# Value Investor INSIGHT

The Leading Authority on Value Investing

November 30, 2006


## Alpha from Omega

*Lee Cooperman began his storied Wall Street career before many of today's hot fund managers were born … and he hasn't lost a step yet.*

As a Goldman Sachs partner and CEO of its asset management business in 1991, Lee Cooperman was financially secure, highly respected on Wall Street … and itching to run his own show. "It was time," he says. "I chose the name Omega, the end of the Greek alphabet, because this would be my last venture."

The second chapter of Cooperman's career has been as impressive as the first. His Omega Advisors, launched at the start of 1992, now manages $5 billion and its flagship fund has earned net returns of 16.3% per year, vs. 10.6% for the S&P 500.

Cooperman's wide-ranging quest for value is currently uncovering many opportunities, including those in energy, healthcare, Japan and what he calls "quality-growth" companies. See page 2

**INVESTOR INSIGHT**

**Leon Cooperman**
Omega Advisors

**Investment Focus:** Seeks companies trading at significant discounts to their private-market values, often due to inappropriately valued growth prospects.

## Compounding Interest

*CEOs who truly focus on compounding shareholders' capital per share are a rare breed. Chuck Akre's success rests on betting big when he finds them.*

**INVESTOR INSIGHT**

**Chuck Akre**
Akre Capital Management

**Investment Focus:** Seeks high-return-on-capital businesses with excellent future reinvestment opportunities that are not fully appreciated by the market.

Having first invested in Berkshire Hathaway in the mid-1970s, Chuck Akre has a simple explanation for the shares' rise from $100 to over $105,000. "They grew book value at an above-average rate – for most of that time above 20% per year," he says. "That became the holy grail for me."

Following this holy grail to identify potential investments has paid off handsomely for Akre, who now manages $1.7 billion. His flagship partnership has returned an annual 21.3% (net) since 1993, vs. 10.7% for the S&P 500.

Akre casts a wide net in his search for "compounding machines," identifying current opportunities in such varied industries as insurance, gaming, automotive supply and dollar stores. See page 11

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# Investor Insight: Leon Cooperman

**Omega Advisors' Leon Cooperman (along with Steven Einhorn, Mark Cooper, Michael Freedman and David Mandelbaum) describes why he always has a view on the overall market, why energy is his largest sector exposure, the worst aspect of money management and why he sees undiscovered value in Corning, 3M, Omnicare and Transocean.**

**Your investing strategy can be described as multi-faceted. Explain the various components.**

**Lee Cooperman:** We basically try to make money for our investors in five different ways. First, we take a position on market direction: Do we think stocks are undervalued and likely to go up or are they overvalued and likely to go down? As good as you are at picking stocks, if you get the market wrong it can overwhelm individual selection.

Second, we spend a fair amount of time on the asset-allocation decision, making a determination on what asset class has the best prospective investment returns 12 months ahead. At the most basic level, we're looking at stocks vs. bonds vs. cash, but we also go deeper into each category, investment-grade vs. high-yield bonds, for example.

Third, our bread-and-butter business and where we've been quite successful is in finding undervalued individual stocks on the long side. Fourth, we look for overvalued stocks on the short side. Finally, we also make "macro" investments, in currencies, global fixed income and the major international indices.

**Many value investors – Warren Buffett most prominently – say they spend little time thinking about the market's overall direction. Why is that an important part of your strategy?**

**LC:** We're not a slave to our market view, but the truth of the matter is that a rising tide does lift all boats and a falling tide lowers them. I would suspect even Warren Buffett has some fairly clear and strongly held broader views when he's short dollars, for example, to the tune of $19 billion. We just apply the same type of thinking when setting our equity-market exposure.

**Steven Einhorn:** Virtually all studies show that about 60% of the return and volatility of the average common stock is determined by the movement in the aggregate stock market. So while we're bottom-up stock pickers, we think it's important to have a view of the economy and the overall market to help us determine which industries and sectors to emphasize.

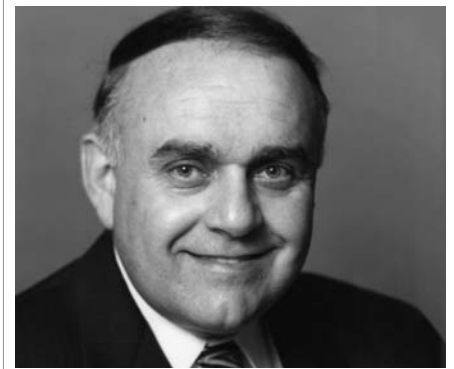
**LC:** There are thousands of mutual funds that will happily manage your money for a management fee of 1% or less. If you're a hedge fund with the audacity to charge between 1% and 2% as a management fee and take 20% of the profits, your clients have the right to expect something more. What I consider "more" is that when the market's overvalued, my clients expect me to figure it out and be hedged and out of harm's way. When the market's undervalued, they want me to be leveraged to the upside. If the U.S. is uninteresting, they expect me to find something around the world that makes sense. That's why I want to have diversified capability – we have an excellent team that is also looking at fixed income, commodities and currencies. Those are areas, if we do them well, in which we can produce additive returns without necessarily correlated risks.

**Do you consider today's U.S. equity market overvalued or undervalued?**

**SE:** I'd describe our view of the U.S. market outlook as respectable. That means a market that isn't susceptible to pronounced downside risk and that should deliver a high single-digit to low double-digit total return over the next 12 months.

**What are the factors driving that view?**

**SE:** One is the economy, which we believe will grow modestly over the next 12-15



Leon Cooperman

## The Forest and the Trees

In 40 years on Wall Street, Lee Cooperman has distinguished himself both by an ability to see the big picture as well as to dive into the details. He rose through the research side of Goldman Sachs, eventually chairing the firm's investment committee and running its asset management business. He was named the #1 portfolio strategist for nine straight years in *Institutional Investor*'s "All-America Research Team" survey. At the same time, the thoroughness of his research on individual companies is legendary – to this day, he's well-known for insightful and tough questioning of executives on analyst calls.

At 63, Cooperman shows no sign of letting up. As he describes it: "I grew up in the South Bronx and am a graduate of P.S. 75 and Morris High School. I went to City University of New York for $24 a semester. I then spent 16 months at Columbia University getting an M.B.A., graduating on January 31, 1967. With a six-month-old son, National Defense Education Act student loans and no money in the bank, there was no opportunity to go on the obligatory six-month tour of Europe before going to work. I started at Goldman Sachs the day after I graduated from business school and I've been working that same way ever since."

# Here's to You, Mr. Robertson

*At the time legendary investor Julian Robertson closed his hedge fund, I described his portfolio as a "lame collection of companies." Mea culpa, Mr. Robertson.* ***By Whitney Tilson***

Six and a half years ago, at what turned out to be the very peak of the Internet bubble, famed hedge-fund manager Julian Robertson closed his fund with the following prophetic words:

> **This is an irrational market, where earnings and price considerations take a back seat to mouse clicks and momentum. The current technology, Internet and telecom craze, fueled by the performance desires of investors, money managers and even financial buyers, is unwittingly creating a Ponzi pyramid scheme destined for collapse. There is no point in subjecting our investors to risk in a market which I frankly do not understand.**

A week later, I wrote a column asking whether Warren Buffett should also call it quits – the parallels with Robertson were many – but answered with an emphatic no because Buffett had not fallen into the trap of buying "companies trading at low multiples but with poor financials and weak future prospects." My argument was that Robertson appeared to have fallen into the trap of buying companies of increasingly lower quality in order to continue paying the prices to which he had become accustomed.

To support my argument, I presented the table reproduced on this page, contrasting the major U.S. public stock holdings of Buffett's Berkshire Hathaway and Robertson's Tiger Management. Every one of Buffett's picks were characterized by solid growth, high margins, great balance sheets, and returns on equity that exceeded their cost of capital. While Tiger's holdings were ostensibly much cheaper, they also had lots of debt, low margins, poor returns on equity and erratic growth. My conclusion at the time: "This is a lame collection of companies … which deserves to trade at a low average multiple!"

As I prepared to interview Robertson recently (*see page 21*), I was curious to see how all of these stocks had performed. Did Buffett's high-quality businesses trading at not-so-cheap stock prices outperform Robertson's lower-quality, but much cheaper, businesses? I certainly would have bet on the former … and I would have been dead wrong.

As detailed in the table on the next page, despite two bankruptcies, Tiger's portfolio did far better than Berkshire's – though both handily beat the market. In just six and a half years, an investor putting $1 million in an evenly weighted portfolio of the Tiger companies would have $823,000 more today than one who bought a comparable portfolio made up

## Stretching for Value?

In a comparison of his disclosed holdings with those of Warren Buffett's Berkshire Hathaway, it appeared in early 2000 that Julian Robertson had fallen into the dangerous trap of chasing low-quality companies in order to find "value." As things turned out (see table, p.20), appearances were deceiving.

| Berkshire Holdings | P/E | Cash/ All Debt | Net Margin | ROE | Average EPS Growth | Steady Revenue? | Steady EPS Growth? |
|---|---|---|---|---|---|---|---|
| American Express | 28 | 14% | 12% | 23% | 18% | Yes | Yes |
| Coca-Cola | 36 | 35% | 19% | 42% | 16% | No | No |
| Freddie Mac | 15 | n/a | n/a | 20% | 18% | Yes | Yes |
| Gillette | 30 | 2% | 13% | 42% | 13% | No | No |
| Washington Post | 23 | 19% | 11% | 14% | 15% | Yes | No |
| Wells Fargo | 18 | 62% | n/a | 14% | 14% | Yes | Yes |
| **Berkshire Averages:** | **25** | **26%** | **13%** | **26%** | | | |

| Tiger Holdings | P/E | Cash/All Debt | Net Margin | ROE | Average EPS Growth | Steady Revenue? | Steady EPS Growth? |
|---|---|---|---|---|---|---|---|
| Bear Stearns | 8 | 16% | 9% | 15% | 14% | No | No |
| Bowater | 38 | 3% | 5% | 5% | n/a | No | No |
| Federal-Mogul | 4 | 2% | 2% | 5% | 15% | No | No |
| GTECH Holdings | 7 | 2% | 10% | 35% | 20% | No | No |
| Navistar | 7 | 25% | 4% | 28% | 41% | No | No |
| Niagara Mohawk | neg | 2% | -1% | -2% | neg | No | No |
| Pittston Brink's | 10 | 37% | 5% | 17% | 20% | Yes | Yes |
| Sealed Air | 27 | 4% | 7% | 17% | 26% | Yes | No |
| Starwood Hotels | 16 | 3% | 6% | 6% | neg | No | No |
| Tosco | 17 | 5% | 2% | 14% | 19% | No | Yes |
| UnumProvident | 6 | 50% | n/a | 14% | 5% | Yes | No |
| US Airways | 11 | 60% | 6% | 3% | n/a | No | No |
| United Asset | 16 | 17% | 8% | 29% | 10% | No | No |
| XTRA | 8 | 0% | 13% | 17% | 7% | Yes | No |
| **Tiger Averages:** | **13** | **16%** | **6%** | **15%** | | | |

*Notes:* 1) Average EPS growth is over the previous five years; 2) "Steady" revenue and EPS growth is defined as increasing every year from 1994 to 1999; 3) Data source: Value Line, 3/30/00

of the Berkshire holdings. And that's not even counting Tiger's short positions at the time. Says a former Tiger employee familiar with the firm's portfolio: "In the first quarter of 2000, Robertson was short a wide range of high-flying Internet companies such as eToys, Priceline.com and Lycos, which means he would have made another 50-60% on the short side. In fact, knowing how he acts when shorts go his way, he surely also would have added with conviction on the way down, so the gains would have probably been even larger."

So, *mea culpa*, Mr. Robertson. You were undone not by your own mistakes, as I originally thought, but primarily by a once-in-a-generation bubble that you correctly and publicly identified.

What are some of the lessons to be learned here? First, buying beaten-down, out-of-favor companies can be hairy – witness the two bankruptcies in the Tiger portfolio plus decliners of 58% and 24% – but also very profitable. The corollary is true as well: paying too high a price for even the greatest business can be an unprofitable endeavor – witness Coca-Cola over this time period.

Another lesson is that while Buffett has often cited the disadvantages of Berkshire's corporate structure, it has some huge advantages that become apparent during times of stress, such as in early 2000. While Robertson's investors could put his fund out of business, Buffett's couldn't. A handful of other great investors, such as Joseph Steinberg and Ian Cumming at Leucadia [LUK] and Michael Ashner at Winthrop Realty Trust [FUR], have learned the same lesson and chosen a corporate structure for their investing as well.

Finally, what better evidence is there for the cliché, "The market can stay irrational longer than you can stay solvent"? All investors, at some point in their careers, will be confronted with markets that appear irrational, in which nothing appears to be working. During times like these, money managers – especially highly successful ones, who can be prone to overconfidence – are inclined to press their bets which, taken to an extreme, can lead to self-destruction. Sometimes the wisest course is to play defense and live to fight another day. VII

*Funds managed by Co-Editor Whitney Tilson own stock in Berkshire Hathaway and Winthrop Realty Trust.*

## The Weak Shall Be Strong

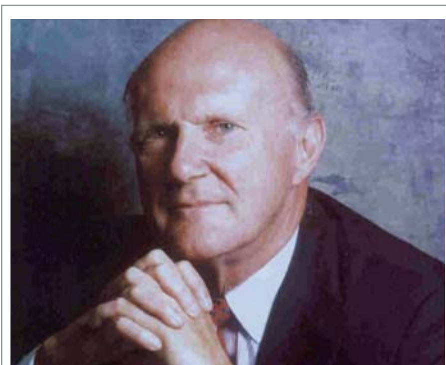
Tiger Management's motley band of disclosed portfolio holdings in 2000 have handily beaten the gilt-edged holdings in Berkshire Hathaway's portfolio from that time. Not surprisingly, both the Tiger and Berkshire portfolios have trounced the overall market.

| Berkshire Holdings | Price 4/30/00 | Price 11/24/06 | %Change | Notes |
|---|---|---|---|---|
| American Express | 45.37 | 59.90 | 32% | |
| Coca-Cola | 49.31 | 46.92 | -5% | |
| Freddie Mac | 46.50 | 67.28 | 45% | |
| Gillette | 39.00 | 60.87 | 56% | Acquired 1/05 by Procter & Gamble; assume PG held to present |
| Washington Post | 532.50 | 735.00 | 38% | |
| Wells Fargo | 21.84 | 35.57 | 63% | |
| **Berkshire Total:** | | | **38%** | Simple average, assuming equal holdings |

| Tiger Holdings | Price 4/30/00 | Price 11/24/06 | %Change | Notes |
|---|---|---|---|---|
| Bear Stearns | 45.56 | 158.60 | 248% | |
| Bowater | 52.69 | 22.23 | -58% | |
| Federal-Mogul | 15.88 | 0.43 | -97% | Went bankrupt 10/01 |
| GTECH Holdings | 4.70 | 35.00 | 645% | Acquired 8/06 by Lottomatica; assume took cash |
| Navistar | 40.44 | 30.81 | -24% | |
| Niagara Mohawk | 13.56 | 41.50 | 206% | Acquired 1/02 by National Grid; assume NGG held to present |
| Pittston Brink's | 16.25 | 55.79 | 243% | |
| Sealed Air | 55.25 | 60.39 | 9% | |
| Starwood Hotels | 20.20 | 65.38 | 224% | |
| Tosco | 30.50 | 116.10 | 281% | Acquired 9/01 by Phillips Petroleum, which in turn merged in 8/02 with Conoco; assume held COP to present |
| UnumProvident | 17.31 | 20.48 | 18% | |
| US Airways | 27.69 | 0.00 | -100% | Went bankrupt 8/02 |
| United Asset | 16.48 | 25.00 | 52% | Acquired 6/00 by Old Mutual; assume took cash |
| XTRA | 39.44 | 55.00 | 39% | Acquired 9/01 by Berkshire Hathaway; assume took cash |
| **Tiger Total:** | | | **120%** | Simple average, assuming equal holdings |
| **S&P 500:** | | | **-7%** | As in all above, excluding dividends |

# "My concept of value has changed"

*Legendary investor Julian Robertson reflects on his storied career, building a great team, "retirement"and what he makes of today's market.*



**Julian Robertson**
Tiger Management

**On retiring:** "I always said if a guy was long the best 50 companies he knew and short the 50 worst, if that didn't work you were in the wrong business."

***Editors' Note:*** *Tiger Management's Julian Robertson called it quits in 2000, explaining that "There is no point in subjecting our investors to risk in a market which I frankly do not understand." It was an unhappy end to one of the most successful careers on Wall Street: At its peak, Tiger managed $23 billion, and even after big losses in 1999 and 2000, Robertson earned 25% annualized returns over 20 years for his investors. Charming as ever at 74, Robertson recently spoke with Co-Editors Whitney Tilson and John Heins at his Park Avenue office.*

**Has your definition of what constitutes value in stocks changed over the years?**

**Julian Robertson:** When I started in the business and for a long time, my concept of value was absolute value in terms of a price-earnings ratio. But I would say my concept of value has changed to a more relative sense of valuation, based on the expected growth rate applied against the price of the stock. Something at 30x earnings growing at 25% per year – where I have confidence it will grow at that rate for some time – can be much cheaper than something at 7x earnings growing at 3%. Some people call that GARP (growth at a reasonable price), I'd call it value. I think that's just semantics.

We've always had excellent analysts, and a good analyst is more adept at making judgments on growth. That's their job – based on the business and the company's position in it, how fast is the company going to grow? It's pretty hard to lose if you're right on the growth rates when the growth rates are high. In that 30x-earnings company growing 25% per year, you'll be bailed out pretty quickly because in about 2 1/2 years the earnings will double and the multiple on that is only 15x.

**You were a pioneer in hedge funds before they became trendy. Is it a good thing that hedge funds have become so popular?**

**JR:** I think it's an inevitable thing. It's the best way to pay a good manager, for one thing, so it does attract the best managers. From the point of view of the investor, he gets a partner in the manager who, in most cases, has all of his money in the same fund. That's a huge advantage. Think about that as opposed to the trust department guy who calls you up reading from a script. You want the guy working for you to have the most to lose – and the most to win – from the selections he makes. He's not going to go overboard wild, because he has the most to lose.

The fact that so many new people go into this business does makes it tougher on those already in it. For example, you used to get a rebate on credit balances when you were short – now borrowing stocks costs you money overall. That alone makes a big difference in the profitability of shorting.

**How activist were you as an investor?**

**JR:** We were never very active in the way people are today. I do remember taking a strong stance with Cleveland-Cliffs, the iron-ore company. In that instance we were doing it as much for all the shareholders as we were for ourselves. It had a board of directors that I think not only all came from the same town, Cleveland, but as I recall were also all from the same country club. We brought in a few outside directors, including an investment banker, a consultant from Booz Allen and a female professor from Yale. We thought our actions would be appreciated, but the press attacked us as brash young upstarts fighting against a long-term management. They made us the bad guys and management the good guys – just the opposite of what was intended.

**Tiger was well known for the quality of its analysts, many of whom now run some of the most successful hedge funds in the business. What was the secret to your finding and developing investing superstars?**

**JR:** : I really think that we benefited from starting with good young people, who begat more good young people. We eventually devised testing that all applicants had to take. We still give that test, which takes about three or four hours. It is part aptitude, but also psychological. It sort of emanated from our having a few people over time who just didn't have the firepower to do the job – it's tragic when that happens, because it's not their fault. So we designed these tests to better avoid that.

The test was also designed to show what kind of team player the person was and their competitiveness. I've found that most good managers are great competitors. I think that all helped us pick good people. Whether it helped as much as having great young people recommending more great young people, I don't know.

**How did you organize the work to get the best out of people?**

**JR:** I was the trigger-puller and they were the analysts. It probably wouldn't have

November 22, 2006

# SuperInvestor INSIGHT

From the Editors of *Value Investor Insight*

UP FRONT

# To Sell or Not to Sell

Typically when we ask even the best investors how they approach the decision to sell, the response begins with a shift in their chair or a nervous laugh. Psychic wounds from selling winners way too soon or selling losers just as they're bottoming out seem to remain particularly fresh.

While the mistakes made can be similar, how great investors approach the selling decision can vary widely. Some are rigidly disciplined, like Rich Pzena of Pzena Investment Management, who sells automatically when a holding reaches the midpoint in the valuation ranking of all stocks he follows. "I arrived at that because otherwise I would have no idea how to sell," he says. "I guess I have the classic value mentality – it's instinctual for me to want to sell as things go up and I start getting nervous. For me, having something systematic that says 'this is cheap' or 'this is fairly valued' is really important."

For others, a rigid buy discipline turns somewhat less rigid when it comes to selling. Says Amit Wadhwaney of Third Avenue Management: "Our valuations have such pessimistic assumptions that to sell once a stock reached our full value would be stupid. We've sold things way too fast, and I've sort of gotten in the habit of dragging my feet before selling."

With the market starting its strong recent rise during the third quarter, how did SuperInvestors react on the sell side? Based on their most-frequent and largest sales, they appear to have used the market uptick more to unload portfolio laggards than to harvest long-term winners. That would explain the sales of stocks like Sprint Nextel, Symantec or Viacom, hardly robust performers in recent years. When they did

take profits, the stocks sold tended to be in cyclical, commodities-based companies, such as Valero Energy or Pioneer Natural Resources.

Not surprisingly absent among the sold winners were companies that Akre Capital's Charles Akre, in his interview in the upcoming issue of *Value Investor Insight*, calls "compounding machines." These rare companies are in great businesses, consistently earn 20% or more on shareholders equity and have superior management reinvesting in the business. One thing that sets great investors apart is their ability not only to find such stocks, but to have the courage and conviction to let them run. If these types of companies start showing up on SuperInvestor sell lists, watch out below! SII

John Heins
Co-Editor-in-Chief

Whitney Tilson
Co-Editor-in-Chief

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**The SuperInvestors**

*SuperInvestor Insight* tracks the activity of an elite group of value-oriented hedge-fund managers (plus Berkshire Hathaway), based on their holdings as filed in Forms 13F with the SEC. While certain activity of specific investors will be highlighted, the focus is on drawing collective insight from this group of 25-30 of the world's best investors, which currently includes **William Ackman**, **David Einhorn**, **Joel Greenblatt**, **Carl Icahn**, **Seth Klarman**, **Edward Lampert**, **Warren Lichtenstein**, **Stephen Mandel**, **Larry Robbins**, **Jeffrey Ubben** and many more.

# Kindred Souls

*When the best professional money managers start buying shares in an investment management firm like Legg Mason, it's probably a good idea to pay attention.*

As any smart money manager would certainly attest, money management is an awesome business, with highly recurring revenues, high returns on capital, low capital needs and copious free cash flow. At the same time, a meaningful portion of the business is tied to equity assets, which have grown 10% annually over long periods of time for even index-hugging automatons. "We're always interested in a good asset manager at an attractive price," says Eminence Capital's Ricky Sandler.

Sandler and other of his SuperInvestor counterparts found such an opportunity last quarter in Legg Mason, the venerable Baltimore-based investment manager with nearly $900 billion in assets under management. (Also attracting attention was growth-fund manager Janus Capital – *see What They're Buying, p. 2.*)

Less than a year ago, Legg Mason could do no wrong in the market's eyes. It was overwhelmingly lauded for the December, 2005 swap of its private-client and capital-markets businesses for the asset management unit of Citigroup, which nearly doubled Legg's managed assets. Superstar Bill Miller, by far the company's highest-profile fund manager, had just notched his 15th straight year of market-beating returns. In February of this year, Legg shares hit a record $140 per share.

Legg's honeymoon with the market turned out to be short-lived. Merger-related cost cuts didn't materialize as quickly as the market hoped. Asset outflows from Citi brokers shifting clients out of what were previously in-house funds came in higher than expected. On top of all that, Miller's Legg Mason Value Trust was finally having a bad year – it's up only 4.6% this year, among the worst performers in its category. Six months to the day after hitting the record high, Legg shares fell as low as $81, off more than 40%.

In his most recent fund commentary, Bill Miller gives a general description of how knee-jerk reactions by the market get built into stock prices: "Time horizons appear to be quite short, creating a just-in-time market – or a data-point-driven market – one that extrapolates each new number as if it were the beginning of a new trend." Just this sort of extrapolation of new data as a trend, says Ricky Sandler, is what attracted him to Legg Mason shares. "You've got a well-diversified, high-quality asset manager in a fundamentally good business," he says, "and very little had actually happened to impair the long-term value

### INVESTMENT SNAPSHOT

**Legg Mason**
(NYSE: LM)

**Business:** Global investment manager serving the institutional, mutual fund and wealth management markets, with nearly $900 billion in assets under management.

**Share Information**
(@ 11/21/06):

| | |
|---|---|
| **Price** | **96.04** |
| 52-Week Range | 81.01 – 140.00 |
| Dividend Yield | 0.9% |
| Market Cap | $12.82 billion |

**Financials** (TTM):

| | |
|---|---|
| Revenue | $3.81 billion |
| Operating Profit Margin | 23.4% |
| Net Profit Margin | 14.7% |

**Valuation Metrics**
(Current Price vs. TTM):

| | LM | S&P 500 |
|---|---|---|
| P/E | 25.1 | 18.0 |
| P/CF | 19.1 | 14.6 |

**Largest Institutional Owners**
(@9/30/06):

| Company | % Owned |
|---|---|
| Axa | 15.9% |
| T. Rowe Price | 6.4% |
| Barclays Global | 3.0% |
| Vanguard Group | 2.4% |
| State Street | 2.4% |

**Short Interest** (@ 10/9/06):

| | |
|---|---|
| Shares Short/Float | 3.6% |

**THE BOTTOM LINE**

The market has overreacted to short-term integration issues resulting from the company's swapping of businesses with Citigroup to focus on asset management, says Ricky Sandler. As merger benefits are realized, the current 14.2x multiple of his estimate of normalized free cash flow per share will turn out to have been cheap, he says.

Sources: Company reports, other publicly available information

of the business."

The strategic rationale for the Citigroup deal – exiting a transaction-driven business in order to increase scale and focus on asset management – is smart, says Sandler. He expects the cost and marketing advantages of the merger, if not realized as quickly as expected, to eventually be significant.

Equally important is Legg's proven record in earning strong, long-term returns and retaining portfolio-manager talent. This will be particularly valuable as the company works through the revamping of the broad portfolio of former Citigroup funds, many of which were poor performers. "At the end of the day, success in building brands and distribution is all about putting up above-average, long-term performance," Sandler says. "Regardless of what may be happening this year, the company has done that well."

Sandler also points out that while Bill Miller is the public face of the firm, Legg has a very well-diversified base of assets with highly accomplished managers. Its Western Asset Management division is among the largest fixed-income managers in the U.S., serving primarily institutional clients. Brandywine Global runs nearly $35 billion in value-oriented equity, fixed-income and balanced portfolios. Batterymarch Financial has been a pioneer in quantitative investing, while Private Capital Management, run by well-regarded investor Bruce Sherman, manages hedge funds.

**ON "PERSONNEL RISK":**

**As diversified as they are, if Bill Miller were not there, that would clearly have a negative effect.**

What could go wrong? There is always risk in buying into asset managers of a decline in the equity markets, says Sandler, although he considers such a risk unimportant over time. "I don't think you really need to have a position on the equity market to own this," he says, "other than to decide whether you think the market is going to be up at least 7-8% per year on average." More specific to Legg Mason is what Sandler calls "personnel risk," namely that Bill Miller stops doing what he's doing. "As diversified as they are," he says. "If he were not there, that would clearly have a negative effect."

At a recent share price of $96, Legg is trading at just over 14x the $6.75 per share in free cash flow Sandler expects the company to earn in the fiscal year ending March, 2008, after adding back non-cash amortization and deferred-tax expenses. "For a business that has high single-digit to low double-digit revenue growth over time requiring little capital," he says, "that's still a pretty attractive price." There's a good chance that even Bill Miller himself would agree. SII


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