride the wave"), value investors (who exploit emotions), and savants (who predict the emotions). Mr. Pzena presented data going back to 1968 which suggested that a simple value strategy, based solely on low price-to-book companies, and a simple momentum strategy, based on the nine-month return, outperformed the market. He noted, however, that if you had used the value strategy during this 40-year stretch, there were eight years when you would have lost 20%. In the grand scheme, he remarked, these are blips – but did comment that "when you're losing 20%, it doesn't feel very good. Clients begin to question you. You begin to question yourself. And investors ask: 'Wasn't it obvious this was going to happen?'"

He then posed the question: "Can you avoid the 20% down periods? Should you?" Mr. Pzena noted the temptation to combine various strategies to avoid such down periods, but remarked that "you can really only do this with a computer." Combining momentum and value requires bargain hunters to "ride the wave" – something that is hard for them to do. Pzena's solution: Instead of avoiding these periods – promise them! If your investors don't like it, they can find someone else to manage their money.

Commenting on market volatility and his investment framework, Pzena made the observation that volatility occurs when investors pay attention to the marginal news instead of understanding the entire franchise. He went on to describe his rigorous investment process. The process, which stresses a formal valuation framework, looks at stocks on a normalized price-to-earnings basis and focuses on the long-run underlying earnings power of the business.

Concluding his remarks, Mr. Pzena gave some insights on what it takes to be a value investor: 1) A value investor has to be willing to invest when the outcome is uncertain; 2) If you need to know what's going to happen, you're not a value investor; 3) The only reason stock prices get really low is because of uncertainty – although you don't know what's going to happen, you can try to size the risk/reward trade-off.

Following Mr. Pzena's speech was the Real Estate Panel with Columbia Business School Professor Chris Mayer, Pershing Square founder Bill Ackman, and Pennant Capital founder Alan Fournier. Professor Mayer began the comments by describing the situation throughout the country and remarking

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CIMA Conference (continued from page 18)

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that "in some parts of the country there are unheard-of vacancy rates."

Addressing liquidity, Mr. Ackman suggested that he "used to think the Fed controlled the supply of money – the rating agencies do it now by endorsing structured products." Mr. Fournier added that the futures markets are implying lower home prices over the next several years – bringing us back to trend.

The panelists continued to discuss the role of the rating agencies, the banks, and the individuals in creating the subprime mess. Professor Mayer contrasted credit card securitizations with asset backed securities, noting the incentives are more cleanly aligned in the former. Mr. Fournier declared that "structured finance is dead" and Mr. Ackman suggested that the rating process be restructured so that the buyers of credits pay for the ratings instead of the issuers.

The panelists agreed that, overall, the presence of sovereign wealth funds will be good for banks -- and potentially good for foreign relations as well. Mr. Ackman said, "They're not going to shoot us if they have money in our banks." Ackman expressed worries that foreign investors will be disappointed if ultimately they lose money in those bank investments.

The second panel of the day covered the topic of international value investing and included Andrew Weiss, founder of Scout Capital, Jean-Marie Eveillard, portfolio manager of the First Eagle International Value Fund, and Jeff Lee, a partner at Owl Creek.

Responding to where the overlooked pockets of value might be, Weiss suggested non-bank financials, exchanges, and credit card processors. Eveillard commented that there are world class industrial companies in Japan. And Mr. Lee suggested Japan, China, and India with the caveat that one needs to focus on management because you need to focus on how to close the discount gap. In the U.S. there are mechanisms for this, in Japan there aren't. Mr. Russo noted that there are many excellent European companies, singling out Nestle.

On assessing foreign management, Weiss stressed the need for humility and the need to demand higher return requirements as well as "big boy" corporate governance. Jean-Marie Eveillard conveyed a skeptical attitude towards management, noting that he never meets with management until he has done a lot of work because then they need to be straight with him. On a lighter note, Mr. Eveillard made the comment that Wall Street's "optimized balance sheets" aren't so 'optimal'."

Paraphrasing Warren Buffett, Jean-Marie Eveillard underscored the importance of understanding companies and their managements: "When rowing a boat, what matters is not how strong your muscles are, but whether the boat is leaking." For example, he explained, "stupid acquisitions bother me more than excess cash on the balance sheet."

In the next panel, Bill Miller, Lisa Hess, and David Winters discussed their best ideas and offered advice to students pursuing careers in investment management. Mr. Miller started with the point that often the best places to look are the areas that have done the worst – housing, financials, and consumer discretionary. He also pointed out that, historically, recessions happen 5% of the time and that if the Fed can't predict them, there's no point for us to try to predict them.

Lisa Hess suggested that the U.S. could offer some good opportunities and remarked that it used to be the emerging markets. Hess noted she especially likes "financials with

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Professor Artie Williams (EMBA '02), Jennifer Wallace (MBA '94), and Professor Bruce Greenwald catch up at the 11th Annual CIMA Conference

The Heilbrunn Center for Graham & Dodd Investing is a premier knowledge center for the practice and theory of investing. Building on Columbia Business School's renowned history in value investing and finance, the center furthers new developments in investing and imparts the original principles of *Security Analysis* authors Benjamin Graham and David Dodd.

Pictured Above: Roger Murray and Robert Heilbrunn

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CIMA Conference (continued from page 19)

Bill Miller and Thomas Russo catch up at the 11th Annual CIMA Conference

Heilbrunn Center for Graham & Dodd Investing

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(Continued from page 19)

moats around them and retail." In contrast, David Winters is focused outside North America where he says you can get both growth *and* value. He said he has also taken an interest in the stocks of luxury goods companies – companies whose stocks have gotten "smashed." Ms. Hess was generous enough to offer her "walk away from the markets for five years and sleep well at night" portfolio to the audience.

Describing the types of companies he looks for, David Winters said he likes good businesses with pricing power at a low price – he called this the "trifecta." An added bonus is when management is "pulling the oar in the right direction – that's a beautiful thing – that's how you get rich!"

Finally, the panelists were good enough to offer their career advice to the students in the room. Bill Miller told the eager students that they "need an edge" and need to know themselves. He said the biggest tendency he sees is that people get "very emotional." He stressed that the "environment where you operate is very important." Lisa Hess added that the "ones who do best are the ones who know themselves best." And David Winters echoed: "Who gets rich? People who do solid fundamental work, have stable emotions, and are long-term investors." Lastly, Bill Miller quoted Keynes: "it is the duty of the long-term investor to endure great loses with equanimity."

The conference concluded with the Keynote address of Daniel Loeb, the founder of Third Point Capital Management. He began his speech describing his early forays into investing during college. Despite a quick and leveraged start, he ended up $7,000 in debt to his father. He didn't pay this off until he was 29.

Mr. Loeb then described the founding of Third Point with $3,000,000, mostly from friends and family. He suggested this was his best career move since he was "unemployable" due to his varied and eclectic background. "Luckily," he observed dryly, "I was there to give myself a job." Mr. Loeb stressed the point that there is more to running a hedge fund than just investing. It is also managing a business and requires one to think deeply about retaining, attracting, and motivating the best employees. He urged those considering a similar path to "give it some thought."

Offering his thoughts on investing, he said that value investing isn't just analyzing numbers – there are a number of pitfalls you have to be aware of: value traps, liquidity traps, catalysts, proper assessment of the business climate, portfolio construction, and risk management. "Value investing" isn't buying the cheap stocks of bad businesses.

Mr. Loeb also offered the audience a look into the various strategies Third Point employs – including special situations, risk arbitrage, and distressed debt. He walked us through his past investment in Dade Behring, a great but misunderstood business. On the topic of special situations and event investing, he stressed the point that the students in the room should take Joel Greenblatt's course at Columbia – or at the very least read his book "You Can Be a Stock Market Genius (Even If You're Not Too Smart)." He also pointed out that although Third Point does engage in activism from time to time, it really is just a small portion of his portfolio.

Finally, Mr. Loeb left us with his insightful comments on risk management. He underscored the difference between net and gross exposure and – alluding to the phrase, "love means never having to say you're sorry" – suggested that, "good risk management means never having to sell something you really like.'"

-G&Dsville

Legendary value investor Jean-Marie Eveillard answers questions from conference attendees

MBA Advice from the Oracle of Omaha

By David Kessler (MBA '08)

On March 21 I flew to Omaha — along with 150 of my classmates — to meet Warren Buffett, MS '51, a man I have admired (some friends would say fanatically idolized) for close to 15 years.

After a tour of the Berkshire Hathaway-owned Nebraska Furniture Mart, we were brought to a room at the Omaha Field Club. Warren Buffett stood at the front — two of his five daily cans of Cherry Coke nearby — and for the next two and a half hours, answered our questions.

The questions covered a wide range of issues, including what he looks for in a business, the current financial situation, recent events at Bear Stearns, ethics, emerging markets, commodities, his relationship with Benjamin Graham and his typical day. His answers were a powerful reminder of his unique ability to distill complex issues down to their bare essence.

When asked about how long the current financial crisis would last, he replied, "I don't know. I have never made money on macro calls." Buffett said that even if he had perfectly predicted macro conditions in 1973–74, he would not have bought See's Candies in 1972 going into a recession and would have missed out on a company that he has referred to as "the prototype of a dream business."

After joking that our graduation was not perfectly timed, Buffett warned that we should not be discouraged from pursuing a career in finance. Finance is only going to become more important as time goes on, he said, and it is a field where one can truly stand out and be recognized.

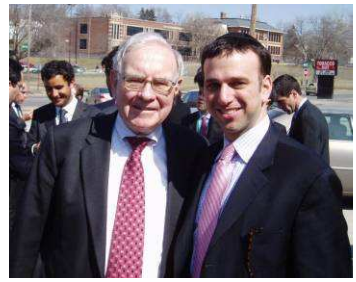
He advised MBA students to learn as much about accounting as possible, adding that, "accounting is the language of business." He also said that writing and verbal communication are extremely important in the business world and that students should seek out ways to improve these skills every chance they get.

Buffett urged students looking for jobs not to pay too much attention to salary. "Who you work for is extremely important, so choose carefully," he counseled, adding that the most important decision of his own career was going to work for Benjamin Graham.

As MBA students, we are beginning our careers in an age where the image of a corporate executive has been bruised. Spending time with Warren Buffett — an astute businessman, a legendary investor, a rational and disciplined person and a generous philanthropist — afforded us the opportunity to learn much more than just how to pick stocks.

Before the trip, I was certain that no one could ever live up to the sincere, humble and generous image depicted of him in books, shareholder letters and TV interviews. I was wrong. Even that lofty image did not hold a candle to the man I was lucky enough to spend half the day with in Omaha.

Originally posted to Columbia Business School 's Blog, "Public Offering" http://www4.gsb.columbia.edu/publicoffering



David Kessler ('08) and Warren Buffett ('51)

SAVE THE DATE

The 12th Annual CIMA Conference
February 13, 2009
Columbia University - Lerner Hall

Past speakers have included: Jean-Marie Eveillard, Marty Whitman, Leon Cooperman, Steve Mandel, Daniel Loeb, Thomas Russo, Bruce Berkowitz, Rich Pzena, James Tisch, David Winters, Bill Ackman, and more...

The conference will sell out, so get your tickets early!

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To hire a Columbia MBA for an internship or full-time position, contact Bruce Lloyd, assistant director, outreach services, in the Office of MBA Career Services at (212) 854-8687 or valueinvesting@columbia.edu . Available positions also may be posted directly on the Columbia Web site at www.gsb.columbia.edu/jobpost.

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