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ValueInvestor INSIGHT

The Leading Authority on Value Investing

Wealth of Experience

Experience is only valuable if you learn from it. Five top investors share their insights on applying yesterday's key lessons to today's opportunities.

Events of recent weeks have made it clear that "normal" is likely to remain an elusive concept for investors in the aftermath of the shocks delivered to markets by the financial crisis. Despite the comeback since March 2009, for most value investors the wounds from painful losses are still fresh, while divining the future for their portfolio holdings has never been more difficult.

Which made it an ideal time to ask five top investors – with more than 150 years of collective experience – to share their insights on the lessons learned from the crisis, as well as on the risks and opportunities they consider most important today. While consensus on the lessons is fairly common, opinions diverge widely when it comes risks and opportunities. See page 2

LOOKING BACK« LOOKING FORWARD»

Applying yesterday's lessons to today's opportunities:

James Montier
GMO

Charles Akre
Akre Capital

Robert Olstein
Olstein & Associates

John Rogers
Ariel Capital Management

David Marcus
Evermore Global Advisors

Keeping a Level Head

The key to success for investors Mitchell Kovitz and Jonathan Shapiro: Aspiring to be "reasonably certain of a good result rather than hopeful of a great one."

INVESTOR INSIGHT

Kovitz Investment Group
Jonathan Shapiro *(l)*, Mitchell Kovitz *(r)*

Investment Focus: Seek high-quality companies whose attractive long-term prospects appear unreasonably obscured by the market's short-term concerns.

Concluding that life as a tax accountant wasn't for him, Mitchell Kovitz needed an "in" to break into the investing business in 1989 and found it in his father, who hired him at Chicago's Rothschild Investment Corp. "I got into the business the old-fashioned way," he says, "through nepotism."

Kovitz has more than earned his place. The equity composite of separately managed accounts he has run since 1997 – now for his own firm – have earned a net annualized 10.2%, vs. 5.4% for the S&P 500.

Finding much better value today in higher-quality rather than lower-quality stocks, he and partner Jonathan Shapiro are focusing on leaders in such markets as pharmacies, home-improvement retail, financial services and banking. See page 13

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Investor Insight: Kovitz Investment Group

Mitchell Kovitz, Jonathan Shapiro and Joel Hirsh of Kovitz Investment Group explain the "five-year rule" that has helped them avoid mistakes, how they try to simplify decision-making, why their most unusual investing experience still holds appeal, and why they believe Walgreen, Lowe's, Bank of New York Mellon and Wells Fargo are mispriced.

Quoting Warren Buffett, you've described your focus on opportunities in which you're "reasonably certain of a good result rather than hopeful of a great one." How is that reflected in your strategy?

Jonathan Shapiro: That reflects our belief that investing success is about making consistent and informed decisions based on hard evidence and sound logic rather than on hopes, dreams and emotions.

It also reflects the types of companies in which we invest. They tend to be market leaders with sustainable competitive positions, economies of scale and/or scope, low capital requirements and competent managers who have shown decent capital-allocation skills. More quantitatively, they have high returns on capital, low financial risk and high correlation between earnings and cash flow. We've built a database over the years of around 400 investable companies, most over $1 billion in market cap, in which we'd be willing to invest at the right price.

Our analysis is centered on determining normalized earnings levels and estimating future cash flows, so we stay away from industries that are more likely to be disrupted by technology product cycles or commodity-price swings. A year ago no business looked predictable, of course, but for the most part, the more stable the business the better.

Joel Hirsh: Top of mind for us in identifying potential investments is what we call the five-year rule. If we hold a stock and the market closes for five years, will we sleep well at night with it in the portfolio? We find answering that question is a great line of defense against big mistakes. If you'd find yourself needing regular market feedback to be comfortable with your estimate of value, maybe it doesn't really have the margin of safety you think it does.

What types of things today are making such admirable companies inexpensive enough to buy?

JS: A lot of the opportunities we're finding really seem to be a function of boredom. There's been little relative interest in the Wal-Marts, Johnson & Johnsons and Procter & Gambles of the world, as investors seem far more enamored with the companies hit hardest by the downturn and which have the most perceived upside leverage to an improving economy.

Blue-chip companies often suffer from not having the "catalyst" so many investors want to see. Our feeling is that if there is a catalyst for an individual stock, it's usually well known and well priced in. For us, the share price and valuation getting low enough is usually all the catalyst we need.

JH: We in many ways are looking for the path of least resistance. We have in the past owned Nucor, which is an excellent business for its industry – variable cost structure, low-cost producer, high returns on capital. It's one of three domestic steel mills controlling two-thirds of the market. At the price we found it interesting, we didn't have to have an opinion about future growth in steel demand because we saw value there even if steel prices stayed at depressed levels. As the share price went up, though, we needed to have a positive view on the future demand in order to justify owning the stock. In general, we'd rather own a Wal-Mart [WMT], where the primary decision is whether the expectation built into the stock that it can't really grow any more is right, than have to think about things like steel-price futures curves.

Another example would be Lockheed Martin [LMT], which we bought last quarter. The stock price fell to where we didn't really need to have a specific opin-

Jonathan Shapiro, Mitchell Kovitz

Meeting of Minds

Intent on pursuing an investment career, Jonathan Shapiro after nearly ten years as a KMPG healthcare consultant returned to school in 1995 to earn an M.B.A. from the University of Chicago. After graduating, he took a first job as sell-side analyst. "It wasn't the greatest first step," he says. "The environment was too promotional, which isn't my personality. I also found it disconcerting that the people I worked with didn't really know much about valuing individual stocks. I was teaching some of them how to do discounted cash flow analysis."

Shapiro in 1999 found a more comfortable home in joining the investment team of childhood friend Mitchell Kovitz at Chicago's Rothschild Investment Corp. The two took the team out of Rothschild in 2003 to set up their own firm, Kovitz Investment Group.

While pursuing a traditional value-investing strategy, Kovitz balks at certain traditional investment-firm processes. One example: "I've always thought regular investment meetings, where people are supposed to bring ideas for discussion, create a bias toward action that is a mistake. If there's something important for us to discuss, we know where to find each other."

ion on overall defense-spending levels, or on spending on key projects like the F-35 fighter-jet program. We thought the worst-case cuts were priced into the shares, so all we needed to believe to see upside was that the odds favored things turning out better than expected. That's an easier analytical challenge to take on.

Mitchell Kovitz: We've had the good fortune to build a client base that allows us to truly have a long-term perspective and that doesn't judge our performance on a quarter-by-quarter basis. So when a stock gets hit because it misses a quarterly sales or earnings number, if the intrinsic value hasn't been impaired – or hasn't been impaired as much as the stock hit implies – that can provide opportunities for us to buy.

An example of that from the fourth quarter of last year is St. Jude Medical [STJ]. The stock fell 15% over a few days in October when sales to hospital customers of its pacemakers and ICDs [Implantable Cardioverter Defibrillators] came in lower than expected. We had followed the company for some time, but the multiple was typically too high for us. But as growth slowed – and especially with this last leg down that we considered an overreaction – the stock got to the point where we started buying from the growth investors who were selling. With our eye on earnings power a few years out, we still think the stock [at around $38] offers excellent value, maybe 30% below our estimate of intrinsic value.

Describe your decision-making process for what makes it into the portfolio.

JS: One thing we may do a bit differently from others is that once we've identified a stock as something in which we're interested, Mitch, Joel and I will all separately look at the valuation and arrive independently at what we think we ought to pay, based on the potential upside and, as importantly, the potential risk. When we reach different conclusions, that leads to a very important back-and-forth as we try to find a meeting of the minds. We absolutely believe the end decision is better as a result.

Do turnarounds often meet your criteria?

JS: Rarely. It goes back to what we said about reasonable certainty of a good result rather than hope for a great one. There's more uncertainty attached to large-scale turnarounds than we'd like. We're more interested in playing the temporary variance from a consistent, documented record of success than relying on a wholesale turnaround or transformation into something new and improved.

Your position in Biglari Holdings [BH], formerly Steak n Shake, seems out of place. What's the story there?

JS: This has probably been our most unusual investing experience. We got into it in 2007 as Steak n Shake's share price fell on what we thought were primarily economic concerns. Sardar Biglari was an activist investor who owned the stock at that time and he ran a proxy contest to get on the board. Once there, he saw how poorly the company was being run – particularly with respect to capital allocation – and he eventually took over in 2008 as Chairman. He's done an excellent job of getting the company on track, reducing costs without hurting the customer experience and redirecting all growth through franchising rather than company-owned stores. This was a case that ended up being a turnaround, although that wasn't at all our expectation going in.

Accounting for a 1:20 share split, the stock price has been as low as $58 and as high as $418 over the past two years. Have you stood pat through all that?

JS: For the most part, yes. We obviously wish we would have averaged down as the shares got so low in 2008 and early 2009, but we were finding plenty of other things to buy that didn't have the same type of risk. Our initial intrinsic value estimate was in the $440 range, adjusted for the split, and after all that's happened we still believe that's about what the shares are worth. With the stock down sharply in the past three months [now around $300], we've been recent buyers as the discount widened.

Sardar has done some controversial things. He proposed a compensation plan that pays him like a hedge fund manager – taking 25% of book-value increases above a certain level – and created a holding company under his name to invest, a la Warren Buffett. We're not overly excited about these extracurricular things going on, but believe the core value in the Steak n Shake business is very compelling.

What role does shorting play in your hedge fund?

JH: We expect over time to generate the bulk of our outperformance from a concentrated long portfolio. But we also believe hedging adds value to risk-adjusted returns over time. So we will have direct hedges and indirect hedges, we'll try to take advantage of relative value discrepancies, and we'll opportunistically short purely to make money.

When our portfolio got to something like 30% in consumer discretionary stocks last year, for example, we used a laddered put spread on two related ETFs to hedge that position. Today we're short cyclical industrials and commodity-related stocks, simply because we consider their relative prices versus the blue chips we own to be extremely high. You can be right there will be tremendous growth in emerging markets, but given today's prices, we think you're better off owning Procter & Gamble, Coca-Cola or Diageo for emerging-markets exposure than, say, a materials, energy or mining stock.

Explain the long case for Walgreen [WAG], one of your largest positions.

JH: We're generally positive on the pharmacy business, which we believe supports extremely attractive economics. It's a combination healthcare business and sundry retailer, with two dominant players, Walgreen and CVS, that continue to take share in a business with clear economies of scale. Each has a store base of highly convenient locations that would be next to impossible to replicate.

Walgreen has weathered the recession better than most retailers, although its higher-margin non-drug sales have been pressured, which has weighed on revenue and earnings growth and held the share price down. We think that's short-sighted, given how the story here is changing from one about store and revenue growth to one about free-cash-flow conversion.

We see several key items driving significantly improved operating margins and returns on capital. They're slowing new-store growth and focusing on improving the economics at existing stores through cost cutting, reducing the number of SKUs and improving inventory turns. Overall store profitability will improve as the existing store base matures – it can take at least two years for a new store to hit its stride, so fewer new stores as a percentage of the total is a positive for margins. On top of all that, the wave people have been talking about for years of blockbuster drugs like Lipitor and Viagra going off-patent is about to hit, which is great news for a company like Walgreen, which makes both higher gross dollars and margins on generics.

We also don't believe top-line growth is over yet. The population is still aging and will consume more drugs. Healthcare reform should significantly increase the number of insured, which will also impact drug usage. New-store openings will probably add organic growth of another 2.5% to 3% per year. Finally, the front-end sales that were hurt by the recession, given the less-discretionary profile of the items sold, shouldn't be gone forever.

All in, we expect Walgreen to increase free cash flow per share at a high-single-digit, low-double-digit annual rate. We're not finding that many businesses capable of that kind of organic growth.

What threat do you see from pharmacy benefits managers like Medco Health Solutions and Caremark (now owned by CVS) pushing their mail-order prescription businesses?

JH: This is not a new risk, and given the secular tailwinds in the business we think PBMs could increase their mail-order share and Walgreen could still generate the free cash flow growth we expect. Unless insurers or employers begin to mandate it, we're also not convinced people are going to stop going to the pharmacist a mile away because they can now more easily get their prescriptions by mail. It's not obvious the cost difference will be enough to change pretty ingrained consumer preference.

One potentially exciting competitive opportunity for Walgreen is to expand its in-store health clinics. With a larger insured population, it will certainly be the case that there won't be enough primary-care physicians, and these kinds of clinics that are staffed by nurse practitioners could expand dramatically to pick up the slack. If that happens, the breadth of Walgreen's store locations and its brand equity could give it a leg up. We look at this as a free option, however, and aren't factoring it into our intrinsic value calculation.

With the shares recently at $32.35, how are you looking at valuation?

JH: As the operating leverage kicks in, we expect within two to three years that Walgreen can earn $3 per share, up from an estimated $2.20 to $2.30 for the fiscal year ending in August. Based on both our DCF analysis and putting a reasonable

INVESTMENT SNAPSHOT

Walgreen
(NYSE: WAG)

Business: Drugstore operator with nearly 7,700 locations selling prescription drugs, non-prescription drugs and general merchandise in all 50 U.S. states.

Share Information
(@5/27/10):

Price	**32.34**
52-Week Range	27.89 – 40.69
Dividend Yield	1.7%
Market Cap	$31.64 billion

Financials (TTM):

Revenue	$65.26 billion
Operating Profit Margin	5.6%
Net Profit Margin	3.2%

Valuation Metrics
(@5/27/10):

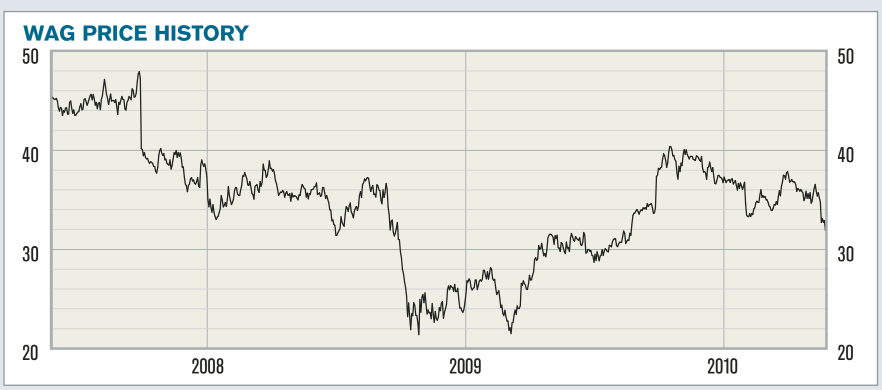
	WAG	S&P 500
Trailing P/E	15.2	17.7
Forward P/E Est.	14.6	13.2

Largest Institutional Owners
(@3/31/10):

Company	% Owned
Vanguard Group	3.8%
Fidelity Mgmt & Research	2.6%
BlackRock	2.5%
Bank of NY Mellon	2.2%
Capital Research	1.6%

Short Interest (as of 5/14/10):

Shares Short/Float	1.6%



THE BOTTOM LINE

With continued solid growth potential and an increased emphasis on store profitability, Joel Hirsh expects the company to increase earnings within two to three years to $3 per share. Based on both his DCF analysis and putting a reasonable multiple on that earnings power, he believes the shares' intrinsic value today is at least $50.

Sources: Company reports, other publicly available information

multiple on that $3 in earnings power, we come up with an intrinsic value for the shares today of at least $50.

How do you compare Walgreen as an opportunity to CVS?

JS: CVS trades at an even lower multiple today than Walgreen, primarily due to integration issues stemming from its merger with Caremark and its underperformance relative to other major PBMs. We like them both, but the complexity of the combined CVS/Caremark makes it a somewhat riskier proposition, so we have a much smaller position.

You are also fans of home-improvement retailers. Describe your specific interest in Lowe's [LOW].

JS: The housing downturn has obviously been a negative for companies like Lowe's and Home Depot, but long-term we think home-improvement retail is an excellent business. Consumers will continue to view their homes as a prized asset, worthy of investment, and there's likely to be a lot of pent-up demand after the past couple of years. The two big market players have further consolidated the business through the downturn, which has supported pricing – in fact, Lowe's gross margins went up in 2009, hardly the norm in retail. We also like that there are no serious competitive threats, including Wal-Mart, which just doesn't have the store space to disintermediate many of the key product categories.

What about the risk to Lowe's of Home Depot emerging as a more-focused, rejuvenated competitor?

JS: Lowe's kind of had its way with Home Depot from 2004 to 2008 as Home Depot struggled to turn things around. Frank Blake, the CEO after Robert Nardelli, has done the right things to slow growth, focus the operational scope, improve customer service and invest in logistics systems, which had always been sub-standard relative to those at Lowe's. While we expect those things to have a positive impact on Home Depot's profitability, we don't expect them to change the competitive dynamic to any great extent with Lowe's. The two companies have been smart about how they compete with each other, avoiding the kinds of price wars that would hurt them both.

Lowe's has grown its footprint rather quickly through the downturn. Do you expect that to continue?

JS: From 2006 to 2009 the company expanded square footage by about 20%. While it still has a fair amount of potential to grow, management recently announced they weren't going to expand the store base this year and instead will focus more on the types of operational improvements we're seeing at Walgreen. We'd be content if they settled into store capacity growth of 3-4% per year. With same-stores sales growing 1-3% per year, that gives them a perfectly reasonable mid-single-digit revenue growth profile. With smart cost control and share buybacks, we'd expect that kind of growth to be leveraged into annual bottom-line growth of 9-10%.

What upside do you see for the shares, now trading at just over $25?

INVESTMENT SNAPSHOT

Lowe's
(NYSE: LOW)

Business: Second-largest home-improvement retailer in the world, operating more than 1,700 large-format stores in the United States, Canada and Mexico.

Share Information
(@5/27/10):

Price	**25.12**
52-Week Range	18.02 – 28.54
Dividend Yield	1.5%
Market Cap	$36.25 billion

Financials (TTM):

Revenue	$47.78 billion
Operating Profit Margin	6.8%
Net Profit Margin	3.8%

Valuation Metrics
(@5/27/10):

	LOW	S&P 500
Trailing P/E	20.5	17.7
Forward P/E Est.	17.2	13.2

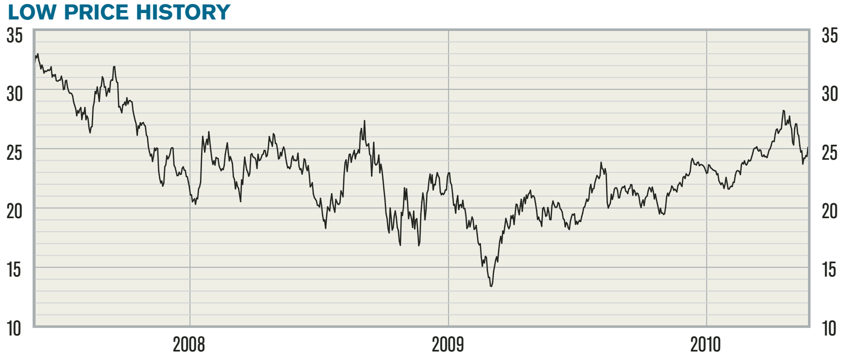
Largest Institutional Owners
(@3/31/10):

Company	% Owned
T. Rowe Price	4.7%
Vanguard Group	3.8%
Capital Research	3.5%
Fidelity Mgmt & Research	3.5%
BlackRock	2.6%

Short Interest (as of 5/14/10):

Shares Short/Float	1.3%

LOW PRICE HISTORY



THE BOTTOM LINE

The company has managed intelligently through the downturn in housing-related spending, says Jonathan Shapiro, and is poised to generate annual bottom-line growth of 9-10% without assuming a return to the heyday of a few years ago. At 16-18x his earnings estimate two to three years out, the shares would trade above $40.

Sources: Company reports, other publicly available information

JS: In 2009 Lowe's earned around $1.20 per share, which we believe was truly a trough level for them. They earned almost $2 per share in 2007, which we don't believe was normal either.

We looked historically at what Lowe's earned on a sales-per-square-foot basis, broken down further by average ticket sizes and the number of transactions. During the boom years, sales per square foot hit $320 and average ticket sizes were about $65. Operating margins peaked at 11% in 2007. We analyzed a variety of scenarios for normalized earnings and arrived at a base-case range of $250-275 in sales per square foot and operating margins of 9%, which would translate into earnings from the existing store base of $1.75 to $1.90 per share. As a check, average ticket sizes within this range would be $55-60, still well below the peak.

If you put a 16-18x multiple on our range of normalized earnings, that would translate into an intrinsic value today in the low $30s. But if the bottom line grows as we expect, earnings in a few years would be closer to $2.50. Using the same multiples, we see the upside by then of $40 to $45 per share.

How are you looking at the downside?

JS: It's hard for us to imagine normalized earnings of less than $1.40 per share, which is around what the company is expected to earn this year. At a 16x multiple, that would give you a share price of $22.50, which is only 11% below where the stock trades today.

Do you have a favorite between Lowe's and Home Depot?

JS: While we still view Home Depot favorably, the increase in its stock price has outpaced Lowe's by a meaningful margin over the past couple of years. Because of that and the fact we believe Lowe's normalized earnings have more room to grow from their current depressed levels, we earlier this year reallocated all our capital invested in Home Depot to Lowe's.

Having weathered the downturn better than most financials, Bank of New York Mellon [BK] stock has gone nowhere over the past year. Why do you find it attractive?

JH: The company in its current form came out of the 2007 merger of Bank of New York and Mellon Financial, creating a formidable global player primarily in the areas of asset custody, securities servicing and asset management. On the back-office side, they do things like hold institutional assets, execute trades and otherwise handle money flowing in and out. Our long-only accounts, for example, are held at Pershing, which is a wholly owned subsidiary. The asset management side consists of Dreyfus, which has a huge money-market-fund business, and several smaller boutique managers. They also have a large wealth management business catering to high-net-worth individuals and family offices.

The business mix is different than a traditional bank's, with non-interest income – mostly fees – accounting for 75% of total pre-tax income. We also like the competitive environment: Scale matters a great deal in most of their markets and they – along with State Street or Northern Trust – are often one of only

INVESTMENT SNAPSHOT

Bank of New York Mellon
(NYSE: BK)

Business: Provider of asset management and securities-related services with $22 trillion in assets under custody or administration and $1.1 trillion under management.

Share Information
(@5/27/10):

Price	**28.03**
52-Week Range	25.80 – 32.65
Dividend Yield	1.3%
Market Cap	$34.00 billion

Financials (TTM):

Revenue	$7.85 billion
Operating Profit Margin	(-14.5%)
Net Profit Margin	(-11.4%)

Valuation Metrics
(@5/27/10):

	BK	S&P 500
Trailing P/E	n/a	17.7
Forward P/E Est.	12.1	13.2

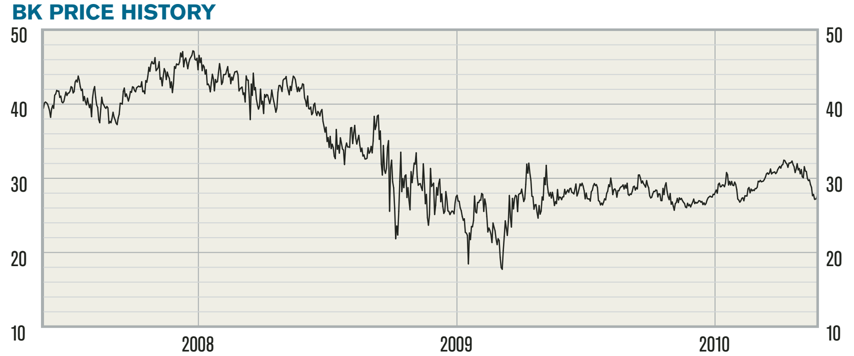
Largest Institutional Owners
(@3/31/10):

Company	% Owned
Davis Selected Advisers	6.1%
Massachusetts Fin Serv	4.9%
Capital Research	4.8%
State Street Corp	3.6%
Vanguard Group	3.4%

Short Interest (as of 5/14/10):

Shares Short/Float	1.4%

BK PRICE HISTORY



THE BOTTOM LINE

The market is treating the company as if it were a traditional bank and not one as focused as it is on fee-generating businesses in which it typically has a leading market position, says Joel Hirsh. At a more reasonable multiple of normalized earnings power he estimates at around $3 per share, the stock would trade for at least $45, he says.

Sources: Company reports, other publicly available information

two major competitors. That translates into better pricing power and margins.

What appears to be weighing on the stock is the fact that the company ended up with more bad assets than expected – mostly real estate related – as the credit bubble burst. We'd argue that the damage has been and will remain relatively light, but it seems to have caught the market by surprise and would explain the rather sharp multiple contraction.

So is this more of a multiple-expansion than earnings-rebound story?

JH: It's both. Earnings are expected to come in at around $2.30 per share this year, but we believe the normalized level is closer to $3. That doesn't require heroic assumptions, just that the excess loan-loss provisioning goes away, assets under management continue to modestly recover and that money-fund fees – which are being waived with interest rates so low – go back to normal.

As for the multiple, we don't think this will continue to trade like it's just another bank. Fee-driven asset managers and servicers have historically traded for 15-20x earnings, which is perfectly reasonable for a company with Bank of New York's business mix and scale. As the market gets comfortable that the credit issues were an aberration, that should translate directly into a higher multiple.

So with a better multiple on higher earnings, we're looking for a share price in the $45-55 range over the next couple of years. While the story and the company may not be particularly exciting, from today's price [of $28] that kind of potential upside certainly is.

Turning to a more traditional bank, describe the potential you see in Wells Fargo [WFC].

MK: Our thesis here is more big-picture than the detail we spoke about for Walgreen or Lowe's. Wells' basic strategy is relatively simple. Attract and retain low-cost deposits by focusing on customer service and building deep and broad relationships with clients. Lend prudently and traditionally, not chasing the latest fad or going far afield to put assets on the books. By executing well, Wells earns net interest margins – 4.3% in the first quarter of 2010, down from an average of 4.9% from 2003 to 2008 – that are the envy of the industry.

The financial-market disruption of the past few years has resulted in Wells improving its competitive position as many competitors have been forced to retrench, sell out or shut down. The benefits of that have shown up in its ability to increase deposits, independent of the huge addition to assets from buying Wachovia in late 2008. Overall, earning assets on which Wells earns a spread have gone up 115% from pre-Wachovia times, while the equity issuance from the acquisition and additional capital raises have resulted in dilution of less than 60%.

We assume Wells has raised all the equity it will need in order to weather ongoing loan writedowns. As a result, as the credit-quality situation stabilizes, we expect earnings power for the overall company to increase sharply.

Put some numbers on that.

JH: When you talk about normalized earnings for financial institutions, you

INVESTMENT SNAPSHOT

Wells Fargo
(NYSE: WFC)

Business: Diversified U.S. provider of consumer and commercial banking, insurance, investment and mortgage financial services. Total assets: $1.2 trillion.

Share Information
(@5/27/10):

Price	**29.41**
52-Week Range	21.57 – 34.25
Dividend Yield	0.7%
Market Cap	$153.23 billion

Financials (TTM):

Revenue	$66.39 billion
Operating Profit Margin	32.5%
Net Profit Margin	17.7%

Valuation Metrics
(@5/27/10):

	WFC	S&P 500
Trailing P/E	17.7	17.7
Forward P/E Est.	15.2	13.2

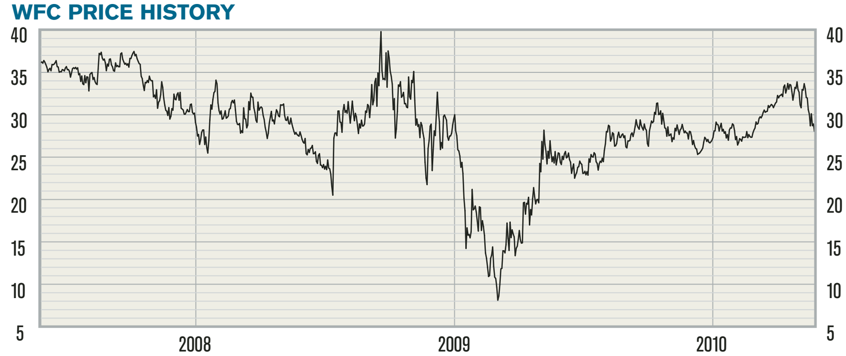
Largest Institutional Owners
(@3/31/10):

Company	% Owned
Berkshire Hathaway	6.1%
Fidelity Mgmt & Research	4.9%
Wells Fargo	3.6%
Vanguard Group	3.3%
Capital World Inv	3.1%

Short Interest (as of 5/14/10):

Shares Short/Float	1.3%

WFC PRICE HISTORY



THE BOTTOM LINE

The company's industry-leading ability to generate earning assets and high net interest margins should result in sharply higher earnings as loan-loss provisions eventually return to normal, says Mitchell Kovitz. At 10-12x the $5 per share he believes Wells can earn within three years, the stock would be worth $50-60 per share.

Sources: Company reports, other publicly available information

also need to have a normalized provision for loan losses. Assuming loan losses return to their historical average – stripping out the too-light provision years of the credit bubble and the massive provisions of the credit debacle – we believe normalized earnings on Wells' current asset base is $4 to $4.30 per share. By 2012, that number should be closer to $5.

Is that growth basically a function of an economic recovery working its way through the financials?

JH: Yes, somewhat. We're assuming Wells' competitive position will allow for continued growth in its asset base along with growth in non-interest income from a depressed level.

If you're right on earnings power, what's a reasonable expectation for the share price, now around $29.50?

MK: Based on our estimate of current normalized earnings and a conservative 10x multiple, we believe the stock is worth roughly $40 today. If Wells earns near the $5-per-share level we expect within two to three years, we see no reason that wouldn't deserve a 10-12x multiple, translating into a share price of $50-60 per share.

With respect to downside, if the economic recovery is much slower or Wells has to raise equity capital and we're wrong by even 50% on earnings power, we'd still make the argument that its franchise and competitive position warrant the same multiple. So while we may be sitting on dead money if that were to happen, we wouldn't expect much worse than that.

You manage a significant amount of fixed-income assets. Any themes of interest in that area?

MK: One fairly surprising opportunity we've found is in certain Alt-A Collaterized Mortgage Obligations (CMOs), trading at 40 to 60 cents on the dollar. We've modeled extremely high assumptions for defaults and severities and low ones for prepayments and still expect to get 12%-plus annual returns. That's certainly not the bulk of what we own, but we think it's an intriguing opportunity.

Any parting advice to investors grappling with an increasingly scary time in the market?

JS: The market is extremely noisy, but you just can't let that distract you from your discipline and your framework. Things like our five-year rule, for example, are even more important in a market like today's.

We've said this since we started out: The market is really just a pendulum that forever swings between unsustainable optimism, which makes stocks too expensive, and unjustified pessimism, which makes them too cheap. All we're trying to do is keep a level head, sell to the optimists, and buy from the pessimists.