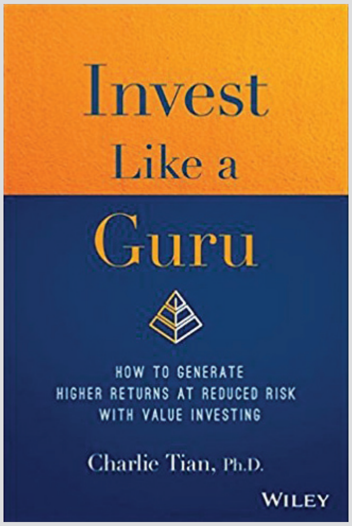


Excerpt from Chapter 2 of the new book by GuruFocus Founder Dr. Charlie Tian,

“Invest Like a Guru: How to Generate Higher Returns At Reduced Risk With Value Investing”.

Though buying deep-asset bargains can be very profitable, this strategy comes with a much higher mental cost to investors. More importantly, business deterioration and the erosion of value put investors in a riskier position. As a result, they need to strictly follow the rules of maintaining a diversified portfolio and selling within 12 months whether investments worked out or not.

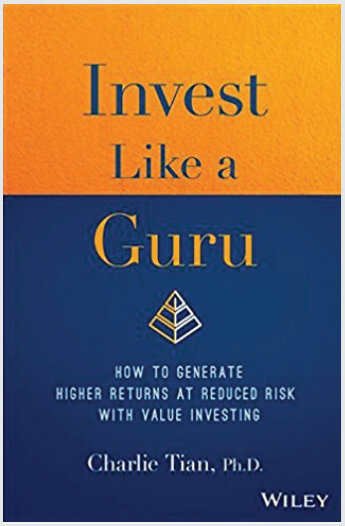
The approach should be to focus on small companies with liquid balance sheets. If a lot of hard assets such as equipment and buildings are involved, the liquidation process can be long and costly, which may eat up all the value the assets have. Buffett had first-hand experience with this. When Berkshire Hathaway finally shut down its textile business and was liquidating, the equipment that originally cost $13 million was still in usable condition and had a current book value of $866,000. The gross proceed from the sale of the equipment was $163,122. After the pre- and post-sale costs, the net proceed was less than zero.[14]

It is very dangerous and costly to hold onto the companies that have complex businesses and illiquid assets. You will get stuck with them while hoping the business will turn around, just as Buffett did with the original textile business of Berkshire Hathaway. If buying mediocre businesses at deep bargain prices for a quick profit is like a date without the intent of getting married, buying them and getting involved long term is like a marriage without love. A lot of other things need to be right to work things out, and it will never be a happy marriage.

One such case, ongoing for the past several years, involves Bruce Berkowitz of Fairholme Fund, one of the best-performing mutual fund managers in the first decade of this century. It has cost both him and his shareholders dearly.

Berkowitz has owned a large position in Sears Holdings, the struggling retailer, for more than a decade. The stock was trading at above $160 before spinoffs, and although he was well aware of the problems with the company’s deteriorating retail business, he has long believed that Sears has tremendous values in its real-estate portfolio and its businesses, and these values can be realized by selling the businesses and real estate. By February 2014, the stock had lost more than 70 percent and was traded at $38, and Berkowitz believed that Sears’ net assets exceeded $150 in value. He wrote in February 2014: “If our research is accurate, Sears’ market price of $38 [is expected] to increase to this value over time.”[15] Two-and-a-half years later, the stock is traded at below $10. Even if we added back the value from the spinoff of Lands’ End and the right to buy Seritage at a discount, the stock has lost more than another 70 percent. Berkowitz is continuing to buy more Sears.

In the meantime, Sears has been doing everything to unlock value under the leadership of another supposedly capable value investor and financier, Eddie Lampert. Sears spun off Orchard Supply Hardware in January 2012 at above $20 and it now trades at 20 cents. The company couldn’t compete with Home Depot and Lowe’s, whether it



was on its own or under Sears, and is now bankrupt. Another spinoff, Sears Canada, was never profitable after the spinoff at $18.5 a share in October 2012; the stock has since lost more than 80 percent and is on its own way to bankruptcy. The Seritage spinoff has been doing relatively well so far, but what the original shareholders received was the right to buy shares at $29.5 instead of simply getting the shares outright as with other spinoffs. Sears itself has been losing money every year for the past five. Most of the $2.7 billion proceeds from selling its primary properties to Seritage was used to cover the cash drain from its operating loss in 2015 alone. What value does it really unlock?

Sears also bought back a lot of shares over the years to "return" capital to shareholders. But for a company that kept losing money, the remaining shareholders only saw their share of loss get bigger and their share of business value drained faster.

One may argue that Sears shareholders could have sold the shares of Orchard Supply and Sears Canada after the spinoffs and benefited by doing so. I would argue that Sears shareholders should have long ago sold their shares altogether. The same is true for Berkowitz. His Fairholme shareholders would have been much better served ten years ago if he had sold Sears at above $160, or six years ago at above $70, or four years ago at above $40, or two years ago at above $30. The stock is now traded at below $10 and he is still not giving up. Instead, he is buying more because the stock is even more "undervalued." The cost to Fairholme shareholders has been steep. The fund underperformed the S&P 500 by a total of more than 35 percent in the last three years and more than 50 percent in the last five years. Should I also talk about the lost opportunities?

The drama continues. Sears is spending heavily trying to turn around its beleaguered money-losing retail business and is hoping to compete against the likes of Amazon and Wal-Mart. Berkowitz has now joined the board of Sears. Such a move will definitely add more to his mental and psychological cost. The surprises just kept coming. Sears' pension fund burned $2 billion in the last several years, which as of today is more than double of the entire market cap of the company. The unlocking of value took longer than expected, which means more value is about to be eroded. In May 2016, Berkowitz thought that the problem with the pension obligation should improve, as the Fed's interest rate hike seemed imminent,16 only to see the interest rate continue to drop. Now he is expecting the retail losses to stop in 2016, which we have yet to see. In the meantime, the company burned through another $700 million in the first quarter of 2016 and issued about the same amount of debt to maintain its cash balance.

Doesn't this sound like a hole that keeps getting deeper? Why would I, as an investor, want to get involved in this mess and witness things deteriorating, hoping the situation will improve? Even if it works out eventually, which to me is very unlikely, the mental and psychological drain is simply not worth it.

Buffett said it best:

> Unless you are a liquidator, that kind of approach to buying businesses is foolish. First, the original 'bargain' price probably will not turn out to be such a steal after all. In a difficult business, no sooner is one problem solved than another surfaces—never is there just one cockroach in the kitchen. Second, any initial advantage you secure will be quickly eroded by the low return that the business earns . . .

There are better ways to make money.