
GuruFocus Interview with Investor Arnold Van Den Berg; Comments on CSCO, MSFT, TOL, MDC, DELL

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Arnold Van Den Berg is a value investor with 43 years of industry experience and founder of \$2 billion firm Century Management. A short time ago, GuruFocus readers asked him their investing questions. His responses, in which he discusses MDC Holdings Inc. (MDC), Toll Brothers (TOL), Microsoft (MSFT), Dell (DELL), Cisco (CSCO), Applied Materials (AMAT), Walmart (WMT), Wells Fargo (WFC), are below:

How did you get started with Value Investing? Any books to recommend? Who are the investors you admire the most?

[Van Den Berg] I got my securities license in 1968, right at the peak of the market. At the time, I was working for an insurance company selling mutual funds. For the next six years, I watched stocks, mutual funds, and individual separate account managers go through one of the most grueling bear markets in history. As I began to analyze the managers whose portfolios held up the best, I noticed that the most successful managers during that rough period used the Graham and Dodd value discipline. Equally important, the value philosophy really registered with me as it was the way I had lived my own personal life. So in 1974, I decided to start Century Management where we have been focusing on value investing for our separate accounts and mutual funds ever since.

The books that I would recommend reading can be divided into three categories: investing, philosophy and health. For investing, I would recommend reading "The Intelligent Investor." I also believe reading Berkshire Hathaway's current and historical annual reports (located on the Berkshire website), "The Essays of Warren Buffett: Lessons for Corporate America" by L.A. Cunningham, and the "Cardozo Law Review Volume 19" is well worth the time. The late Philip Fisher wrote several books that are very good: "Common Stocks and Uncommon Profits", "Conservative Investors Sleep Well," "Pathways to Wealth Through Commons Stocks," and "Developing an Investment Philosophy." Seth Klarman's "Margin of Safety: Risk-Averse Value Investing Strategies for the Thoughtful Investor" is a good book about risk. An easy, but good, read for those just getting started would be "Value Investing Made Easy" by Janet Lowe. Then there is Roger Lowenstein's "When Genius Failed: The Rise and Fall of Long-Term Capital Management;" there are some great lessons in that book. And for a more in-depth understanding, lifetime study, and reference is "Security Analysis" by Benjamin Graham and David Dodd.

As for philosophical books, I would like to recommend several that have had a major influence on my life: "From Poverty to Power," "Eight Pillars of Prosperity" and "As a Man Thinketh." These are written by James Allen who is my favorite author. James Allen was a man who devoted his life to seeking the truth. He wrote many other books that are all worth reading. Each of these books has tremendous lifetime principles – you must read these books over and over because each time you do, you will get more out of them. I have been reading James Allen's "From Poverty to Power" for more than 30 years. It's only after you experience something that you can go back and say, "Oh! Now I understand this!", so I prefer to read his and other good books many times over, rather than just reading more books that don't seem to add more than the original great works.

A sub-category of philosophy is goal setting. Here, I would recommend "Think and Grow Rich" by Napoleon Hill, and "The Wisdom of Your Subconscious Mind" and "The Knack of Using Your Subconscious Mind," both by J.K. Williams. J.K. Williams spent over 50 years studying the subconscious mind.

In the area of health, I would recommend "The China Study" by Dr. Colin Campbell. It is my personal feeling that this book will be as important to health one day as "Security Analysis" is to stocks.

The investors I admire most are Benjamin Graham, Warren Buffett, Walter Schloss, Prem Watsa, T. Rowe Price (the person), John Templeton, Philip Fisher, Peter Lynch, John Neff, and Seth Klarman. While there are many other great investors, I have chosen these because all of their writings are worth studying.

How does a macro view play a role in your investing decision making?

[Van Den Berg] We are bottom-up investors. In other words, we focus on the fundamentals of each business and the price we pay. However, we also believe there are two macro factors that greatly influence returns; they are interest rates and inflation. These two play a big role in determining what multiples you can pay for a company. For example, we believe that in a low inflationary environment of 1% to 3.5%, you are likely to see a median P/E between 17 and 20 for the average company. In a 3.5% to 4% inflationary environment, you are likely to see a median P/E between 15 and 16. If inflation ranges between 4% and 5%, the median P/E is likely to drop between 12 and 14. And if inflation ranges between 5% and 7%, you could see the median P/E drop to a range between 9 and 11. So while the fundamentals of each business are very important, understanding the inflationary environment that we are currently in or going to have can make a big difference in your returns. After all, if earnings are going up but multiples are coming down due to increasing inflation, you might find that stock prices are not going to return as much as if you were in a lower inflationary environment.

Furthermore, depending on how high inflation goes and how low the multiples go, your stock prices might even be going down. In a deflationary environment (very low growth), you could also have a very low median P/E ratio similar to those seen during high inflation. The only way you can protect yourself against high inflation and deflation is to buy stocks at low multiples.

What is your opinion on high oil prices, its impact on consumers, and the economy?

[Van Den Berg] A sustained period of high oil prices can be detrimental to the economy because oil is a major cost in a wide spectrum of economic activities. Not only is oil used for transportation fuels, but it is also a major input for chemicals and plastics (affecting manufacturing costs), for fertilizers (affecting food costs) and for textiles (affecting clothing and household products like carpets). The consumer, especially the low-end consumer, gets squeezed by rising commodity prices. Without a commensurate rise in wages (which leads to inflation), consumers are forced to reduce spending in other areas, such as discretionary spending and housing. This is especially a problem for households that are heavily indebted, as those are often forced into default. High oil prices benefit oil producers, but serve as a tax on most sectors of the economy. We estimate that a \$10 increase in oil prices negatively impacts the economy by \$70 billion. So the recent rise of prices from about \$75 to \$100 (at Cushing) would produce a drag of about \$175 billion on the economy. With U.S. GDP currently at \$15 trillion, this represents a negative impact of about 1.2%, or about a quarter of our normal nominal growth rate of 5%.

However, prices will not be elevated forever. Over the intermediate and long term, two things happen:

- First, demand destruction occurs as consumers of oil change their behavior to consume less oil. This can come in the form of less driving, driving more fuel efficient cars, moving into higher density urban areas (out of low density suburbs), mass transit, technology change, and bankruptcy.
- Second, supply expands. New fields are found, and new techniques for extracting oil are found. This has already begun to happen, as hydraulic fracturing used successfully on natural gas is now being adapted for oil extraction.

I would like to hear your thoughts on macro fundamentals, particularly related to U.S. inflation and the corresponding issue of monetary tightening? Is the Fed going to tighten this year? Are fundamentals in the U.S. and the overall global economy strong enough to absorb this tightening, which has already begun in China and Europe?

[Van Den Berg] The Federal Reserve has already signaled that it will allow QE2 to end in June, assuming nothing changes in the macro environment. Beyond that, it is not signaling a hike in the fed funds rate until 2012, at the earliest. In his recent press conference, Ben Bernanke admitted that the tradeoff between the benefits of a third shot of quantitative easing are poor compared to the possibility of higher inflation. Therefore, the Federal Reserve is likely to take a wait and see attitude when QE2 ends in June. This is a de facto tightening, but because QE2 liquidity has flowed mostly into assets — and not into the general economy.

The effect on the economy will be minimal, but the effect on markets may be substantial. We are probably already seeing the effect of tighter money in the recent declines in both the equity and commodity markets. Given the fragile state of the economy, it is unlikely that the Fed will raise interest rates this year. The Fed will likely wait for indications of a stronger recovery and a general increase in prices before tightening. When this will happen is anyone's guess. We believe that commodity prices will come down later this year as China's growth slows, Europe stumbles, and the U.S. economy remains sluggish. We still do not see inflation as a major problem for the short and intermediate term. However, depending on Fed policy, it could become a major problem over the long term.

In general, we believe the biggest problem, from a monetary perspective, is the euro, as the ECB is tightening in the face of capital flight and deflation in the weaker countries in order to snuff out inflation in the core. This has exacerbated the imbalances and the debt crisis, with the Euro threatening to disintegrate. The problem countries are currently experiencing what is called an "internal devaluation," where wages and prices are forced down in a grueling deflation which increases the already onerous debt burdens. It is only a matter of time before they cry uncle and opt out.

As a long-time value investor, what are your main concerns for the next few years? How do you see increasing inflation affecting asset prices in general?

[Van Den Berg] The most immediate concern is the European debt crisis and how that will be resolved. While default by Greece is widely expected and default by Ireland is considered probable, it does not appear that the markets are prepared for a full European currency crisis. This would result in an aggregate demand shock, where demand collapses in parts of Europe, though it would also result in more balanced subsequent economic activity and growth. In the U.S., the primary risk in the intermediate to long term is the combination of high deficits, rising health care costs, and unsustainable pension commitments. The deficit is currently running at about 10% of GDP, which is itself unsustainable.

However, it is largely a function of the recession with significantly reduced revenues and higher expenses, much of which is "stimulus." In the long run, Medicare/Medicaid is the largest item on

the Federal budget, and expense growth is projected to significantly outstrip tax revenue over the next 10 to 20 years. While the cost of health care is the most difficult issue politically to address, pensions, including Social Security and state/local pension plans are also projected to run large deficits in the coming years. If these problems aren't addressed, the U.S. could face a fiscal crisis.

We are in a unique economic environment in which higher inflation and deflation are both possibilities. Most people are more concerned about inflation, but continued declines in housing prices, high unemployment and sluggish growth continue to imply deflation. In one of our recent studies (we will have a complete presentation on our website in the next month), we concluded that the housing market will take at least three to four years to work its way down to a level of normal inventories. We feel the unemployment rate will take at least five years to get to normal levels, as the economy will have to create roughly 216,000 jobs per month to get back the jobs that were lost as well as absorb the new work force coming into the economy. In addition, the measures to solve our fiscal problems must also be dealt with. Therefore, these factors will be a drag on our economy for probably three to five years. This creates a risk of deflation as well as inflation.

Both high inflation and deflation are bad for financial asset prices. Higher inflation results in higher interest rates which raises stock discount rates and results in lower stock valuations. Deflation squeezes margins and reduces cash flows and earnings, resulting in — once again — lower stock valuations.

We have done a study of the effect of inflation and deflation on stock P/Es and on stock returns, using the Value Line median P/E of 1700 stocks. As we stated in our previous answer to the question **How does a macro view play a role in your investing decision making?**, P/Es can have a wide range depending on the inflationary or deflationary environment.

We have done a great deal of thinking on this subject as we first wrote about these problems in our December 2004 issue of The Value Investor newsletter (this is still available on our website). We believe the only way to invest in the current environment, since we are not sure which way it will go, is to buy companies that you are sure have survivorship characteristics as well as low multiples, as this will protect you in a deflationary environment as well as an inflationary environment.

When markets or individual stocks become overvalued, you must be prepared to trim your positions back and hold cash, even though it is difficult to hold cash as it does not give you any return. However, we believe that holding cash can help both long-term stock and bond investors as they await lower prices that the current problems will create.

You seem to believe that there will be high inflation risk in the coming years. What is the best strategy in this inflationary environment?

[Van Den Berg] It is important to define what we mean by inflation. Inflation rates in the low single digits (1% to 3.5%) generally meet the definition of low and stable inflation. Inflation rates greater than 4% or lower than 0% have a high risk of destabilizing the economy. The primary risk of inflation stems from the potential for monetary policy errors. Monetary policy makers do well when the underlying environment is relatively stable. But when conditions change suddenly, there is a possibility for error. Thus, monetary policy errors can be either deflationary or inflationary. The risk is especially high in unstable monetary environments, like we are experiencing today.

Both inflation and deflation compress valuations. In the 1970s, stocks sank to single digit P/E ratios. We all know what happened to markets in the early 1930s. Generally, economic instability is bad for valuations.

We believe that we could go through a period of above-average inflation (on the order of 5%), but nothing like we saw in the 1970s. This period will be very poor for stocks. Since it is difficult to predict the timing of such episodes, we adjust for inflation (and deflation as well) by adjusting our valuations for lower price multiples. When we find bargains, we will buy them; when we cannot find bargains, we will hold cash. We expect that conditions in the economy and in the market will run counter to our investment philosophy for short periods of time, but we know that over the long run value investing outperforms.

There was a piece in OID approximately eight years ago where you discussed the post-bubble periods. It was transformative for me but I wonder where you think we are at presently. It seems the risks are greater than ever as our government tries to solve an over-consumption problem by issuing massive amounts of debt. You can buy some very high quality companies at single digit PEs but the market generally trades higher (even if you think the reported numbers are clean enough) and profit margins are at all-time highs. Many more years of effectively going nowhere until we get significantly cheaper?

[Van Den Berg] Over time, price determines return. Buying high quality companies at single digit P/Es gives us the opportunity to make money, even in an uncertain and unstable environment. Obviously the profits have to be real and sustainable, but assuming those two conditions are met, if we buy companies at the right price, we are discounting the risks. We can't hedge every risk (even cash can be a bad investment), but we can hedge valuation. Stock bubbles are always followed by a bear market. A major characteristic of bear markets is that things that would normally cause the market to explode — like low interest rates — have either minimal or temporary effects. In bear markets, earnings could continue to grow, but multiples become

compressed. This causes stock valuations to trade up one to two years, but then revert back to low levels and start the cycle over. Over the duration of the bear market, the prices of stocks may not significantly appreciate. Stocks that may look cheap on a multiple basis may often get even cheaper. This is exactly what we have been seeing since 2000. At the end of the bear market, multiples have compressed to very low levels. This sets the stage for the next bull market.

How much longer will we be in this bear market? Bear markets typically last about sixteen years, so I would say that we have about five more years to go. This coincides with our earlier comments on how long we think it will take for the real estate, unemployment, and fiscal problems to be reconciled. The way to invest in this kind of environment is to stay focused on the valuations of individual companies. You can still make money in this environment by buying stocks when they are cheap and selling when they are near fair value (remember that multiples are compressing, so stocks won't go as high as one would expect in a normal environment). When bargains can't be found, hold cash.

Your value mandate gives you the flexibility to invest in any sector/size. In the last few years you have concentrated into high quality U.S. multinational companies (WMT, MSFT, etc.) because that's where you saw the relative value. Unfortunately, many have underperformed their smaller/illiquid/cyclical/low quality alternatives and have gone from cheap to cheaper. Why do you think this is the case and what could be the catalyst to make them regain performance leadership?

[Van Den Berg] As bottom-up managers, we analyze and value stocks on their individual merits and invest wherever we see the greatest risk adjusted values, whether that is big cap, mid cap, or small cap. Historically, the best values generally show up most often in small and mid cap stocks. However, as you point out, our portfolio has a larger proportion invested in big cap stocks than smaller cap stocks. Incidentally, from a historical perspective, it's more than has been our norm as well. There are several reasons for this. First, over the last several years, our analysis revealed more value in big cap stocks than any time in the past 15 years and resulted in a much larger number of big cap stocks showing up cheap, while at the same time small companies were relatively expensive. Because of this dichotomy, leading up to the recession, we had a larger proportion invested in large cap holdings than small cap holdings. Second, while recessions bring opportunities to invest in small and mid cap stocks (this recession was no different in that respect), we maintained our tilt towards big cap stocks as we feel the risk adjusted values to be generally superior for *our* big cap holdings for the environment we see over the next three to five year period.

With regard to the big cap stocks' recent performance, it is often difficult to explain why some stocks can be undervalued for long periods of time before their value is recognized. With that said, we do recognize that a number of large cap stocks have experienced a slowing growth

profile and a corresponding contraction in valuation multiples.

At today's prices, a significant number of the large cap stocks we own are priced as though they will experience negative sales & earnings growth. We feel these assumptions are too onerous as the companies benefit from emerging market demand growth (usually 25%+ of sales), an economic recovery in developed countries, industry specific growth drivers, industry consolidation, and cash flow generation (many companies generate free cash flow \approx to net income).

Large cap stocks are presently at historic lows relative to small cap stocks and versus their own history. We feel large cap stocks' defensive characteristics will prove more attractive as the global economic recovery matures.

That said, we continue to search for the best risk adjusted returns across sectors, industries and cap sizes and won't hesitate to invest in the best values, regardless of cap size, as the opportunities arise.

What are the more important metrics that you use to define value? Can you please describe your approach to valuation?

[Van Den Berg] We use a multi-factor approach to define valuation. The methods employed include:

- Private market value analysis – This model compares the company you are analyzing against peers that have been acquired over the years. Adjustments are made to peer group buyout multiples based on the time period examined (bubble or bust periods), business similarities and a company's relative merits. Some multiples used include: EV/Sales, EV/EBITDA, P/Cash Flow, P/Free Cash Flow, P/E, and P/BV. We also employ a DCF on free cash flow to determine the company's private market value.
- LBO model – This model calculates how much the stock is worth based on how a lender would value the company. Conservative sales, margin and cash flow are used and a lending discount rate is employed.
- Historic multiple analysis – This method compares the stock's current valuation against where the stock has traded in the past. Appropriate adjustments are made to determine the correct multiples to employ based on how the company's growth and return profile has evolved.

Some multiples reviewed include: EV/Sales, EV/EBITDA, P/Cash Flow, P/Free Cash Flow, P/E, and P/BV.

In your newsletter published six months ago, you concluded that it would take two to three years for the real estate inventory to work out. How is this related to investing in home builders?

[Van Den Berg] As value investors, we sometimes look for investment themes as this helps to increase the number of investment opportunities. We realize it is difficult to accurately predict macro markets with any consistency for a variety of reasons, one being the complexity of the variables involved. While difficult to predict the timing of a recovery, we do feel comfortable, as we have stated earlier, that at some point housing demand should increase, driving construction to more normalized levels. Historically, homebuilder stocks have recovered well **BEFORE** the industry has recovered. Once the general consensus feels that housing has recovered, the opportunity to profit from what is typically a large discrepancy between the market value and the intrinsic value is significantly diminished. The highest probability of success appears to occur when purchasing stocks at a discount to intrinsic value, which is almost always **early**, averaging down through the bottom of the cycle, and having the patience and discipline to wait for the cycle to turn. Whether the market turns in three or four years is much less important than understanding the individual companies involved, provided that the holding period gives you a good return.

You have been adding to MDC since 2008. Why do you like MDC specifically? Compared with Toll Brothers?

[Van Den Berg] Actually, we like both companies and own both companies. However, MDC Holdings Inc. (MDC) has traded at a greater discount to its potential earnings power and what we believe to be its intrinsic value. In the past, the homebuilders who were more disciplined capital allocators appeared to have had the opportunity to purchase related assets at significant discounts. We believe that both MDC and Toll Brothers (TOL) understand their strengths and weaknesses more than most of the other publicly traded builders. While TOL is a great operator, it did not appear to have the same upside as MDC and has not traded at as large of a discount for as long as MDC. Also, both have very different operating models. TOL makes money throughout the entire construction cycle from developing raw land to building houses and does this better than most homebuilders. MDC, on the other hand, maintains a relatively low supply of land, generally purchases finished lots and profits primarily from constructing homes. MDC's shorter supply of land provided flexibility during the downturn, leading to lower debt and greater cash balances than most peers.

While MDC's stock price has been flat, we find it more important to assess the company's specific fundamentals. Over the past two years, the company has been putting its cash to use by buying land and homebuilder assets and continues to increase its potential earnings power. Although we may have to wait a few years for demand to increase and the market to adjust, we feel that this is the best time to take advantage of this opportunity.

How do you define "high quality?" What factors will make you think a company has a high quality business?

[Van Den Berg] Companies that are of real high quality have a true franchise, have pricing power, an enviable competitive position, a strong balance sheet, earn a good return on capital and equity, and have a culture that can stand the test of time. I am sure that most of your readers would agree with this. This is the ideal, but very rarely do you have the opportunity to buy the ideal at cheap prices. Most of our returns have been by companies that did not fit this category of the ideal, but the price made it an ideal investment. However, in order to get a good value, which is what we are looking for, it is not sufficient to *just* have a great company; you also need to buy it at good price. If not, you may end up with a comfort stock that gives you a mediocre return. Always remember that even a great company can disappoint you, especially if it is not bought right.

Why are you investing heavily in technology stocks now?

[Van Den Berg] We are investing in these stocks because we think they are cheap. It's hard to say why they are cheap, but we suspect that it is because these stocks, which are mostly large caps, have lower earnings growth than they did ten years ago. This reduces the valuation multiples and brings down prices. However, we believe that Mr. Market – in one of his depressive stages – has underestimated future prospects and driven prices down to irrational levels. It is anyone's guess as to when prices will rise to reflect reality, but we are confident that it will happen and that our value philosophy will be vindicated – once again.

Many of these stocks are priced as if there will be no future earnings growth because the US economy is sputtering and new technology will make the giants of old technology look like dinosaurs. We disagree. Microsoft may not be the juggernaut of old, and, yes, Windows PC sales are slowing against difficult comparisons and some lost share in net books, but they are a major player in cloud computing, are experiencing strong sales in productivity software, are gaining share in gaming consoles, and are gaining share in search.

In addition, they have a significant hidden asset in a large number of non-paying Windows and Office customers, which equals to roughly 30% to 40% of the market. Intel may not be a strong player in cell phone and mobile chips, but they make far more money off of cloud-based server chips that support the cell phones and tablets in use. Applied Materials is an arms dealer – they sell the equipment that will be used regardless of the technology platform chosen. Technology is changing, but the most important driver of that change is significant demand growth, especially in emerging markets.

A good example is Dell. Here is a stock that has beaten expectations for three consecutive quarters; margins are up, market share is up, and international growth is expanding. The cash generation is ample and the balance sheet is strong. Yet the stock is trading at 10x this year's earnings and 9x next year's earnings. We are confident that the market will recognize this value soon, but we have no crystal ball to tell us when this will happen.

The following table highlights some of our other technology holdings:

	P/E	P/E ex cash
Microsoft	9	7
Intel	10	9
Cisco	10	7
Dell	10	10

The P/E is calculated normally, while the P/E ex cash gives them credit for their net cash holdings (in the case of Dell, we have excluded a portion of its cash which is held to offset a working capital liability, otherwise its P/E ex cash would be similar to the others).

Just as importantly, these companies are posting earnings growth, have strong franchises and strong balance sheets, generate significant cash flow, and return cash to shareholders. These are just the least expensive; another supposedly favored stock, Apple, is also inexpensive at 9.5x cash-adjusted earnings. While one could argue that PC growth is slowing and the low-end consumer PCs are being pressured by tablets, it would take significant declines before these stocks become fairly valued. If investors really believed that iPads were going to take significant share from PCs, then Apple would be trading much higher than it is (as iPads are currently a small fraction of the overall PC market). In truth, we believe that with penetration rates hitting inflection points in several emerging markets, there is more upside to current PC growth rates than downside.

Why Cisco?

[Van Den Berg] Cisco (CSCO) is currently experiencing competitive pressures in its switching business as it transitions to a new technology and engages in aggressive discounting to drive

adoption of its new products (new products, by the way, that now use Intel chips). This has caused earnings to weaken and growth to grind to a halt, which is why the stock is cheap. It is further distracted by an array of consumer businesses acquired over the years that are not yielding much in the way of profits. It is a classic fallen angel in a mature industry that overreached and got sloppy. We believe that Cisco has been hurt by a combination of poor execution and a disruptive product transition; but it has a powerful franchise, the product transition will pass, and it is making the right moves to clean up its business. Not only is Cisco trading at 10x EPS, but at 10x modestly depressed EPS. It doesn't have to get a lot right to make the stock work.

You previously told a very interesting story about silver crashing in the 1980s. What is your view on gold and silver?

[Van Den Berg] It is easier to estimate price bottoms on metals than price tops. On the low end, production costs guide us to buy points. I have yet to identify an equivalently relevant fundamental to guide us to sell points. The best I have come up with is a price that would generate a decent margin for the average mining company. Unless metals are at or near their cost of production, which they aren't currently, we don't get involved.

In 1999, you wrote "Over the next 10 years we believe that the return on the S&P will be between 2% to 7%." That was similar to the prediction of Warren Buffett in 1999. Even that turned out to be optimistic. What are your views of the broad market valuation and the expected return of the S&P in the next 10 years?

[Van Den Berg] I believe what we said back in 1998 was that if you used the most optimistic price to sales ratio for the S&P of 1.25 and you assumed a growth rate of 7.5%, then the most optimistic 10-year annualized return we could foresee would be 3.25%. However, if you used the historical average price to sales ratio for the S&P of 0.80, then we projected the 10-year annualized return would be -1.22%. With results in, the 10-year return for the S&P 500 ended 2008 was -1.41%. As we look forward, if profit margins go back to their historical average, and if inflation remains between 1% and 4%, I believe that we could see a return over the next 5 to 6 years that ranges between 7% and 10%. However, if inflation gets into the 5% to 7% range, and I am not saying it will, but if it did, then multiples would drop and returns would likely range from flat to 2% over 5 to 6 years. You can see how important profit margins and the inflation rate are when it comes to thinking about future returns.

But from where we are today, I feel comfortable foreseeing high single digit returns over the next 5 to 6 years. I am not projecting that these returns will go in a straight line, we might even have a recession somewhere during the next five years, but over this timeframe I think a high single digit annualized return is very possible. Once we get beyond the 5 to 6 year time frame, I believe America has the possibility of entering into a major bull market for stocks that could be very exciting. It could rival any major bull market we have seen. In the long run the world should continue to benefit from an emerging middle class in developing nations. To provide some perspective, the U.S. created \$36 trillion in wealth on 300 million people in 20 years. Can you imagine the wealth that will be created over the next 20 years when you add China and India's 2 billion plus people to the list of consumers? Our large cap multinational companies derive 53% of their sales from overseas and will benefit from these growing markets.

You have bought and sold CPI Corp several times over the last 12 years and are once again the largest shareholder. A good free cash flow business with poor reinvestment opportunities. They bought back stock for awhile and have been paying down debt more recently and have acquired PCA, Kiddie Kandids and now Bella Pictures. This has allowed them to spread their digital technology over a bigger base. Sittings are down but price per sittings are up. I would think they would eventually sell the business to a Buffett type investor who could take the cash flow and redeploy elsewhere. How do you see this playing out?

[Van Den Berg] As one of the originators of the national portrait studio business, CPI Corporation (CPY) has a long heritage with the lowest cost structure in the industry. CPI Corporation generates substantial free cash, which it has deployed in a variety of ways: debt repayments, acquisitions, share repurchases and dividends. While I have no special insight as to whether a Buffett-type investor would make a play for CPI Corporation, it would not surprise me as the nature of CPI's business could lend itself to that type of outcome.

In the meantime, I expect CPI Corporation to continue to deploy its healthy cash flow generation in the same manner as it has in the recent past, with continued debt repayment, dividends and share repurchases. Any future acquisitions, I believe, will be structured much like Kiddie Kandids, where it paid \$2.6 million and will earn in excess of \$7 million in EBITDA in its first full year of operations. Its Bella purchase (for which it paid virtually nothing) provides a low-cost, low-risk entry into the multi-billion dollar wedding portrait business. Each incremental dollar of revenue spread over its low cost processing infrastructure provides substantial operating income leverage, as can be seen by the results of the Kiddie Kandids operation.

You seem to be reducing your exposure quite a bit in the stock market. Is this because you think the market is over-valued at this time? If I remember correctly, you were still buying heavily in 2007, such as Talbots, YRC Worldwide, WP Stewart, etc. What do you see different to make you go more to cash at this point compared to that time period?

[Van Den Berg] Since the beginning of the year, many of our stocks reached our targets and by selling them, our cash balance has increased. While we have found several new ideas, the dollar values invested haven't yet made up for the values sold; we certainly anticipate this will change. We will happily invest when we see good values considering the current environment.

Can you give us a few great value stock ideas today in the small and micro cap space, and explain why you like them?

[Van Den Berg] We generally don't talk too much about our small cap ideas as they are hard to come by and often harder to accumulate. Furthermore, it would not be fair to our clients to share this information before we have taken our full positions in their accounts.

What are your personal favorite one or two stock ideas right now?

[Van Den Berg] I believe large cap tech stocks are one of the cheapest areas of the market. Stocks like Microsoft (MSFT), Dell (DELL), Cisco, and Applied Materials (AMAT) are names that come to mind. In the non-tech environment, Walmart (WMT) and Wells Fargo (WFC) represent good values today, especially if you have a three to five year time horizon. With regards to the technology stocks we named, they are loaded with cash and selling at low multiples of earnings and free cash flow. Isn't it interesting that 10 years ago the market was silly with excitement about tech stocks and willing to pay 30, 40 and 100 times earnings, yet today they sell at 8 to 10x earnings and free cash and the market yawns?

At least one thing hasn't changed; the market wasn't looking at the fundamentals in 2000 and isn't looking at them now.

How about international stocks? Do you think the best way is to invest in U.S. companies that have strong operation in other countries?

[Van Den Berg] Yes. We prefer to own U.S. domiciled companies that have a reasonable amount of sales and earnings coming from outside the U.S. rather than buy foreign companies directly. This is not to say you can't make money owning foreign stocks directly. However, we prefer to buy U.S. domiciled companies at bargain prices, where we can have a higher degree



of confidence in the accounting and legal systems, plus we don't have to worry about some of the additional risks that are associated with directly investing in lesser developed countries. With that said, we would not hesitate to own companies in more developed parts of the world such as Japan, Germany, France, England and Scandinavian countries.

End.

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