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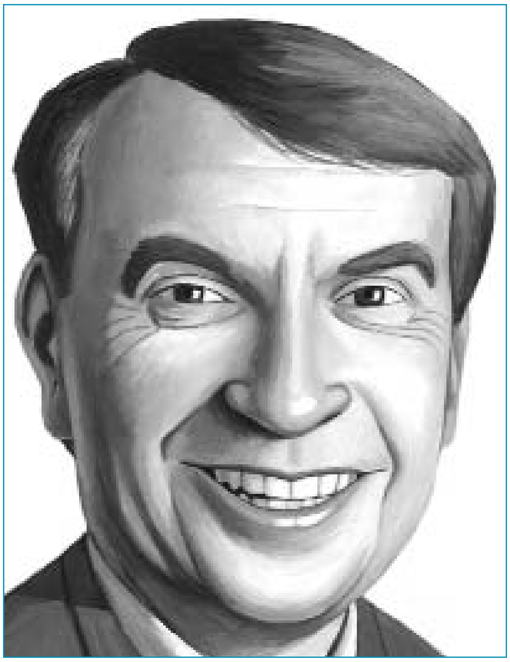
INSIDE

listeningin

Stabilizing Influences

Morris Mark Finding Values With Market, Regulatory Issues Still In Flux



***Morris Mark** is an equities guy, through and through. The president and chief investment officer of **Mark Asset Management**, which runs about half a billion in hedge funds and such, Morris is a fundamental, value-oriented, bottom-up kind of guy. The kind who came up through the ranks at Goldman Sachs, Furman Selz, and First Manhattan, doing things like nitty-gritty real estate and arbitrage research, before striking out on his own in the early 1980s — and who is still doing that same kind of close analysis in managing his clients' portfolios. Last year was painful for Morris, as it was for most investors, reinforcing the lesson that value offers little refuge in the midst of a systemic crisis — and pushing him into the unfamiliar role of market theoretician, calling for the completion of the half-done market stabilization project...at the same time that he's been snapping up crisis-created values for his funds. Listen in.*
KMW

If I had been handing out prizes, I think you would have gotten the one for the most bullish long-term outlook among all the contributors to my 10th anniversary issue a couple of months ago, Morris.
Really? Wow. I didn't think I came out *that* bullish when we spoke. What I was trying to say was that stocks look more attractive than just about any other asset, on a risk-adjusted basis. But I emphasize "risk-adjusted" because that doesn't mean there isn't risk; it just means that other things either have more risk or less potential for gains – have lost valuation or are experiencing severe problems. The ironic thing is that– in whatever you want to call the last cyclical phase, and I might call it a cyclical bull market – the one area that really didn't get crazy was the stock market. But that doesn't mean that the stock market didn't get hit when the system imploded –

You're classifying 2003-2007 as a cyclical bull market, but saying valuations did *not* get to extreme levels?
Exactly. Multiples never got crazy and I can't, off the top of my head, think of any domestic sector that really took on a speculative tinge.

Residential real estate certainly did.
But not the real estate *equities* market. Al-

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Charles Powell
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though the REITs obviously were terribly affected.

Well, you *were* most bullish, long term, predicting that "together, the U.S. and China will lead the world recovery into a far more stable and prosperous economic environment than anyone currently envisages."
Right. That is my long-term thinking. Implicit in that is the assumption that, at some point, this country will do a better job of addressing the issues regarding growth and the economy. Right now, I would say we're sort of halfway there – but only half.

Even that is a pretty optimistic statement coming from a seasoned Wall Streeter –
Let's just say that Ben Bernanke, as far as I can determine, seems to understand that there is a need to have a stabilized financial system. And our government also seems to understand that. That is why I would say we're halfway there. I do believe we have stabilized the system, although we have not finished the job. But I don't believe, in other respects, we're doing all that we can or should do to encourage economic growth domestically. That is exemplified by the fact that resources are so under-utilized.

"That zero interest rates are coexisting with record gold prices tells you, in their combination, that there is an awful lot of risk aversion still out there."

What should we be doing, now that we're no longer staring directly into the abyss?
We have to be doing two things. As I said, I believe we have stabilized the system and we've done it in some very important ways. The Fed has provided needed liquidity – and I don't see an immediate end to the need for it to continue to do that.

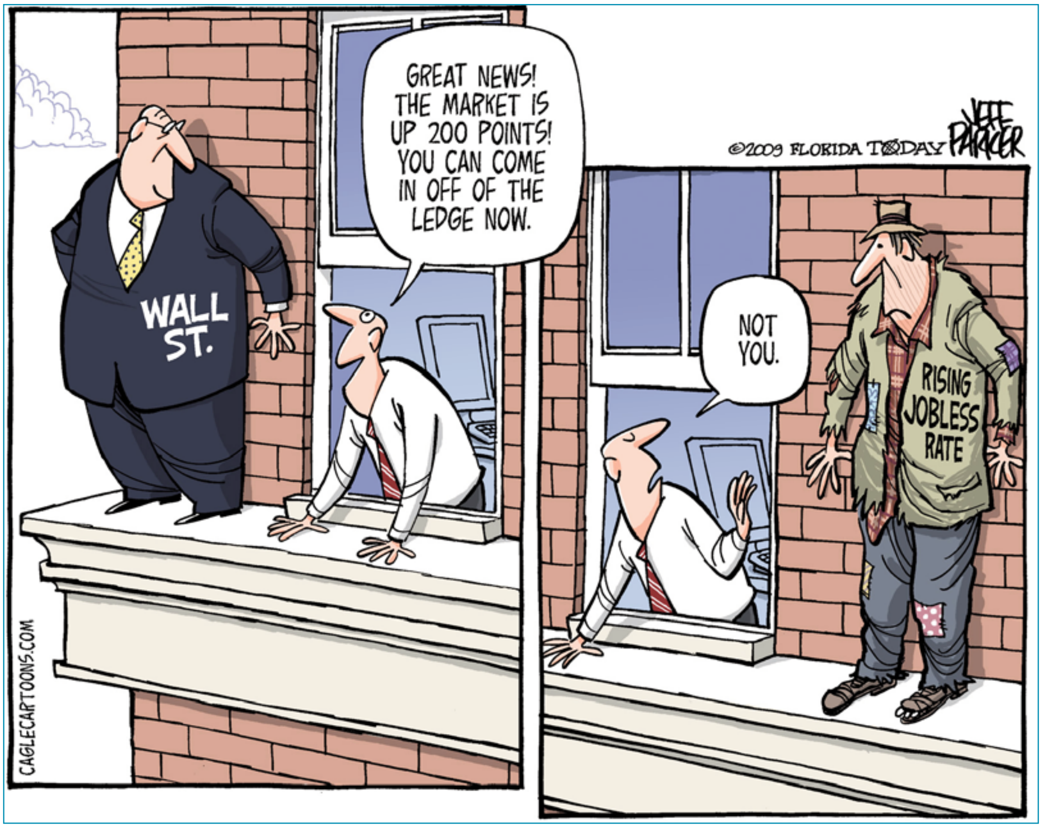
No?
No. Because when you have had the kind of shock to the system that we had, it is dangerous to tighten too soon. The shock we had was the financial equivalent – fortunately, it never degenerated into the real-world equivalent – but it was the financial equivalent of the Great Depression. When you have something like that occur, if you ease up on your support too soon – before all the pieces are in place and before confidence and growth are restored on a self-sustaining basis – the experience of 1937 and 1938 shows you how quickly you can slip backwards. So I'm implicitly assuming that the Fed and the government will *not* withdraw support until it really becomes advisable.

No small assumption, that.
Right. But secondly – and this is really important – a great deal of capital has been raised as the capital markets have been restored by important financial intermediaries. The banks have raised literally hundreds of billions of dollars of *equity* capital – and that is important. When you had a system under stress, where the mechanisms of financing were clearly broken – injured by *bad* governmental decisions as opposed to aided by better decisions – it was necessary to reverse those decisions, which fortunately did take place. Then the follow-up, with a lot of new capital being raised went a long way towards restoring systemic stability, both domestically and – importantly – worldwide. Right now, there's no substitute for the American Federal Reserve as the world's critical central banker. If we don't get it right, we have just seen what happens to the world. There was no decoupling. I believe that in the future there may be significant differences in relative performance among nations, but there will be no decoupling; this is one fairly integrated financial system.

Globally?
Exactly. But that means there still are things that have to be done here.

The Fed is taking tons of flack for what it has already done — in terms of flooding the system with liquidity, for instance.
That just proves that people have very short memories. I mean, all we have to do is look

back to a year ago and look at where the LIBOR spread was then and look at what was going on. Banks were afraid to lend money – to other banks.



Even overnight.
Overnight! So the Fed guaranteed those loans. People were afraid to buy commercial paper and yet, at the same time, they were still – and interestingly *still are* – anxious to give the government the use of their money *for nothing*. That hasn't changed. Then the banks took the bailout money and deposited it at the Fed, because they have now been given some interest on their reserves at the Fed, which is an important positive reform. So then it became essential that the Fed in turn take that money that the banks had deposited with it and lend it out, because no one else was lending. The Fed had to perform the role of the bankers.

Because the bank couldn't or wouldn't do it themselves.
As I said, memories are very short. But all you have to do to understand the importance of the Fed and the government *finishing* the job of re-stabilization is just look at three things: Look at the yield on federally guaranteed securities, look at the price of gold and look at the daily action in the equity markets.

In what ways?
Well, the yield on government guaranteed securities tells you – remember, the Fed does not control treasury bill yields. The Fed does not control treasury bond yields. You could argue that it can influence them, and as long as the Fed has credibility as an institution – which fortunately it still has – it *can* influence them. But that doesn't mean that the Fed can control rates – and the yield on T-bills right now is zero. It is not zero because the Fed funds rate is zero. The yield on bills was zero when the Fed funds rate was higher. Today's T-bill yield is reflective of the fact that people were traumatized and still are. So when guys are critical of the Fed for supplying liquidity, it's well to recognize that level of trauma. My response to suggestions that the Fed should tighten is typically, "Call me when T-bill yields get to a half of 1%." And I'm not trying to be facetious. I look at indicators.

Another one you're watching, you said, is the price of gold, which is on a tear?
Where gold is concerned, we right now have an anomalous situation. So it is something you have to come back to in terms of how you look at your strategy as an equity investor. The price of gold is now over $1,100 an ounce.

Why do you say it's an anomaly?
Well, let's just say that it is certainly not impossible – because we're there – to conceive of gold at $1,100 an ounce. It's obviously not impossible to conceive of T-bill yields at zero, either. But it's anomalous to have them *together*. Generally, T-bill yields at zero are reflective of fear of deflation and of depressed economic activity and just generalized fear. You don't give the government money for nothing when you have 100 other places to put it – unless you're

afraid of something. Conversely, gold at $1,100 an ounce means that a number of people are saying, "Gee, I'm really afraid of inflation." So for these two things to be happening at the same time tells you that the job of re-stabilization is *not* done. That zero interest rates are coexisting with record gold prices tells you, in their combination, that there's an awful lot of risk aversion still out there. So the Fed is, in effect, sending people a message: "Don't be so afraid, have faith, we're there, the system is there, so put your resources to work."

Somehow, that is not terribly reassuring. Especially when the markets are gyrating.
That is why I mentioned the third thing I am watching, which is market action. This may seem somewhat less consequential, but it affects me as an equities investor and should bother everybody.

You're bothered by the *rally*?
No, what I am talking about is the pronounced movement in the equities markets we've been seeing on any given day – and the fact that the next day, the market often wakes up and seems to forget where it was the previous day, especially in the last hour. When you see that, you have got to say to yourself, why? You can watch it. What I am talking about here is not a perfect pattern, but it's not an unusual pattern,

What's causing this pattern, do you think?
The answer is leveraged indexes. This goes back to how you both solve the first issue and then get to a more sustainable healthier growth pattern, where you actually eat into the unemployment rate, domestically. We now have a system which seems to encourage gambling and, really, the violation of the margin rules – in everything but, *maybe*, the letter of the law. Certainly violation of the *spirit* of the margin laws is encouraged these days. What hasn't really been taken into account yet is that fact that we have had 10 years now of the equities markets going no place, which means they really can't be used to raise the kind of capital that they should be used for. I think, in fact, that the greatest example of how that has happened can be seen in the emergence of things like the leveraged indexes.

You lost me there.
Okay, let me explain what I mean. You can, on any given day, buy an ETF which will let you double or triple whatever position you have and it's totally legal. But if you or I decide to go out and buy shares in JP Morgan, well look, we can only lever that position at most one-to-one. Yet if I buy the leveraged finance industry ETF, I can buy the financial stocks as a group at three-to-one leverage, and then – since it's a marginable security, I can, if I want, go to six-to-one leverage. I can't do that if I buy JP Morgan directly. But what is the difference? Now, the margin rules are controlled by the Fed but it is the SEC that has determined that these leveraged index ETFs are securities that can be traded – and therefore, margined. What this tells me is that the SEC is violating a very basic rule, which is that "what goes on in Vegas, stays in Vegas." *This* is Vegas.

You mean, in other words, that Wall Street has become a massive casino?
Right, and it's not funny, because you're talking about the corruption of the capital-raising mechanism of the western world; it has been turned into a craps game.

Because so many of the popular new trading instruments are utterly divorced from any capital raising function?
Exactly. Quite the opposite, many of them are destroyers of capital. They lose money for the people who use them, but they create a tremendous amount of intraday movement, usually in the last hour of the trading day, movement that has no bearing on what is really going on in the world, either way.

Are you saying that you would ban ETFs and derivatives?
No, there's nothing wrong with the ETF concept, but if there's a reason to have margin rules – and clearly there is – then they should apply to ETFs. The system needs to be fixed. We have to have capital adequacy. We have to have transparency. The job of stabilizing the financial system has to be finished now – so that, at least for the next 20 years – it will work. Then, of course, someone will come up with something else. But certainly part of permanently stabilizing the financial system is to bring some coherence to our regulation of the existing capital markets, the trading markets. Now, if you want to make a conscious decision that you're going to allow six-to-one leverage, well, they did that before 1929. But okay, if that is your conscious decision, then at least it will be out there. But if you're making an unconscious decision, saying, "Well, we really want to have stability in the financial markets; we want the capital raising mechanism to be appropriately structured so

that it performs its function and, therefore, we don't want margin higher than 50%," and yet you're still allowing leveraged index ETFs, then what is your rationale? There is no rationale for allowing leveraged index ETFs. That is what I mean about finishing the job of stabilization.

That would be quite a turnaround from the Greenspan Fed, which made no bones about believing margin requirements were useless relics.
Maybe they, in effect, made that unconscious decision, but the conscious decisions of *this* Fed and Treasury Secretary have been just the opposite. The conscious decision that the Secretary of the Treasury talks about–and I fully agree with – is that we want the system to be stable. Timothy Geithner and Larry Summers are really smart people. They have said, "We want the system to be stable," which effectively means delevered. What I am saying is that if that is the case, then gee, they sure should not lower margin requirements. They don't want to put more leverage in the system. But by allowing trading in the leveraged indexes, that is exactly what we have in the markets.

It's not just leveraged index ETFs that pile leverage into the markets. There are tons of ways that all sorts of swaps and derivatives introduce enormous embedded leverage into the markets.
Absolutely. I'll put it this way. I sure don't want the Fed to relent unless and until a lot of these other things are addressed, meaning transparency; much more regulation of rating agencies – and of things like the indexes. I'm assuming that, over time, the job will get done. That is my implicit assumption but, at this point, it's only an assumption. The reason I'm assuming the job will get done is because the Secretary of the Treasury and the Chairman of the Council of Economic Advisers say that this is going to be a major focus now.

You *are* an optimist, considering the hash Congress has been making of even the most obvious proposals to rein in risk-taking.
Well, as I said, I'm not sure, but let me just put it this way: The President did reappoint Mr. Bernanke. Bernanke seems to be the best student of the Great Depression who has been put in a responsible economic position in a generation. So I'm just assuming, over time, they will get it right and that they will not relent.

It has been argued that "best student" isn't saying much in his case —
I can't argue the academic fine points. I'm prepared to assume, since the man in large part devoted his career to studying it, that he knows something about the Depression. But I don't *know*, no one does. That is why we get up every morning and go to work. One of the things we learned from last year is that, internally, we just don't want to have any leverage. We don't believe it's necessary for successful investing over the intermediate to longer term, and we believe that not being leveraged gives you a tremendous amount of staying power if there is a miscue or if there are – and there are going to be – some bumps in the road, for sure. You just want to make sure that you can take advantage of the opportunities and not get stuck in too many potholes.

What other lessons have you taken away from last year?
Well, I'm basically an equities investor; I don't claim to be a market theoretician, although I've gotten a lot more familiar with the system as a result of what happened last year. Another thing that strikes me – and this is a domestic consideration – is that for things to get better, we've got to be more actively encouraging capital formation. My reason for that is really simple. When I look at T-bill yields of zero and gold at $1,100, that tells me there's a lot of risk aversion out there. In terms of equities, that risk aversion in the capital markets has really been built up over a long time. Basically, equities haven't gone anyplace for 10 to 11 years. The U.S. economy is much bigger. The world economy is far bigger. The potential opportunities and responsibilities are much greater. The nominal dollars are worth less, but stocks are trading at the same nominal dollars as they were 10 or 11 years ago – which is really much lower in real dollars than they were 10 or 11 years ago. That is just another way of saying that people have been conditioned to be very, very risk averse. While there is a limit, obviously, to what the Fed can do or should do, it would just seem to me that we ought to be much more actively encouraging capital formation. I am not counting on the fact that we're going to do it, though –

How, pray tell? Through the tax code?
Well, it seems to me that changing the tax code would be one way to do it. The President has said he favors – but has not introduced – legislation that would call for no capital gains tax on any new business that is started. It would just seem to me that we should be encouraging true

long-term investment. I mean, Lou Gerstner has said in perverse way that we ought to tax short-term gains very heavily. I think taxes are pretty high already, so I wouldn't say *that*. But, again, it seems to me that we should be encouraging true long-term investment. I don't think you can target it to just new businesses. I think you should give people a chance, encourage them to take their money out of zero-yielding instruments and put it to work in better quality equities and debt securities. But to get the tax break, we should say that they have to own those things for a long time – three years, five years, something like that. In other words, we should be encouraging people to really deploy capital, as opposed to trade indexes.

The equities market is dominated by institutions, which don't pay taxes, so tweaking tax policy isn't likely to change their behavior —

No, but that is an interesting question. The institutions, after all, get that tax benefit because they are supposed to be investing the workers' money, right? They're not supposed to be trading it.

Have you looked at turnover lately?

That is my point, precisely. Now, I don't think you can tell people what to do and if they turn over an investment and they make a short-term gain, they'll pay the tax, and if they don't make a gain, they'll generate the loss. But the point is, it would seem to me that you want to incentivize people to be longer term investors. Maybe in the case of an institution, we should reverse the existing incentive. Now, they don't pay a tax if they short-term trade; well, maybe they should – but maybe that tax should disappear if they invested long-term, instead. Look, I'm not a tax theoretician; I'm not a government official. I do know, though, that to get growth on a long-term basis, we've got to encourage capital formation. We'll eventually get growth anyway, but it won't be as strong as it might have been. We will get growth because the world is growing. We're part of the world and we will be selling things and providing services to the parts of the world that are going to be growing faster. Therefore, we'll benefit.

U.S. exports have already bounced better than most thought possible.

Exactly and I believe our exports are going to get stronger and stronger. I think also that we're going to continue to provide services to the world, as long as we don't discourage institutions from existing in this country. Goldman Sachs is a tremendous national asset –

You're saying that with a straight face?

I am not trying to be funny at all. Goldman is a tremendous national asset because the world comes here to raise money. Even though a lot of world's rapidly growing countries have their own capital market facilities, as they should, the fulcrum is here.

And we had better hope it stays here —

I expect that it will, but do I know for sure? Of course not. I expect that there is going to be growth here, anyway, but we're not investing on the assumption of optimum growth. We are investing on the assumption that the stabilization of the system will continue and will be improved upon.

So where are we in the cycle? Is the recession really over?

Well, I think you have got to be really careful. I would just say that the very short answer to your question is, yes. The slightly longer answer is that you really had two unfortunate episodes, one on top of the other. One was a significant economic downturn that was going to be a recession, even before Lehman, and then the other was a systemic crisis that was piled on top of it. The systemic crisis turned the recession into something that obviously was very sharp. But I believe that it has bottomed out and started to recover, and I believe, over time, we will continue to recover. But it was like a one-two punch. The first part was the housing crisis and the mortgage finance crisis, which was going to create tremendous problems no matter what. But at least, let's just say last July, most people weren't worried about banks being able to pay out their deposits or about money market funds paying off – and yet that did become the case once the financial crisis hit. But now, I believe people are no longer worried about the safety of their bank accounts or money funds and that we have begun the recovery from some of the issues that precipitated the crisis in the first place – but it is going slowly.

Are you surprised, with credit card companies demanding higher rates than loan sharks and with employment in the tank?

The way I look at it is that consumer confidence is a function of how well off you are – and how well off you are is a function of your net worth and of your employment prospects. It will happen as wealth is restored and regenerated – and that is what has to happen – and when I say wealth, I mean everybody's wealth. There wasn't a 401K plan or an endowment plan or a pension fund that wasn't hit hard. Confidence isn't merely a psychological thing; it's a real thing. The recovery we seem to be having in the capital markets will, as George Soros says, help the recovery in the economy, which it will, if it continues, help the recovery in the financial markets. That is his reflexivity theory in action. There absolutely is a cause and effect relationship that works both ways; that is about the best way to put it.

So how do you translate all of this into what you're doing as an equities investor?
The kinds of things that we're interested in owning, which in general are better quality names with high internal returns on capital, are things we can own in reasonable size. Things where we believe there is an opportunity and a capacity to build value.

Are you still finding those, after the rally we've seen since March? Granted, the more speculative names led the upswing, but –
Well, ironically, the multiples that the better companies are trading at still are pretty low. First of all, if you measure them against bond prices (which I think is a little too cute, but is done nonetheless all the time), you find that the risk-adjusted rate of return on high-quality equities versus high-quality fixed incomes is extraordinarily high. But I'm not even looking at that because I have opinions on fixed-income prices. I just say that the multiples that they're trading at in relation to their current earnings and growth prospects and, in most cases, to their internal rates of return on capital and to their ability to generate free cash flow are still pretty modest. The multiples have come down and the prices haven't done that much, on average. Obviously, good companies have done well but there are some good companies that have really been building a tremendous amount of value. Basically, the way I'd say it is that really decent companies used to trade at multiples reflecting their growth rate – at a ratio anywhere from 1.5-to 2.5-to-1, depending on how fast they were growing. But right now, it doesn't make much difference how fast a company is growing. Most entities are trading at multiples in relation to their growth rates of no more than one times, and usually a lot less.

How are you measuring those growth rates, considering that almost everything stopped growing, at least for a while, a year ago?
Well, because the "growth rate" can be a somewhat amorphous concept, I would just suggest looking at things like P/E ratios, earnings outlooks, free cash flow, and the ability of a lot of businesses to very profitably participate in the growth of the world economy. Many are still very reasonably priced. Now, that doesn't mean they won't get hit if the market gets hit. As I said, there are going to be bumps or worse at some point. But you just don't know when or from what level. Nevertheless, just sort of looking through that, within reason, and looking at current prices, they're very reasonable.

But you *are* focusing on companies showing top-line growth in this environment?
We are focusing on companies that can show growth in an *improving* economic environment – and I believe we are in an improving economic environment. This clearly is not a skyrocketing environment, but we're in an improving economic environment. The farther – let's just say, west – you go from the United States, the faster the rate of growth in the environment.

So you're investing in Asia and international markets generally?
Indirectly, definitely. Directly, to some degree. But indirectly – look, we own **Google** [GOOG].

So you're not worried it's going to take over the world? You're pulling for it to do just that?
I'm worried, as an investor, that at some point Google may do something foolish which would engender some sort of a political reaction, or backlash. But they seem to be doing just the opposite. They really seem to be providing a lot of value in ways that are making people's lives either more affordable or more productive, and they're doing it by using technology to provide really important services. Still, I worry all the time; I worry about everything. It's my nature; I can't help it. And yet I still wasn't worried *enough* at the end of 2007. Because, frankly, I didn't own any housing stocks. I thought I just owned great investments. So last year one of the things we discovered is that when they go after the system, it doesn't make much difference what you own. It *does* make a difference coming out of a crisis, but not going into them. In any event, the point I was making about Google, as an example, is that it derives more than 50% of its revenues from international markets. Its domestic business, I believe, will continue to grow very strongly and I believe its

international opportunity is even greater.

How do you go about valuing something like Google?
Really simple. We estimate that it'll earn something north of $27-$28 a share next year. So it's trading at 20 times earnings. Even though it spends, for a company of its type, fairly heavily on new hardware to improve the quality of its services, Google's free cash flow is roughly three-quarters of its earnings, so it has a free cash flow yield of 4% to 5% on next year's numbers. The underlying growth in demand for its service, meaning in the people that use it, still seems to be 35% to 40% per annum domestically and, I believe, even higher internationally. As the economy improves, we would expect its revenue growth rate to reflect that more closely. I'm not saying it's going to 35% or 40%. But in the last quarter it was 7%, which, in relation to most businesses in a recessionary economy, was excellent. But I would expect that revenue growth rate to go into the teens and maybe the low 20s for a number of years.

As you said, there are always bumps —
But in Google, you have plenty of cushions. It has no debt, and it has, off the top of my head, $40 or $50 a share in cash. So if you net out the cash, the multiple's lower; if you don't want to net out the cash, fine, that gives us a tremendous source of stability, security and opportunity to take advantage of acquisitions, which will help it do its job better. I believe its earnings will grow faster than its revenues, and I believe its revenue growth is just starting to rebuild. It has a whole range of additional services that it may be able to provide, which can create new profit centers, the most obvious being mobile computing as opposed to desktop computing. Providing software applications on a much less expensive basis by centralizing the provision of the software through servers that operate in centralized data centers. They refer to this as "cloud computing." It's something you're not paying anything for in the stock here. Now, I'm not saying you *should*; I think you can just focus on the core information distribution function that Google provides, which is the equivalent of the Yellow Pages, TV (to some degree), newspapers, magazines, as channels of distribution. Google doesn't create the content, though it has certain proprietary services that it does provide, which I regard as the equivalent of content. Things like Gmail and Google maps and Google Earth. But it really is just a better physical distribution vehicle for somebody else's content than a delivery truck, than newsprint or a CD. Most of its content, in the sense of entertainment or even news stories, is generated not by Google but by the same sort of people that have always generated it.

So what is it going to do when it succeeds in putting all the "old technology" media out of business?
Well, yes –look, I think the business models of journalism are going to adjust for the fact that revenue is no longer going to be generated by selling pieces of paper on the street corner. Things like the Drudge Report and the Huffington Post – while I'm not saying anything about their quality – are journalism.

The history of journalism is often tinged yellow — and that is no more likely to change than is human nature. But even scurrilous journalists require a tiny share of the revenue they create to survive; it can't *all* go to the distributor — or there will be nothing to distribute.
No doubt. I am just saying that the advantages of Google's distribution system are overwhelming. It is a worldwide company. But they are not dominant in every market and we have some other investments in companies that provide some of the same functions Google provides, say, in China. But Google is important in Brazil. It will be important in India. It's important in Western Europe and Central Europe and Eastern Europe, not including Russia.

So am I to take it that you're adding international exposure to your portfolio more via companies like Google than via direct investments in equities traded in foreign markets?
Remember, we're a U.S.-based investment firm and, therefore – I don't want to say we have an edge in any unfair way – but if we do have any kind of an edge, it is here. In terms of our ability to do research, visit companies, go to meetings, go to conferences, go through written material, talk to analysts, talk to competitors, we're here. So we're going to have, in general, better access from a research point of view to companies that are domiciled in this country. Besides, a very high percentage of the major companies that operate throughout the world happen to be domiciled in this country. As I said, though, we do own some positions in stocks that are not domiciled in this country.

What are some of the other investment

themes you're following?

One is – I can't predict the price of gold, but I *do* know that everything that has happened – and going on the assumption that the monetary authorities are not going to relent until the world is in better, more stable shape – tells me that the chances are we're going to have inflation. Likewise, if I were to use historic mathematics, even if gold didn't increase any more from where it is right now, there's an awful lot of inflation built into the future. So we definitely want to own businesses that we believe have the ability, at least in terms of their structures, to offset inflationary tendencies. Do you want an example?

Of course.

Visa [V]. I am not super-excited, *per se*, about the prospects for credit cards, but I am very, very positive on the prospects for using plastic instruments, whether they're credit cards or debit cards, to an increasing degree all over the world. If there is inflation, that will mean that the nominal dollar or yen or euro amounts of transactions will go up. Everybody's costs of business will also go up, but a great deal of Visa's costs are fixed. They provide a marketing service and data processing services and the costs of providing one of those services is, in fact, going down. The cost of providing data processing is going down because chips are getting more powerful. The cloud is a tremendous vehicle for enhancing the productivity of technological hardware and software, and Visa should be a beneficiary of that. They use it. Meanwhile, their revenues should reflect whatever the price of gasoline is in dollars, whatever the price of hamburger is, if you get my point. And that will be true throughout the world.

So you see inflation as a global prospect?

Yes. I am not saying this is a bet that the dollar will decline versus the euro or stuff like that; that is a separate issue. I'm just saying there probably is going to be inflation in most currencies. Therefore, we want to be sensitive to that in anything that we own. Visa just strikes me as a very attractive business whose revenues are determined by the *nominal* dollars that will be generated, while there also is a secular shift to the use of its services, particularly because of the growing use of debit cards.

And its valuation, you find alluring?

I think so, for a really high-quality business that is debt-free, that is a huge free cash flow generator. It's trading at, basically, 20 multiples, growing at least at a 20% annual rate, if not faster, and it does not need to use the cash it generates to maintain that growth rate.

You mentioned gold earlier. What about the miners or the metal itself?

Well, that is harder, because the businesses are more complex. But one thing that has occurred to us is that the gold stocks have not gone up as much as gold has. That is unusual. So we have some interest there. Though as I noted, the way I look at it, gold does not have to go any higher for inflation to pick up. Assuming the world grows at least some, gold doesn't have to go any higher for the nominal price of a lot of other commodities to stay very strong and for the businesses involved in producing and processing those commodities to make a ton of money. All things equal, I'm absolutely not fighting this move, because it just seems to me that unless and until we can become a lot more productive on a sustained basis, gold prices probably aren't going to collapse. Leave it at that.

So you do own some mining stocks?

Yes, we own some miners. We like companies that are producing real goods whose prices, as I said, probably won't be hurt by inflation.

Can I assume, then, that you have no use for fixed-income investments here?

Well, that is too broad a statement. It just seems to me that the risk/reward in governments is not appealing – what do they offer today, other than the absolute security you get from knowing you're going to get your money back, in nominal terms? I don't denigrate that, but you're paying a huge premium today for that insurance because you're getting no, or very little, return. The numbers for fixed incomes don't seem to work right now – except in the case of TIPS, where I can buy what would seem to me to be the highest quality inflation insurance for a very little cost in terms of the yield differential between TIPS and government securities that don't provide that insurance. But to get back to our themes, another is technology, which is something of extreme value, produced in this country. Still, you can't just say, "own technology," because the new is always replacing the old; it is a dynamic marketplace. What I would say is that the companies involved in providing value-added to the "cloud," to the new centralized data services seem to me to be very attractive. You can buy them at very reasonable multiples of current earnings and with terrific balance sheets. Therefore, they have a lot of room to build their value, either internally or through acquisitions. Something like **Cisco**, [CSCO] has a terrific balance sheet and technology. It basically provides the networking equipment that you're going to *need* to make a core infrastructure based on centralized data processing work in an internet world. You can't do it without those switches, the routers, the video – all of those things. And Cisco can produce virtual switches now. They're setting themselves up to be a core technology provider built around the cloud.

Another theme I want to mention may sound sort of funny – it's a little early, and therefore, we're not nearly as involved. But we think home building stocks are really interesting.

Homebuilders?

It's early, so nobody stands out yet. I've got a package of about four or five. But if there's going to be inflation, which I believe there will be, and if you've had housing prices marked down by 40% or 50%, which in many markets is what you have had, taking housing pretty much back to its trend line –

Still, inventories of unsold homes — not to mention ones that have been hanging back from the market —

I'm not saying that we could or should see a reemergence of the housing bubble. But housing is a core good; a core consumer product. And you can say there is still a lot of supply around, but we have gone from over-building to a construction rate, which – if you had a normally-growing economy – wouldn't even make up for physical obsolescence. There are 60 or 70 or 80 million – I don't know the exact number – existing housing units in the country, and historically, fire, flood, depreciation, etc., eliminates about 1% of them a year. Now, if you become less wealthy as a society, you don't get rid of them, and you don't live as well. But if you want to assume a growing economy, that is sort of your minimum depreciation rate. Meanwhile, housing starts have now fallen to a level of 500,000-600,000 a year. Of course, we know there are a hundred reasons why. I'm not minimizing that at all. We also have a broken mortgage finance system. But all of that does seem to be built into a lot of the share prices of the builders. Besides, the builders just got a huge capital infusion this week.

They did?

The bill extending the housing investment tax credit, which was about to expire, to next April has a provision in it enabling all companies, except those who received TARP funds (basically, the banks) to carry back their losses for five years, for tax purposes. Well, this will particularly benefit the builders, most of whom were quite profitable, three, four and five years ago, and then lost a ton of money. So yes, they're smaller companies today; the stocks are at lower prices. But now they'll be able to get back the taxes they paid for those years, which is a lot of money.

Another taxpayer-funded bailout —

It is a capital infusion. And they paid the taxes in the first place. Anyway, we are trying to focus on the better ones. A great many of the builders have rebuilt their balance sheets. That gives them a lot of staying power, and they are trading around book value – which, granted, wasn't a very good indicator of value in the group a year or two ago, but a lot has been written down since then. Still, we don't have nearly the kind of positions in the homebuilders that we have in the other areas I have mentioned. This theme may require a little patience, but affordability is now very high. A long time ago – I started out as a housing analyst before I started my investment management firm, and some of the great early things we made a lot of money in were builders. This goes back to the early '80s, when we started, or even before we started. A lot of times, what goes around comes around.

Okay. But even if someone is willing — and able — to take on a mortgage today, where are they going to get a loan?

Good question. We have a mortgage finance system that is so broken that the only real large-scale sources of mortgage money are Fannie Mae and Freddie Mac, which effectively means the federal government. I don't see how that changes for some time. On the other hand, housing is really important, and I just don't see how the government cannot continue to make sure that, for low- to-medium-priced housing, the mortgage money will be there for some time to come. You might want to point out that it is the older generation lending to the younger generation through these mechanisms. It is.

It is the only way the older generation can hope to sell its houses: Lender financing.

That is exactly right. I mean, we can go through a hundred reasons why this is the case. But securitization, conceptually, was not a bad idea. It just was *not* regulated, as opposed to improperly regulated. It was mis-named, mispackaged; it is going to take a long time to put those pieces back together. But in between, there is still a real need to finance housing. Yes, Fannie and Freddie need more capital infusions, but put it this way: At some point they're going to have to re-equitize them and re-capitalize them and re-regulate them intelligently. Because mortgage money has to be there. It is an economic, political and social imperative. I don't care who is President.

Speaking of politics, Wall Street is about as popular these days as swine flu in a nursery school. Do you see lasting changes in its regulatory or economic position coming out of all of this?

I wish I were smart enough to answer that question definitively. But it seems to me that what is being talked about – and what is necessary – is a combination of two things: A lot more transparency – I mean, collateralized debt obligations were opaque instruments that nobody could evaluate, or understand, or even could look inside of. I just don't believe that is a way to have a satisfactorily operated financial system in an information-intensive industrialized world. The other thing that is needed is a real emphasis on capital adequacy or, as one Congressman put it, having skin in the game. I believe that will be a direction that things go. Of course, all things equal, that will create another real issue – because you can't say, "We can't have too big to fail," when what you *really need* are well-capitalized institutions *that require scale*. I would assume the answer has to be regulation and assurance of capital adequacy.

And reining in leverage?

Sure. I don't understand how banks could, in effect, make loans that they called mortgages where there was no equity. Now, if you do it as a private investor, that is your business. But if you do it where your deposits are effectively insured by the FDIC or implicitly guaranteed in some way, that is another issue, a separate question. There was certainly a breakdown in regulation. A breakdown in understanding, for example, of what CDSs were and how they should be regulated. The idea of trading derivatives contracts where neither party has an insurable interest in the underlying asset, that is really questionable policy. But it happened, and nobody looked. In fact, it is still out there, without either transparency or centralized clearing. There is a real question whether that should be allowed. If I want to go short a stock, I either have to own it or borrow it. I just can't bet on it.

Unless you use derivatives.

Exactly, that is my point. You could have naked shorting of stocks using derivatives – and you still can. I am not a regulator. I just know that the job of stabilization has to be completed. I am assuming it will happen. But we're protecting ourselves not only in terms of how conservatively our own financial balance sheet is set up, but also by making sure that the balance sheets of most of our investments are also conservatively structured. That said, we feel lucky today, as investors, that we can buy some great names that have terrific financial stability at really very attractive prices.

Thanks, Morris.