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OUTSTANDING INVESTOR DIGEST, INC

Outstanding Investor Digest

PERSPECTIVES AND ACTIVITIES OF THE NATION'S MOST SUCCESSFUL MONEY MANAGERS.

The following was excerpted from our 9-page feature with:
Pzena Investment Mgm't

Volume XXI Numbers 1 & 2 February 29, 2008

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OID POTPOURRI: SETH KLARMAN, BOB RODRIGUEZ, BILL NYGREN, WALLY WEITZ & THOMAS GAYNER

We're pleased to bring you the following assortment of perspectives from *OID* contributors. First, Seth Klarman recounts how the mad financial whizzes lost control of their creations, and why the revulsion against risk may not yet be over. Then Bob Rodriguez sounds a further note of caution, as he reviews the origins of the credit crisis, its severity, and its likely outcome. Third, Bill Nygren speaks to one of the curses of being a value investor — that when opportunities

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PZENA INVESTMENT MANAGEMENT'S RICHARD PZENA
"THE QUEST TO GET THE TIMING RIGHT IS WHAT TRIPS UP MOST INVESTORS."

If investors are unable to endure periods where they're down 20%, Vanguard founder John Bogle has said, they have no business being in stocks. In acknowledgement of that principle, Richard Pzena not only prepares his clients for the inevitability that a downturn of 20% may happen, he *promises* them that it will.

Pzena Investment Management was founded in 1995 — not the most auspicious time to start managing money

(continued on page 24)

LEGG MASON VALUE TRUST'S BILL MILLER
"THERE'S *ALWAYS* SOMETHING IN EVERY CRISIS WHICH IS 'THE WORST IT'S EVER BEEN.' "

It's been two years since Bill Miller's remarkable record of beating the S&P 500 for 15 straight years at his flagship, Legg Mason Value Trust, came to an end. Incidentally, according to Janet Lowe's book on Miller, that record lasted almost twice as long as that of Fidelity Magellan Fund's Peter Lynch, which lasted for 8 years.

Furthermore, during that stretch, Miller not only outperformed the index consistently, he *trounced* it over all —

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WESCO FINANCIAL'S CHARLIE MUNGER
"THIS COMBINATION OF ENVY AND SELF-SERVING BIAS CAUSES PEOPLE TO GO RIGHT TO THE LIMIT."

Once best known as a curmudgeon's curmudgeon in his straight man role at Berkshire's annual meeting, Charlie Munger has developed a cult-like following of his own. His one-man show — the Wesco Financial annual meeting — draws what he calls the "hard-core nuts" from far and wide, who come to hear the wit and wisdom of the man Buffett says gives "the best 5-minute opinions in the world."

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PZENA INVESTMENT MGMT'S
RICHARD PZENA
(cont'd from page 1)

in a bottom-up, deep-value style. After excellent absolute returns in the first two years, Pzena's flagship Value Service ran into the two-tier market and internet bubble of 1998 and 1999. During that stretch, several money managers with long and distinguished track records either lost their jobs or threw in the towel, while others suffered redemptions — in some cases, of up to 50% of assets under management. We can safely assume that the pressures on a manager with a much shorter record must have been enormous. Of course, for those value managers, like Pzena, who were able to both keep their jobs — and, importantly, not succumb to the temptations of style drift — vindication was around the corner.

It's the ability to survive during those periods when a particular investment style is out of favor — when, as Pzena puts it, you're buying companies where the news is so awful, it makes you think you should have your head examined — that has been instrumental to Pzena's impressive long-term record. Through December 31, 2007, Pzena Value Service has a compound annual return of 13.0% net of fees for the 12 years since inception versus 10.9% for the Russell 1000 Value Index and 9.3% for the S&P 500.

The excerpts which follow were selected from comments by Pzena at the February 1, 2008 Columbia Investment Management Conference — a joint production of CIMA (the student-run Columbia Investment Mgm't Association) and the Heilbrunn Center for Graham & Dodd Investing — as well as comments he made on his conference call on February 12th. We find his thoughts on the inevitability of 20% declines — of which, he says, peak-to-trough, his firm has weathered three — the folly of trying to time the change in market cycles and, finally, where he's finding the best opportunities today to be most interesting. We hope that you agree.

MOMENTUM INVESTORS LIKE TO *RIDE* THE EMOTION — VALUE INVESTORS TRY TO *EXPLOIT* THAT EMOTION.

Investing involves riding an emotional rollercoaster at times.

Richard Pzena: My talk today is entitled: "Surviving the Cycles of Investing." What I hope to do is give some perspective on what it's like to go through the emotional rollercoaster of being an investor. And what that really means is: How do you make it though the down periods? — because I don't think a lot of people need a whole lot of guidance or hand-holding on how you make it through the good periods.

So I have three objectives today. One is to talk a little bit about the different ways there are to win in investing. Each of those has its ups and downs, and we'll look at some of them. I'm going to talk about the wisdom of trying to time these cycles versus plowing your way through them. And then I'm going to try to give you some perspective on where I think we are in the various cycles of investing.

And value investors try to *exploit* that emotion....

Pzena: Let me start by identifying the three basic styles of investing. One is the people that like to *ride* the emotion — the momentum investors. There's plenty of good academic support and lots of great managers that have performed very well using momentum investing styles.

Then there are people like us who try to *exploit* the emotion — and there's also a lot of good academic support for value investing, and lots of great managers who have done a good job.

Then there's a third category — they're the people who try to *predict* the emotion. And I have no clue how you do this, but there are people who have had success doing it.

Value and momentum strategies have both been successful.

Pzena: So let's start with a look at value investing. Value investors, as we all know, are people who react to prices that are offered in the market. We tend to believe that the fundamentals of the business will eventually be reflected in the price — and when the price is very different from those fundamentals, we'll take advantage of that.

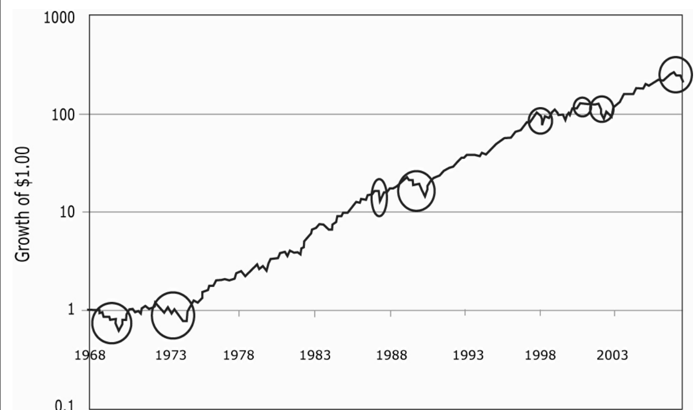
There is a basic belief amongst value investors in "regression to the mean". And a naive view of value is just low price-to-book. But you can use low price-to-anything as your naive estimate of value — low price-to-earnings, low price-to-sales, or low price-to-cash-flow. And if you had invested in a *very* simple strategy of buying low price-to-book stocks over the last 40 years [based on the cheapest quintile of the largest 1000 stocks], you'd have made about 200 times your money versus about 60 times your money if you'd invested in the S&P 500. So it's a pretty successful strategy....

And momentum investing basically performed just as well. We define momentum as just buying the companies that had the best trailing 9-month price performance — nothing sophisticated, just very naive. So either one of these strategies would have been very successful over the last 40 years....

(continued on next page)

CHART 1

DECLINES OF 20% OR MORE
IN A VALUE STRATEGY*
1968 - 2007



**Price/book: lowest quintile of 1000-stock universe.*
Source: Sanford C. Bernstein & Co., Pzena Estimates

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PZENA INVESTMENT MGMT'S
RICHARD PZENA
(cont'd from preceding page)

But when you're losing 20%, you start to question yourself.

Pzena: Now, what I want to focus on are the eight times in the last 40 years that you would have lost 20% in a naive value strategy. When you look at **CHART 1**, those circles are *little* blips in the scheme of going up 200-fold. And from a purely analytical perspective, you'd just look at it and say, "Who *cares* if I'm down 20% eight times? I'm up 200-fold over this 40-year period." And I think that's actually quite a logical conclusion.

The problem with that conclusion, though, is that while you're losing that 20%, it doesn't feel very good. And not only doesn't it feel good, you start to question whether you're doing the right thing. And when you have clients who are entrusting you with their money, they for sure will question if you know what you're talking about. They'll say, "Wasn't it obvious that whatever was going to happen was going to happen? Everybody in the world seems to know it except you."...

And *everybody* knew the banking crisis was upon us....

Pzena: The last circle in the chart is the current period which covers the last 12-1/2 months or so — where, if you were just a naive value investor, you would have hit that negative 20%. (Fortunately, maybe it looks like it's over, but we don't really know.) And if you had looked at the companies that would've been in your naive value portfolio, it would have been financials, consumer cyclicals, and housing and housing-related stocks.

And, of course, anyone who just lost 20% that has entrusted their money to you is going to say, "*Everybody* knew we were going into a recession; *everybody* knew the banking crisis was upon us; *everybody* knew retail was a lousy place to invest in a recession. What's *wrong* with you?" And, of course, those are all questions we get....

Should investors try to avoid those 20% down periods?

Pzena: So the question you really start to ask yourself is, "Can I avoid those 20% down periods? *Should* I try to avoid those 20% down periods?" And one of the ways that people think about doing it is to say, "Wow, both momentum and value investing have spectacular long-term returns. What if I combined them in such a way that I would have even better returns?"

And I'm pretty sure that if you mathematically modelled this, you *would* find that you could improve your performance by combining value and momentum strategies — and reduce your volatility.

A leopard shouldn't try to change its spots....

Pzena: But I think you can only do that if you have a computer picking the stocks — because when you have

(continued in next column)

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people picking the stocks, it's *very* difficult. First of all, even though both of these styles over the long run look like they have the same performance, they tend to be negatively correlated in the short term.

And if you were to try and implement this — and require bargain hunters like us to ride the wave, or require trend followers to dig in the dirt — the odds are you're going to fail. And I've experienced and witnessed that over time. Trying to invest where you don't have a particular expertise or the particular emotional makeup winds up detracting from long-term returns.

So we *promise* those down 20% periods to our clients....

Pzena: So given that, what do you do? Well, my solution — because I haven't yet figured out how to avoid those -20% periods in my career — is to *promise* them to my clients. I tell them, "This *is* going to happen. And if you don't like it, we're not the right people for you. You should try and find someone who you think might be able to predict the sentiment changes."

PORTFOLIO REPORTS estimates the following were Pzena Investment Management's largest equity purchases during the 3 months ended 12/31/07:

1. FREDDIE MAC
2. FANNIE MAE
3. CITIGROUP INC
4. CAPITAL ONE FINL CORP
5. POPULAR INC
6. TYCO ELECTRONICS LTD
7. ERICSSON LM ADR
8. BANK OF AMERICA CORP
9. MORGAN STANLEY
10. IMS HEALTH INC

[Editor's note: Pzena knows of what he speaks. Regarding the inevitability of 20% declines — and the gain that often follows that pain — he had this to say on his fourth quarter conference call on February 12th:

"This understanding of our approach is crucial, considering we've undergone three separate incidents of peak-to-trough performance declines in our history greater than 20%. At the peak of the internet bubble, for example, our Pzena Value Strategy trailed the broad market by over *6,000* basis points cumulatively since inception. Nine months later, the portfolio had made up the entire difference versus both the broad market and the value benchmark.

"During the next seven years, the portfolio earned 21.4% per year versus 2.1% for the broad market. That created far more excess return than the previous underperformance cost. But the gains came only by sticking with the program and enduring some pain."]

Pzena: And you don't know *when* it's going to be a momentum market and when it's going to be a value market. I'm going to try and show some common signs of when each might be the case. But when you're sitting in the middle of it — and people are focused *only* on what the next piece of information is instead of what the value of the franchise is — there is no telling where share prices can go.

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PZENA INVESTMENT MGMT'S
RICHARD PZENA
(cont'd from preceding page)

A momentum market cares only about the next piece of info.

Pzena: Take Citigroup, as an example. They had $18 billion of losses. And, of course, people who are fearful of investing in Citigroup think they're going to have more losses. Yet someone that's detached would sit there and say, "So *what* if they have more losses?" The $18 billion — which sounds like a *very* large number — is, after tax, about $2 a share. And the stock price fell $35 a share if you measure from its peak to its trough.

So, if they lose *another* $2 a share, does that matter? It only matters if you really think in the long run, there's some undermining of value in the Citigroup franchise. And when you study the Citigroup franchise, you find that they had very little to do with structured finance — with taking mortgages, converting them into CDOs, and structuring them. They didn't make a whole lot of money doing that. So when they lose a lot — because of the inventory or trading positions they had — that magnifies the focus on these kinds of things even though the underlying businesses are mostly not impacted. And people don't quite get that.

One of the questions people ask is, "How can you possibly understand what's on the balance sheet at Citigroup? It's not possible." Of course, it was not possible three years ago either, when Citigroup's earnings were skyrocketing and the stock was selling for almost $60. It's just that people have decided to focus on that today. And that focus in a momentum kind of market — which pays attention primarily to the next piece of information — is a very difficult one for pure value investors to make money in.

Riding through those down 20% periods is the smarter way.

Pzena: And so the age-old question is: Do you try to predict those down periods, or do you ride through them? And obviously, I've decided that riding through them is the smarter way to be. But to do that, you need to have some kind of system or process in place that doesn't *allow* the emotions of the moment to influence what you're doing.

And those emotions are *strong*. When you get a call from your biggest client, their question is — and it's the most common question that we ever get as investors — "Don't you read the newspaper? If you read the newspaper, how could you possibly want to own these companies given what's going on?" And the answer is that you have to have a framework so you have some real understanding of what the underlying value *is* of the Citigroups of the world. What is the underlying value of all of these companies?

You need to try to behave rationally and tune out the noise.

Pzena: Now, what we do is we have a formal valuation framework that compares the price of the shares to what the long-term normal level of earnings is — not the earnings you get in a stressed environment like we're in now for financials, or the earnings that you get when there are no credit losses or when there's a benign interest rate environment. What are their normalized earnings in the long run?

[Editor's note: Pzena, along with co-managers John Goetz and Antonio DeSpirito, asked (and answered) that same question about top purchases Freddie Mac and Fannie Mae in their annual letter to shareholders of the John Hancock Classic Value Fund:

"Fannie Mae and Freddie Mac ... are two world-class franchises with an enormous competitive advantage — their government charter provides a funding advantage

(continued on next page)

CHART 2

AVERAGE ANNUALIZED RETURNS
OF MOMENTUM AND VALUE STRATEGIES

Before the beginning of a recession, momentum strategies excel					After a recession is underway, value strategies excel			
Begin	End	Momentum Returns*	Value Returns*	Recession Start Date	Begin	End	Momentum Returns*	Value Returns*
Jan-'69	Dec-'69	(7.5%)	(21.3%)	Dec-'69	Jan-'70	Jan-'71	(7.3%)	23.3%
Feb-'71	Dec-'73	13.2	(2.6)	Nov-'73	Jan-'74	Aug-'77	3.3	26.6
Sep-'77	Nov-'80	42.8	15.5	Jan-'80 & Jul-'81	Dec-'80	Sep-'86	14.9	25.8
Jul-'89	Oct-'90	(9.4)	(24.6)	Jul-'90	Nov-'90	Feb-'93	25.0	45.1
Mar-'97	Feb-'00	67.2	7.4	Mar-'01	Mar-'00	Nov-'02	(32.1)	8.1
Jan-'07	Dec-'07	26.0	(11.1)	?				

Gross of fees. Excludes periods when neither momemtum or value was outperforming.
**For the purposes of this analysis, momentum is defined as the highest quintile of the 1,000 largest stocks measured by nine-month price momentum. Value is defined as the cheapest quintile of the 1,000 largest stocks measured by price-to-book.*

Source: Sanford C. Bernstein & Co., Pzena Analysis, Empirical Research Partners

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PZENA INVESTMENT MGMT'S
RICHARD PZENA
(cont'd from preceding page)

that generates consistently strong returns on equity. In addition, both are well positioned to benefit from the current turmoil in the mortgage market. They are gaining market share, raising credit guarantee fees, imposing stricter underwriting standards and generating higher rates of return on their new investments because of the wider spreads between mortgage rates and their borrowing costs.

"However, the market has focused on the write-downs both companies have had to take on their balance sheets. For example, Fannie and Freddie package the vast majority of their mortgages into securities, and accounting regulations require these securities to be 'marked-to-market' — that is, assigned a value based on current market prices. Since the prices of many mortgage-related securities have declined, the companies have suffered some losses on their securities. These are paper losses, though, and they have not changed the fundamental strength of the companies' business models nor our expectations of their normalized earnings power. Consequently, we believe that Fannie and Freddie are trading at a 70% discount to fair value — the most undervalued stocks in our universe."]

Pzena: And when you look at the underlying earnings power and the price every day, then you can try to behave rationally and try to tune out the noise. And you call it "noise" because you don't know when the noise is going to get so powerful that it's going to swamp you — and you don't know when the noise is going to be ignored. And I can tell you that with the same piece of information out in the market, there are times when the market will ignore it and times when the market will pounce on it.

And so my advice is to be comfortable as an investor with what your skill sets are — and as an investor with other money managers, to find people who happen to be experts in their particular areas that stick with those disciplines — because trying to predict is almost impossible. And acting after the fact, which is the standard way people behave, is surely a failed investment strategy....

AS INVESTORS GET COMPLACENT, MOMENTUM WORKS. THEN AS THINGS GET TOUGH, *VALUATION* MATTERS.

The beginning of a recession marks a reversal in psychology.

Pzena: So let's talk about some of the cycles that we see in value and momentum investing. And these cycles are pretty powerful. What we've done is look back over the last 40 years to try and identify the time periods when momentum strategies trounced value strategies, and when value strategies trounced momentum strategies — and try and see if we can identify any patterns. And when you do this, you actually identify some quite interesting patterns.... (**See CHART 2**)

The first period in the last 40 years where momentum strategies dramatically outperformed value strategies was January of '69 through December of '69. And a recession began in December of 1969. Almost simultaneous with the beginning of that recession was a complete reversal in the psychology of the markets — and value strategies dramatically outperformed momentum strategies. So the dividing point was actually the start of the recession....

Momentum strategies outperform prior to a recession....

Pzena: The next recession was in November of 1973. For the three years prior to that recession, momentum strategies dramatically outperformed value strategies. This was the Nifty-Fifty period. And after the recession began, value strategies dramatically outperformed momentum strategies for three years. The timing of this was fairly coincident with the beginning of the 1973 recession.

Now, what you observe in every one of the recessions over the last 40 years — give or take a few months, because it isn't precise — is that the momentum strategy won in the period leading up to the recession, and the value strategy won in the period following the beginning of the recession.

Investors invent reasons why what's worked will continue to.

Pzena: Now, how can you explain this behavior? Well, I explain it by saying that as you get late in an economic cycle, the investment community at large starts worrying about the next recession, and they start fearing what will be negatively impacted by that recession — and they want to get out. And so they do.

And where do they want to put their money? Into what's *working* — the momentum stocks. Why? It's because investors become complacent — because the economy is strong and things are going well. And then they start to make up reasons why all these stocks they're plowing their money into will not be impacted by the next recession.

And they ignore all the normal rules of economics....

Pzena: The last cycle was the internet bubble — which I'm sure you all remember very clearly. What did we talk about in the late '90s? We talked about a new economy. The world is different this time — so you can ignore all the normal rules of economics and supply and demand and just buy technology stocks. And if you can think back to the economic environment we were in, it was just after the Asian currencies collapsed. So the investment world was looking at U.S. industrial companies and saying, "There is no chance that they will ever be globally competitive. They're all going to be put out of business by Asian industrial companies."...

And of course, then we get into the downturn — and people start saying, "This doesn't make any sense." So they bail out of what was working — the momentum stocks — and they start thinking about valuation once again.

This time, it's the permanent shortage in commodities....

Pzena: And we've had the same thing happen this past year with the China thesis — where there's again been a *very* strong suspension of normal economic rules. We've heard new words like "decoupling" — that the world is now a differen[...] re going to have high[...] ent shortages[...] rging demand f[...]

THE PRECEDING WAS EXCERPTED FROM OUR 9-PAGE FEATURE

[Editor's note: Pzena expanded on this theme on his February 12th conference call:

"On the opposite side of the ledger from financials are energy and commodity stocks which have been the focus of momentum investors. These businesses were generating

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WARREN BUFFETT, BERKSHIRE HATHAWAY

"Some major financial institutions have experienced staggering problems because they engaged in the 'weakened lending practices' I described in last year's letter. John Stumpf, CEO of Wells Fargo, aptly dissected the recent behavior of many lenders: 'It is interesting that the industry has invented new ways to lose money when the old ways seemed to work just fine.'

"You may recall a 2003 Silicon Valley bumper sticker that implored, 'Please, God, Just One More Bubble.' Unfortunately, this wish was promptly granted, as just about all Americans came to believe that house prices would forever rise. That conviction made a borrower's income and cash equity seem unimportant to lenders, who shoveled out money, confident that HPA — house price appreciation — would cure all problems. Today, our country is experiencing widespread pain because of that erroneous belief. As house prices fall, a huge amount of financial folly is being exposed. You only learn who has been swimming naked when the tide goes out — and what we are witnessing at some of our largest financial institutions is an ugly sight."

Chairman's Letter to Shareholders — February, 2008

ROBERT E. TORRAY, TORRAY FUND

"As we write, cataclysmic losses on sub-prime mortgages, collateral debt obligations, credit default swaps, derivatives and bond insurance have cast a dark shadow over our markets. We expressed deep skepticism about these complex financial constructs in our June 2007 semi-annual letter, but nothing at the time remotely suggested what was to come. It seems that prominent bank executives, some of whom have since been fired, had no clue of the risks either, or perhaps, given the enormous, though illusory, profits at stake, they simply chose to ignore them. While there is no minimizing the debacle, the main victims, at least so far, have been the very institutions that caused it — large commercial and investment banks, mortgage companies, and so on. In the ultimate irony, it would appear Wall Street's rocket scientists designed a heat-seeking missile that hit themselves. The good news is, regardless of how things turn out, history confirms that shareholders in large, quality companies will continue to prosper as the economy and earnings grow in the decades to come.

"Although this is easy to say, it is also easily forgotten when markets turn down. Following our company's inception in 1972, a period preceded by a wild speculation in the day's most popular stocks, prices collapsed nearly 50% on the heels of the Arab oil embargo which drove crude up five-fold, wrecking the world's cost structure. During the crash of '87, the Dow fell 36% top to bottom in less than two months, equivalent to 4300 points today. Most of the loss, a staggering 31%, occurred in the last four days alone. One can just imagine the response if the same thing happened today. At the time, we thought the New York Stock Exchange, in an effort to forestall the panic, surely would close for a while — it didn't.... Fifteen years later, 9/11 accelerated the unwinding of the tech/telecom/dot.com mania. When it was over, the S&P and NASDAQ had suffered losses of 50% and 80%, respectively.

"Investors' response to each of these jarring downturns was to sell the shares they had eagerly bought at much higher prices earlier on. This proved a big mistake as subsequent recoveries and the long-term picture confirm. Underscoring the point, studies show that after compounding, 90% of the return on stocks is generated on just 1.5% of the days the exchanges are open. Translated, the odds are 66.5-to-1 against those that trade in and out of the market based on the direction it's headed."

Letter to Shareholders — February 4, 2008

MARTY WHITMAN, THIRD AVENUE VALUE FUND

"The common stocks of all companies affected directly or indirectly with the current mortgage meltdown cratered in price during the quarter. One, CIT Common, became available at a modest discount from tangible book value — while other common stocks, Ambac, MBIA, MGIC and Radian, have been selling at discounts of around 70% from tangible book value, or NAV. In our opinion, there is much profit to be made in these issues at these prices whether the companies continue as going concerns, or enter into a period when the companies run-off their books of business in whole, or in part, as we wrote to you last quarter. We classify these investments as 'distress investments', where the fund tries to acquire meaningful positions in the most senior issue which will participate in a reorganization, i.e., the fulcrum security. In prior distress investing for the fund, the fulcrum security had always been a debt instrument. In these cases, however, the fulcrum security is the common stock."

Letter to Shareholders — January 31, 2008

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