

LEARNING FROM DR. MICHAEL J. BURRY'S INVESTMENT PHILOSOPHY

A journey through the investment stages of the man who bet against arrogance and put the financial industry in check.

Introduction

Financial markets are rife with stories about big companies, banks and investment funds going bust or irredeemably going bankrupt, mind-boggling trades and hedge fund wizards making money from wild ideas. *'The Big Short'*, the film adaptation of Michael Lewis's book, has reverted public attention to the subprime crisis and the strong conviction investing strategy. By watching this movie, not only did we, the **Panda Agriculture & Water Fund team**¹, rediscover the book, which we had read, it also prompted us to delve further into Dr. Burry's investment philosophy. **This document humbly seeks to be the most complete compilation of Dr. Michael J. Burry thoughts**².

We hereby aim to reveal the ins and outs of a relatively unknown investment philosophy. This appeared as a necessity to us, in a hostile monetary environment in which central banks manipulate the value of money and create a strong 'monetary illusion' in financial assets, especially stocks, securities and commodities, among others.

In this document we have assembled Dr. Burry's hedge fund track record, numerous investment cases, invaluable statements about general investment issues and all his operations -- buys, sells and shorts made before his time as a money manager.

Why is a compilation of Dr. Michael J. Burry's investment philosophy necessary?

In science, knowledge is cumulative. In finance, however, it is cyclical, with market participants making the same mistakes over and over again³. One of our commitments to the financial industry is to keep already-learned lessons alive in long-term collective memory⁴.

We want to contribute by making financial knowledge less cyclical and more *anti-fragile*⁵.

We are also interested in promoting Dr. Burry's unorthodox value investing approach. When asked about our investment approach we usually say that our philosophy is 50% value and 50% global macro. When it comes to analyzing companies, we focus on critical value points, paying special attention to cash flow generation (something Dr. Burry also does). As portfolio managers however, we also look at the global environment and macroeconomic trends. In fact, one of the reasons for starting Panda was our having identified agriculture as one of the strongest macroeconomic trends in the coming decades.

Our intention is obviously not to take merit for other people's work. Others have also made significant contributions to unravelling Dr. Burry's investment philosophy. We want thank those people in advance, starting with Michael Lewis, the author of *The Big Short*⁶, a book that we highly recommend not only for telling Dr. Burry's story but also for its accurate description of the financial industry's guts and plots.

In a summary of Dr. Burry's thoughts, Tren Griffin⁷ sets down twelve simple points that capture his vision. We are also indebted to Tariq Ali, who runs the Street Capitalist blog where we found an extremely interesting article entitled *Learning from Michael Burry*⁸, which inspired us to write this essay.

Dr. Burry has a strictly traditional understanding of value. He has said more than once that his investment style is built upon Ben Graham and David Dood's book "Security Analysis":

¹ At the end of this essay you will find a short description of *Panda Agriculture & Water fund* and our contact details.

² First version, released in October 2016. We thank Gabriel Colominas (@GabrielCobi) for his help in preparing this document.

³ López Díaz, S. *Birthdays, Bulls and 'Bonassus'*. Exane BNP Paribas, Equities Banks Research, February 2016.

⁴ In *The Ascent of Money*, Niall Ferguson describes about how investment bankers and Wall Street CEOs who have not experienced recent crashes (1987, 1998, 2001) tend to underestimate the possibility of a new crash, "Markets do not have too much memory".)

⁵ Taleb, N. N. *Antifragile: Things that gain from disorder*. Penguin Books, November 2012.

⁶ Lewis, M. *The Big Short: Inside the Doomsday Machine*. W. W. Norton & Company, March 2010.

⁷ Griffin, T. *A Dozen Things I've Learned from Dr. Michael Burry about Investing*. <https://25iq.com/2016/03/25/a-dozen-things-ive-learned-from-dr-michael-burry-about-investing-2/>

⁸ Ali, T. *Learning from Michael Burry*. <http://streetcapitalist.com/2010/03/24/learning-from-michael-burry/>

"All my stock picking is 100% based on the concept of a margin of safety".

But Burry is not an orthodox believer. He believes that had he been alive today, Graham himself would have used hedging, options and other financial innovations. Burry's behavior suggests that he views value investment as a broader concept -- he usually picks technological stocks, made a spectacular bet against mortgages' 'fake value' and now also invests in water and agriculture.

Good ideas, such as value investing, have value in themselves. Not acting upon new ideas however, only overexposes people to perpetuating past mistakes or using inaccurate approaches in an ever-changing world. Being an outsider to finance -- as Dr. Burry was -- helps people keep an open mind. He also is a contrarian investor through and through, always looking for unfashionable stocks and focusing on in-depth research and developing analytical skills. The Scion portfolio was highly concentrated, always with fewer than 25 stocks. The closer we look at what Dr. Michael Burry likes to do and the way he invests, the clearer it becomes that his abilities and approaches are like a shutting circle. His is definitely a unique style.

Learning from Dr. Burry's investment philosophy

We believe that the best way of understanding Dr. Burry's investment philosophy is through his own words. This paper contains a meticulous compilation of his thoughts, selected statements from his **letters to investors**, quotes from **The Big Short**, extracts from posts he made on the amateur internet forum **Silicon investor** and finally, insightful company analyses he published in a document called MSN Money Articles -- essentially an **investment diary**⁹. We have done our best to collect and sort through this vast amount of information in the most useful way. We have also included some quotes, **highlighted** relevant parts and made comments about the contents.

The time frame between Dr. Burry's first post in Silicon Investor in 1996 and his latest thoughts for Michael Lewis's book published in 2010 spans over 14 years. One thing is clear, as he was about to become a professional money manager in late 2000 his personality as an investor was already shaped and changes during that preceding period are imperceptible.

When he started his fund, Dr. Burry shut down his personal blog and stopped making his investments public, yet we can get valuable insight into his investing process, incentives and other issues from his letters. One of the best sources that can help us understand him is the MSN Money Article

investment diary in which he wrote many investment case studies. It is unfortunate that so little transpires on the specific positions of the Scion Value Fund, but we do have statements from his pre-money manager time and his personal investment diary where he discusses certain stocks.

Before we start our compilation, we would like to offer a short but powerful message of wisdom every investor should always keep in mind:

ID: *"Don't worry about missing a rally. Worry about losing your money."*

1. Investing is a hard, never-ending learning process

If we had to define Dr. Michael J. Burry in one word, that word would be 'conviction'. And if that had to be in two words, then it would be 'Strong Conviction'. Although this is what he is best known for, we would like to point out that Dr. Burry did not restrict this attitude to the subprime issue. He already displayed this type of approach four years before he came up with his famous bet:

SI 5-jul-2000: *"I'm not stopping myself out. This is a volatile stock, and I knew that going in. It could easily jump 7 points a day after it falls 6 the prior day. This is one that I could end up crucifying myself on, because **I think I know something about the company that others generally don't. Gives me a sense of bravado in the face of technical weakness.**"*

Just a few months later, in his second letter to investors (2001, Q1), as he mulled over the idea of *stock options* as remuneration for hot tech companies' employees, we can see that the strong(est) conviction strategy was already an important basis for his approach:

MBL: *"But, Mike, what if you are the only one that thinks of (stock) options this way? If everyone else thinks another way, doesn't that make how you think of it irrelevant? I would argue that if I am the only one that thinks in this manner, and **if I am correct, then my understanding becomes a competitive advantage that makes the subject even more relevant**"*

Someone who shows such conviction in their investment theory has to be a contrarian investor most of the time. Which is what Dr. Burry is, not only because it fits his

⁹ Sources can be identified by the capital letters at the beginning of each paragraph. **SI** for Silicon Investor, **TBS** for The Big Short, **MBL**

for Michael Burry Letters to Investors and **ID** for Michael Burry in the investment diary -- MSN Money Articles company case studies.

investment style but because he has lived through the bubbles, dotcom and subprime times. His fixation on rationality and keeping things simple brings him to an extreme defense of his positions, revealing himself as a contrarian, as he does in the 2006 Q3 letter to investors:

MBL: *"Never before have I been so optimistic about the portfolio for a reason that has nothing to do with stocks. This year the portfolio is down, but our performance so far is solely due to our credit default swap positions."*

In his 2005 Q3 letter to investors, Dr. Burry explains in a few words why he follows a contrarian investing strategy with short positions on mortgage-backed securities.

MBL: *"Sometimes, markets err big time. Markets erred when they gave America Online the currency to buy Time Warner. They erred when they bet against George Soros and for the British Pound. And they are erring right now by continuing to float along as if the most significant credit bubble history has ever seen does not exist. Opportunities are rare, and large opportunities on which one can put nearly unlimited capital to work at tremendous potential returns are even more rare. Selectively shorting the most problematic mortgage-backed securities in history today amounts to just such an opportunity."*

Contrarian investing is not incompatible with humility and being aware of one's limitations. It is what Dr. Burry calls 'scientific art'.

ID: *"I might even make an error. Hey, I admit it. But I don't let it kill my returns. I'm just not that stubborn. In the end, investing is neither science nor art - it is a scientific art. Over time, the road of empiric discovery toward interesting stock ideas will lead to rewards and profits that go beyond mere money-."*

Timing is what turns a strong conviction strategy into a contrarian one. In fact, the most important pillar of investing is the timeframe one works within. Indeed, other market participants need time to digest information and recognize value. This is why in October 2008, with world equity markets tumbling, Warren Buffet wrote a column in the New York Times entitled "Buy American. I am."¹⁰ encouraging investors to buy American company stocks and bet on their

long term wealth generation. Dr. Burry highlights how market participants' timeframe can be key in his case study of the Pixar animation films company – incidentally founded by Steve Jobs:

ID: *"Pixar Animation Studios is a stock sitting where no one can get it. Even if analysts or portfolio managers like the long-term story, the Wall Street Marketing Machine will not allow them to buy it."*

The problem? Pixar's next feature film will not be released until November 2001 -- a full two years after the last, "Toy Story 2." No matter that the first three releases -- "A Bug's Life," "Toy Story," and "Toy Story 2" -- establish Pixar as a 1.000 batter later in the season than any other major studio before it. No matter that Pixar promises at least one theatrical release per year from 2001 on, and has beefed up its talent pool with the likes of animation guru Brad Bird. For Wall Street, this is a timeliness issue."

But his investing style is a lot more than this. Dr. Burry truly believes that independent researchers can achieve extraordinary results through their own methods:

MLB: *"I have always believed that a single talented analyst, working very hard, can cover an amazing amount of investment landscape, and this belief remains unchallenged in my mind."*

As Tren Griffin said before we did, Dr. Burry's investing style decidedly is a value one, especially centered on margin of safety. As you can read in an extension of the quote highlighted earlier:

ID: *"My weapon of choice as a stock picker is research; it's critical for me to understand a company's value before laying down a dime. I really had no choice in this matter, for when I first happened upon the writings of Benjamin Graham, I felt as if I was born to play the role of value investor. All my stock picking is 100% based on the concept of a margin of safety, as introduced to the world in the book "Security Analysis," which Graham co-authored with David Dodd. By now I have my own version of their techniques, but the net is that I want to protect my downside to prevent permanent loss of capital. Specific, known catalysts are not necessary. Sheer, outrageous value is enough."*

¹⁰ Buffet, W. *Buy American. I am.* New York Times, Online edition, 16 October 2008.

<http://www.nytimes.com/2008/10/17/opinion/17buffett.html>

The classic definition of “margin of safety” is investing in companies with a market price significantly below their intrinsic value. The point is to avoid overvaluation and big drag-downs by buying good businesses at low prices. Without wishing to delve deeply into the debate, we would like to point out the concept of ‘intrinsic value’. Markets and economic environments can change rapidly, industries can transform or disappear. Intrinsic factors are few, and value is not one of them. We can see margin of safety in companies with undiscovered or unlocked potential value, but there is nothing intrinsic there. Dr. Burry also understands margin of safety as a way of hedging his portfolio, something we will look at further on. For now, we see no better tech stock than Amazon to introduce Dr. Burry's unorthodox view of the concept of margin of safety.

SI 30-Jul-2000: “OK, so it's contrarian, but it is also one of the most visible, over-analyzed stocks by pros and amateurs alike. Where's my advantage in understanding Amazon.com? Quest for Value's an interesting book, **but I still don't see the margin of safety in an option, at least as I define a margin of safety. More likely, a diversified portfolio of these sorts of companies may indeed provide the few rockets that offset or more than offset the ones that go to zero.** So you then have a margin of safety in the portfolio. But I don't see the margin of safety in an individual Z, precisely because you are projecting based on many assumptions that have no fundamental basis in past reality, and because you do not have infinite time for the security to come around - after all, it is an option in that regard. And in Amazon.com's case, a debt-laden one at that.”

Dr. Burry's analysis ethos is based on nonconformism, and who better than himself to explain it:

ID: “**I care little about the level of the general market and put few restrictions on potential investments. They can be large cap stocks, small cap, mid cap, micro cap, tech or non-tech. It doesn't matter.** If I can find value in it, it becomes a candidate for the portfolio. It strikes me as ridiculous to put limits on my possibilities. I have found, however, that in general the market delights in throwing babies out with the bathwater. **So I find out-of-favor industries a particularly fertile ground for best-of-breed shares at steep discounts.** MSN MoneyCentral's Stock Screener is a great tool for uncovering such bargains.”

¹¹ Bill Miller, the famous investor, outperformed the Standard & Poor 500-stock index each year from 1991 to 2005. In April 2012, having incurred huge losses, he stepped down as lead manager of Legg Mason Capital Management Value Trust. For more



SI 28-Jun-2000: “Jim, that takes guts. Not to buy it. To post that you bought it. I won't buy it at all. **I don't see a margin of safety, and I do believe margin of safety should apply in all cases. But on the other hand, I think we should all remember AOL when everyone was thinking it was little kiddies internet.** Then it became baby boomer's internet all of a sudden and the stock was off to the races. When all those people were quitting the service, someone was looking at how few were quitting relative to how many people should have been quitting. That someone got rich. **Visionaries can get rewarded, and I see your point on Amazon. But if baseball is a game of inches, then investing is a game of tenths of percents across the portfolio. And hence it is hard for me to justify buying a lottery ticket, which is exactly what Bill Miller¹¹ does from time to time. Granted, the lottery is somewhat rigged in his favor by his design, but it is still a lottery ticket.”**

Dr. Burry makes a strong distinction between rational and deeply thought-out investment and ‘lottery tickets’. It is like having Benjamin Graham's ghost writing on an internet forum and reliving the old investing v. speculating argument. Going back to the margin of safety issue, can margin of safety be found in a real estate company -- even if it is selling its best properties? Dr. Burry's answer to this question is “yes”:

SI 27-Jul-2000: “But the purpose of this post is Senior Housing, a stock that I proposed and was discussed not so long ago. Today they did

information: Zweig, J. *The Long Climb and Steep Descent of Legg Mason's Top Stock Picker*, WSJ November 2011.
<http://www.wsj.com/articles/SB10001424052970204517204577044570430299472>

something very significant. They sold Brookfield. That's their best property holding, with the best tenants and best lease terms (for SNH). My initial reaction was "Oh crap." But it looks like FFO by **my calculations will only dip about 1.5-2 mill thanks to saved interest expense, and the dividend is still well-covered by the only slightly-less rock solid Marriot leases.**

But this telegraphed some other positives. One, **management is not simply inflating assets. A worry was that they would not sell assets when prudent to pay down debt, as they get paid based on a % of assets. Here we have a loss of assets.** That tells me management is doing right by shareholders to a large degree, and makes me more comfortable.

Second, **the properties were sold for about 20% more than the price paid by SNH.** The Marriott properties sit up at \$325 million paid by SNH, or thereabouts. The market cap of SNH now is \$217.8 million plus what will be only a little over \$55M in debt. **There are also a few other properties but I don't need a calculator to find the margin of safety here. It's big.** And the dividend still seems safe.

Third, Senior Housing may actually be able to realize some value for shareholders. **If management is willing to sell assets - as I said, not necessarily an expected attitude - then Senior Housing may realize more gains, keeping the Marriott properties to pay the dividend."**

Amazon was not the only tech company on Dr. Burry's radar during his quest. Apple -- the most valuable tech company of all time -- was discussed in Silicon Investor and from a margin of safety perspective at all times:

SI 17-May-1999: "I like AAPL because it IMO is now a bona fide value stock on an enterprise value/ratio basis, and is generating tons of cash. I see loads of opportunity, an extremely strong balance sheet, and little downside. And I see a huge contrarian play because a generation of security analysts has been trained to think that whatever is wrong with this world, AAPL is a part of it.

What the price will do in the next 12 months, I don't know. Whether day traders will ever mature, I don't know. Whether value will even become more important over the next year, I don't know. **I just see an absolute value in AAPL at recent prices.**

I do feel the greatest margin of safety was back at 34 when no one ever thought it would move, but that there remains a margin of safety for longer-term holders.

For other tech value, I'm now a proud shareholder in Oracle at 24 3/8. 30X earnings, so you gotta understand the business. After consulting with some techie friends and family and doing some DD, I finally do. It goes in the long-term hold, Buffett-like stock for me. Pairs to my AAPL and my APCC as Buffett-like tech stock long-term holds."

In one of his letters, Dr. Burry summarizes valuation perfectly -- and is quoted by Michael Lewis in his book:

MBL: "In essence, **the stock market represents three separate categories of business.** They are, **adjusted for inflation**, those with **shrinking intrinsic value**, those with **approximately stable intrinsic value**, and those with **steadily growing intrinsic value**. The preference, always, would be to buy a long-term franchise at a substantial discount from growing intrinsic value"

Companies with value trading at a discount are what every value investor -- and most investors -- look for. But how are value and discounts over it determined? Dr. Burry clearly addresses the issue in his investment diary:

ID: "How do I determine the discount? **I usually focus on free cash flow and enterprise value (market capitalization less cash plus debt).** I will screen through large numbers of companies by looking at the enterprise value/EBITDA ratio, though the ratio I am willing to accept tends to vary with the industry and its position in the economic cycle. If a stock passes this loose screen, I'll then look harder to determine a more specific price and value for the company. When I do this I take into account off-balance sheet items and true free cash flow. **I tend to ignore price-earnings ratios. Return on equity is deceptive and dangerous. I prefer minimal debt, and am careful to adjust book value to a realistic number."**

In another of his communications to investors, from the 2006 Q3 letter, Dr. Burry gives his view of how growing competitiveness and moats are increasingly blurred:

MBL: "Too, **competitive threats are both manifest and underappreciated.** Analyzing a Cisco in a world with a Huawei, a Whirlpool in a world with Haier, a Microsoft in a world with a Google -- well, this is a

special challenge. It would be the definition of bad analysis to inadequately account for all competitive threats, yet at current prices, the market has done so. Of course, **public securities are further supported by the prices that leveraged investors such as private equity firms and hedge funds can and must pay, rather than what is rational for a cash account long investor to play.**"

Understanding a business model is essential to determining whether a company will continue reporting profits in the future. What Dr. Burry understands is that opportunities lie where other investors, a.k.a. Mr. Market, have failed to understand a company's business. Specifically, we can see this in his account of his Paccar investment:

ID: "With that said, I present a company that I've bought lower, but still feel is a value. Paccar (PCAR, news, msgs) is the world's third-largest maker of heavy trucks such as Peterbilt and Kenworth. **We're possibly headed into another recession, and if Paccar is anything, it is cyclical.**

So what on this green earth am I doing buying the stock now? Simple. **There is a huge misunderstanding of the business and its valuation. And where there is misunderstanding, there is often value.**

And over the last 14 years, the stock has delivered a 384% gain, adjusted for dividends and splits. **So it is a growth cyclical.** One does not have to try to time the stock to reap benefits."

Dr. Burry continues his account with the company's key distinguishing features:

ID: "In fact, despite the high fixed costs endemic to its industry, **Paccar has been profitable for sixty years running. With 40% of its sales coming from overseas, there is some geographic diversification. And there is a small, high-margin finance operation that accounts for about 10% of operating income and provides for a huge amount of the misunderstanding.** The meat of the business is truck production.

The competitive advantage for Paccar is that **the truck production is not vertically integrated. Paccar largely designs the trucks, and then assembles them from vendor-supplied parts.** As Western Digital found out, this model does not work too well in an industry of rapid technological advancement. **But Paccar's industry is about as**

stable as can be with respect to the basic technology. So Paccar becomes a nimbler player with an enviable string of decades with positive cash flow. Navistar, the more vertically integrated #2 truck maker, struggles mightily with its cash flow."

Some types of business such as real estate companies, automotive or agricultural machinery manufacturers use a financial subsidiary in order to take advantage of business loans, generate synergies, facilitate sales and increase earnings and profits. We believe that complementing a company with financing facilities -- depending on the industry's stage in the cycle -- could significantly increase its industry exposure. When things are going bad in a debt fueling cycle and the company's leading standards have been overly permissive, its financial subsidiary could trigger a whole series of problems. But such subsidiaries are not only important for their businesses or related risks. Their debt, which is used to finance loans, is also important to tone the company's enterprise value and its derived ratios, such as enterprise value/free cash flow. Usually, with the financial subsidiary's debt in the whole picture, the company looks less attractive and more overvalued, which can be misleading. Dr. Burry discusses this in his analysis of Paccar:

ID: "**But the debt is where a big part of the misunderstanding occurs. In fact, companies with large finance companies inside them tend to be misunderstood the same way.** Let's examine the issue. Yahoo!'s quote provider tells us the debt/equity ratio is about 1.8. Media General tells us it is about 0.7. Will the real debt/equity ratio please stand up? With a cyclical, it matters.

So we open up the latest earnings release and find that **Paccar neatly separates the balance sheet into truck operations and finance operations.** It turns out that the truck operations really have only \$203 million in long-term debt."

At least, if there is no financial mismanagement, the financing company's debt becomes irrelevant for certain ratios and valuation metrics.

ID: "**The finance operation is where the billions in debt lay. But should such debt be included when evaluating the margin of safety? After all, liabilities are a part of a finance company's ongoing operations.** The appropriate ratio for a finance operation is the equity/asset ratio, not the debt/equity ratio. With \$953 million in finance operations equity, the finance equity/asset ratio is

19.5%. Higher is safer. Savings and loans often live in the 5% range, and commercial banks live in the 7-8% range. **As far as Paccar's finance operations go; they are pretty darn conservatively leveraged.** And they still attain operating margins over 20%. I do not include the finance operation liabilities in my estimation of Paccar's current enterprise value."

But issues such as debt, financial troubles or similar should not obscure the potential of some businesses with complex business models or different ways of making money, as is the case of Clayton Homes.

ID: "Clayton Homes, a major player within the manufactured housing industry, is an excellent candidate for best-of-breed investing in an out-of-favor industry. **But before investing in Clayton, one should make an effort to understand this fairly complex industry. Let's take a look how Clayton makes money.**

Specifically, **money can be made - or lost - at several levels of operation.** A company can **make the homes** (producer), **sell the homes** (retail store), **lend money to home buyers** (finance company), and/or **rent out the land** on which the houses ultimately sit (landlord). **Clayton is vertically integrated and does all these things."**

Clayton Homes¹² was four companies rolled into one and could be better described as a full-value-chain-in-one company.

ID: "**When Clayton sells a home wholesale to a retailer; the sale is booked as manufacturing revenue.** Clayton may or may not also own the retailer. The retailer then sells the home to a couple for a retail price; **the sale is booked as retail revenue if Clayton owns the retailer.** In Clayton's case, about half of its homes are sold through wholly owned retailers.

The couple may borrow a large portion of the purchase price from Clayton's finance arm. If so, that retail revenue is booked as equivalent to the down payment plus the present value of all future cash flows to Clayton resulting from loan repayments. The firm can be either aggressive (aiming for high current revenues) or conservative

(minimizing current revenues) in booking this revenue, also known as the gain-on-sale. **Since inherently this gain-on-sale method causes cash flow to lag far behind income, a conservative approach would be prudent.**

Now that Clayton has loaned the money to the couple, the firm can sit on it and receive the steady stream of interest payments. **Alternatively, Clayton can bundle, or securitize, the loans and re-sell them through an investment banker as mortgage-backed securities.** Because the diversified security is less risky than a single loan, Clayton can realize a profit on the sale of the mortgage-backed security, especially if the firm was conservative in estimating the loan's value in the first place. Moreover, **Clayton's finance arm can act as the servicing agent for the security and earn high-margin service fees.**

Finally, through Clayton's ownership of land and some 76 communities, **the company can sell or rent land to the couple for the placement of their new manufactured home."**

Restricting investments on the basis of size is the same as intentionally avoiding certain industries merely because they seem difficult to understand. Dr. Burry invests in value. He may also buy the type of major companies that are typically within Buffet's scope if they are trading at reasonable prices.

ID: "**I also invest in rare birds** - asset plays and, to a lesser extent, arbitrage opportunities and companies selling at less than two - thirds of net value (net working capital less liabilities). **I'll happily mix in the types of companies favored by Warren Buffett - those with a sustainable competitive advantage, as demonstrated by longstanding and stable high returns on invested capital - if they become available at good prices.** These can include technology companies, if I can understand them. But again, all of these sorts of investments are rare birds. When found, they are deserving of longer holding periods."

In Dr. Burry's statements, we can clearly see that is he is always looking deeper down -- debt payments, lower interest expenses, etc. Looking at the big picture is a typical

¹² Clayton Homes was acquired by Berkshire Hathaway at the end of July 2003. The mobile home maker company continues to be part of the holding headed by Warren Buffet. Sorkin, A. *Buffett Wins Battle to Buy Clayton Homes*, New York Times, July 2003.

<http://www.nytimes.com/2003/07/31/business/buffett-wins-battle-to-buy-clayton-homes.html>

of a value-based approach and margin of safety is absolutely key in Dr. Burry's investing philosophy. In his first letter to investors in January 2001, just two months after starting the fund, he wrote about how the Scion Value Fund was an un-hedged hedge fund:

MBL: "Common hedging techniques include shorting stocks, buying put options, writing call options, and various types of leverage and paired transactions. While I do reserve the right to use these tools if and when appropriate, **my firm opinion is that the best hedge is buying an appropriately safe and cheap stock** (...) the charter investors in the Fund -myself included- entered November in a hedge fund that was, by all convention, completely un-hedge."

Understanding margin of safety as a hedge is the logical consequence of taking value investing philosophy to its limits and combining it with a strong conviction approach. Burry's lack of use of futures or options is also striking. His most successful investment strategy was only made possible through derivatives. Although his strategy against the subprime mortgage market was underway, in the third quarter of 2006, he admits to not doing very well with put options:

MBL: "Our experience with equity index puts has not been a good one, especially now that indices are surpassing or approaching all-time highs."

Short selling is a common hedge, an issue that Dr. Burry discusses in some letters to investors. The quote below is extracted from the 2001 annual letter:

MBL: "Short selling is of course the investment technique most readily identified with hedge funds. As you know, **I do not and will not simply seek to hedge the long position of the Fund's with a basket of short positions**, or for that matter with index put options. It will never be my purpose to sell stocks short as part of risk management program. **Rather I approach the shorting of common stocks in an opportunistic manner that is many ways the mirror image of my approach to going long on stocks. I Short a stock for the Fund when there is some temporary, manipulated, or misunderstood phenomenon that has caused the stock to rise to an egregious valuation.**"

In the same part of the letter, Dr. Burry mentions a quote by the founder of the Vanguard Group -- John C. Bogle, one of the world's most famous investors -- ridiculing his strategy:

MBL: "His technique to manage risk is to buy on the cheap and, if he takes a short position -- I hope you're all sitting down for this -- it is because he believes the stock will decline". (John C. Bogle)

Dr. Burry continues his response to Bogle with a short explication about short selling:

MBL: "**In all respects, he describes my strategy exactly right** -- even inserting an 'If' to reflect that I only occasionally take short positions. I contacted Mr. Bogle after reading this characterization, and not surprisingly we are of a different mind on this matter. He is, after all, a strong efficient markets proponent. What I propose just does not seem terribly plausible in his view. **Nevertheless, this is what I do.** I believe the stock will decline resulting in profit. I trust, forewarned, you were sitting down.

I will note that short selling has become extremely competitive. Much as the opportunity to find merger arbitrage opportunities at decent prices shriveled as capital flooded investment funds devoted this activity, the short selling field has become awfully crowded as a result of recent broad market declines. (...) As a result, **my version of short selling at the portfolio level might be considered special-situation short-selling.**"

In the never-ending argument between value investors and efficient markets advocates, Dr. Burry clearly takes sides, but, as always, without forcefulness:

ID: "**I do not view fundamental analysis as infallible. Rather, I see it as a way of putting the odds on my side. I am a firm believer that it is a dog eat dog world out there.** And while I do not acknowledge market efficiency, **I do not believe the market is perfectly inefficient either. Insiders leak information. Analysts distribute illegal tidbits to a select few. And the stock price can sometimes reflect the latest information before I, as a fundamental analyst, catch on.**"

Margin of safety and short selling are the final consequence of something more fuzzy and complex: company valuation. Fortunately for our analysis, Dr. Burry tends to talk extensively about specific companies and valuation -- not only about how he values a company's business but also how Mr. Market does:

SI 27-Jul-2000: "Yeah, but unfortunately **ALSC's (Alliance Semiconductor Corp) stock value depends on industry valuations, owing to the fact**

that a good part of the value is an inflated portfolio that can't be sold because the company has no plant of its own. Looking at history, the market values ALSC largely on this portfolio probably because of the lack of plant. I don't agree with this, but try as I might, the operations are not worth the current price either. The absolute risk low but not zero, and in any case technically the thing looks headed to \$14. I can wait. It's nothing personal against the stock (or you - I still think it was a good pick), but if I can get it at \$14, then that's nearly 50% just back to here."

SI 27-7-2000: "I would guess the exceptions to the 3-year rule would be tech companies - for many obvious reasons. I would also guess that it would still hold for slower-growing, more traditional companies. And ALSC tripped my sell point - I'm out already. It may go up, but I've vowed never again to cling to a falling knife. There are plenty of other opportunities out there."

same question. It wasn't always negative, but it was never big enough for me to think it would not become so significantly negative during a downturn as to wipe out the small positive during the boom time. Net zero or net negative over the cycle.

I thought there might be a dynamic that I did not understand. And could not understand. How comfortable for me to know that DHOM's CFO is in the same boat. The way some of these companies purchase inflated real estate during the boom times, I guess I shouldn't be surprised."

We can find the same free cash flow point of view in many of his company analyses such as that of the truck maker Paccar, for whose valuation Burry introduces a cyclical component. Another important point here is coming up with figures not disclosed by the company and Dr. Burry's method for finding them:

ID: "Now come the ratios. **Operating cash flow last year was \$840 million. What is the free cash flow? Well, you need to subtract the maintenance capital expenditures. The company does not break this down. One can assume, however, that, of the annual property and capital equipment expenditures, a portion is going to maintenance and a portion is going to growth. Luckily, there is already a ballpark number for the amount going to maintenance - it's called depreciation. For Paccar depreciation ran about \$140 million in 1999. So in 1999, there was approximately \$700 million in free cash flow.**

Can it be that Paccar is going for less than 4 times free cash flow? **Well, it is a cyclical, and Paccar is headed into a down cycle. So realize this is 4 times peak free cash flow.**

In past downturns, cash flow has fallen off to varying degrees. **In 1996, a minor cyclical turn, cash flow fell off only about 15%. In the steep downturn of 1990-92, cash flow fell a sharp 70% from peak to trough. Of course, it has rebounded, now up some 700% from that trough. The stock stumbled about 30% during the minor turn, and about 45% as it anticipated the 1990-91 difficulties."**

Free cash flow is a point in every company targeted by Dr. Burry, no matter the industry he analyzes or the general economic momentum. Without free cash flow generation, the company analyzed loses its appeal. Let us look at Pixar Animation Studios to understand this fully:



Dr. Burry's statements cover from basic issues to the analysis of very different types of companies and industries. He always addresses, however, the issue of free cash flow and overlaying the importance of aligning incentives and interests. In this instance, he talks about the home building industry and the now delisted company Dominion Homes:

SI 22-7-2000: "Why **"in a period that profits and revenue are growing and strong, why can they not generate enough cash to provide positive cash from operations for a single quarter?"**

Bob, you hit on the primary reason I'm not in the home builders. Looking at the cash flows of the few companies I was interested in led me to the

ID: *"But I would never invest in this company if I couldn't see the financial kingdom behind the magical one. And I do. Pixar is generating cash at such a rate that it is building its new Emeryville digs out of cash flow-- with no financing -- and still laying down cash on the balance sheet. **At present, cash on hand tops \$214 million. Jobs is a fan of cash flow and cash strength because he thinks it helps him negotiate with Disney. "Hey, if you don't want a piece, we'll just finance it ourselves..." Whatever the reason, I like cash too."***

Lest you missed it, let us highlight Dr. Burry's final statement, as it sheds pertinent light onto his personality:

ID: *"Whatever the reason, I like cash too."*

Now, moving on to Pixar's income and cash flow generation:

ID: *"The next year and a half will include the driest quarters Pixar will ever see. Still, Pixar sees the coming pay-per-view release of "A Bug's Life" generating gross revenues of 15-20% of worldwide box office receipts before Disney takes a cut. And "Toy Story 2" will go into home video release this October, generating about 35 million in unit sales over its lifetime at a higher average selling price than originally forecast. Helping to generate enthusiasm for this release -- and to help cement the evergreen nature of the "Toy Story" characters - - will be a new "Buzz Lightyear of Star Command" television show, which debuts this fall as part of Disney's 1 Saturday Morning program.*

***These are additional revenue phases for established assets.** To believe in Pixar as an investment, one has to **believe in the evergreen nature of its creations. Pixar's full product life cycle, managed correctly, can be extremely long. And as Pixar releases more films, more life cycles are put into play,** overlapping and creating smoother and larger earnings streams.*

*Pixar is guiding us to earnings of \$1.30 this year, but it is likely we'll see earnings exceeding \$1.35. **History tells us Pixar's free cash flow runs quite a bit higher than its net income. That's how cash on the balance sheet jumps \$17 million in one quarter despite net income less than half that.** As an enterprise less its cash, the price of Pixar is currently trading at about 21 times accounting earnings, but only **about 14 times free cash flow.** Earnings will fall next year, and the stock is heavily shorted in anticipation. It's not like me to say this, but getting*

*into the quarterly accounting minutiae here is a bit counterproductive. **The business plan is intact and there is a working program for creating brand equity.***

Dr. Burry sometimes mentions great stock bargains, trading at incredible discounts. This is the case of Industrias Bachoco, a Mexican agricultural company, whose incredible free cash flow yield he highlights, seeing an excellent opportunity:

ID: *"Industrias Bachoco is a Mexican chicken products producer. **Number one in the country, trading at about a 20% free cash flow yield and at half book value. Enterprise value/EBITDA multiple is just over 2.5X.** Economic trends vary, but **this company has been around for the last 50 years,** and in the last several years it paid off, out of free cash flow, an acquisition of the No. 4 player in the industry.*

*Numbers 2 and 3 in the industry are associated with Pilgrim's Pride and Tyson Foods. **I admit-this is not a great business. Maybe just worth book value. OK, double the share price and give me book for my shares."***

Here, Dr. Burry seems to understand that low valuation means nothing outside industry context, but even with mere book value this looked like a great opportunity. Sometime after his first investment in Industrias Bachoco, he writes about the company again in his investment diary:

ID: *"The market capitalization of the stock is \$450 million as I write this. The company has just \$33 million in debt paired to \$128 million in cash, for an enterprise value of \$355 million. Earnings before interest, taxes, depreciation and amortization (EBITDA) was \$145 million during 2001. Free cash flow was \$100 million. **The trailing enterprise value: EBITDA ratio is therefore 2.45, and the free cash flow yield is 22%. The company continues to trade at just over half book value, and it paid a dividend during 2001 amounting to 7.7%. The price/earnings ratio is just under 4. All these numbers are not so bad at all, especially when one considers that 2001 was a difficult year for the industry,** as the economy softened along with pricing. In all probability, the sell-off occurred because of the recent run-up a sell on the news phenomenon.*

As I noted before, the company is the leading producer of poultry products in Mexico, where

chicken is the Number one meat. **Pilgrim's Pride and Tyson Foods lag Bachoco in Mexico, where fresh chicken products are much more broadly accepted than processed chicken products.** Bachoco, having been in the Mexican chicken business for decades, has a natural advantage that can be exploited if the company is run well, and it does seem to be run well."

Dr. Burry brings out the best of himself in analyzing concrete issues in order to fine-tune his valuations. Here, he discusses how companies allocate assets and resources in different segments and businesses. This is a delicate issue for non-activist investors. The effects of strategic decisions on company performance must be looked at closely, especially in logistics companies, such as GATX Corp:

SI 11-Jul-2000: "I would like to bring to this thread's attention that **GATX is announcing it will sell its Terminals division.** In my web site analysis justifying my buy, I had said,

"There are a lot of assets ripe for shedding (as indicated by the \$115 million being paid for just two of its tens of terminals) as well as potential for high returns in certain operating segments (especially Capital). **This company needs capital allocation expertise, and if it didn't have it before, it has it in spades now.**"

I was referring to Buffett jumping two-feet-first on board. **Terminals includes many terminals owned outright -at least 15 in the US - and several significant stakes in international ones that bring its total to at least 34 terminals.** They also own 4 pipelines, and they own, not lease, the significant amount of land related to all this. Now it's for sale. The question is what is left? **We'll have to see what all this goes for, but this could drastically reshape the balance sheet and place a load of capital in the hands of the master allocator.** There's even a vehicle already existing within the company, Capital, that is growing at least 15 years and has interests in telecommunications. GATX Rail and the steamship company are both still there too."

Dr. Burry emphasizes how insiders and major money managers lead company management to take one decision or another, especially in terms of asset allocation:

SI (12-Jul-2000): "My understanding is that Buffett handles the supercat float, namely National Indemnity, among others (namely Gen Re), while Simpson handles the GEICO float. According to the

latest filing, GEICO and its subsidiaries own 5.9% of GATX. Berkshire Hathaway through National Indemnity appears to own 14.9%. There's a difference there - 9% absolute - that I'm attributing to Buffett. I have never heard nor read that Lou Simpson stretches outside of GEICO to manage Berkshire's other float.

Moreover, there is a similar arrangement for Dun & Bradstreet (14.9% for National Indemnity reported, then 4.9% for GEICO) and I know that there were comments on DNB at the annual meeting from the chief tans themselves. Pretty specific too. Why would they pay less attention to a stake in GATX, especially when the fundamentals of the investments (unlocking value by corporate action) are so similar?

I could be mistaken, as the ways of Buffett are never entirely clear. Nevertheless, it appears that **GATX has had a fire lit under it since Berkshire took a stake. Sold off 81% of its Logistics and now will sell off 100% of its Terminals, both pieces that have great asset and strategic values but generate little in operating profit. We're getting left with the cash-generating machines of the company and the investment arm.**"

The point here is a company with strategic assets making little profit from them. When business diversification leads to mismanagement, selling those assets is one option. In the logistics industry, it is customary to sell strategic assets at a good price due their strategic value. With the cash earned the company may buy more profitable assets. This is not plain vanilla but it is a way of revitalizing this type of business, as Dr. Burry says:

"This company needs capital allocation expertise"

Legal structure can also be critical in managerial decision-making -- a change from partnership to corporation, for instance, could make a huge difference:

SI 20-Jul-2000: **"The thing about Buffett and ServiceMaster is that it IS a different company now. It was a partnership when he was known to have liked it and owned it. Now it is a corporation. No doubt so that the company could better fund its acquisitions. But taxes take a much bigger bite and have severely affected the resulting cash flows. The issue now is, now that they have acquired their way into being a bigger company, can we get some organic growth please? Without additional capital requirements? So I don't think it is near the**

company it was when Buffett liked it. BUT I do like the business economics pre-tax, and would like to invest in them again at some point. To understand it, though, requires more than a quick once-over, because once-over it is not too attractive."

Looking at a company's management's motivations or historical behavior can be key when making investment decisions. In the case of Clayton Homes, Dr. Burry compares the company with its peers' management style and highlights the conservative style of Clayton's managers, which is especially valuable in such a cyclical industry as home building:

ID: *"Clayton never participated in these excesses. In fact, despite the sub-prime category into which the industry's loans fall, loans originated by Clayton have a delinquency rate of only 1.65%. And while other manufacturers struggle, Clayton still runs every single one of its plants profitably. The Q4ly report made 65 of 66 quarters as a public company that Clayton has recorded record results. Now, amidst bankruptcies and general industry malaise, Clayton can take its efficient, Internet-enabled operations and strong balance sheet and go shopping. (...)*

Clayton strives to be conservative in its revenue recognition and acquisition strategy. It imposes the barest of office spaces on its executives, and provides all its employees direct and indirect motivation to improve company-wide efficiency and performance. For instance, it matches 401(k) contributions only with company stock, and plants are rewarded on individual profitability measures rather than volume of production."

One issue intrinsically tied to valuation is competitive advantage, or moat. As Pat Dorsey clearly describes in his *Little Book that Builds Wealth*¹³, moats are one of the keys for long term investors. Distribution networks are one of these moats described by Dorsey, and an essential one at that. If a product cannot reach its potential market, the company will go out of business. In the Pixar Animation Studios case, Dr. Burry discusses how a distribution agreement with Disney is affecting company performance and how Pixar's position will change:

ID: *"In 2004, Pixar will release its final film under the distribution agreement with Disney. This agreement is an onerous one that Pixar agreed to*

when it had much less success under its belt. Currently Pixar only gets 50% of the gross revenues of its product after Disney deducts the costs of its distribution and marketing. Disney's claim on distribution and marketing fees is such that the entire domestic box office for a film can mean no profits for Pixar. Already Pixar is of sufficient strength to extract a much more lucrative deal from Disney. After a few more blockbusters, Pixar will be in a position to restructure a new agreement with tremendous implications for Pixar's bottom line.

The key is that any additional concessions from Disney should flow nearly untouched to the bottom line. An additional concession of 20% of profits after distribution costs should result in roughly a 40% boost to Pixar's operating income from a given film. Knowing this, we can estimate that in 2005, we should see a big boost to Pixar's income and at the minimum rejuvenation of its growth rate. Pixar's cash earnings over the next."



One industry traditionally left out because of its impenetrable risk and its total lack of moats is the fashion retail industry. A light joke about an otherwise difficult topic might be a good way to introduce it:

SI 6-Sep-2000: *"In any case, my GPS (Gap Inc) position is really a hedge against my wife's spending"*

Geez, I couldn't afford that much Gap. I kid you not when I say on a Saturday we may visit 3 different

¹³ Dorsey, P. *The Little Book that Builds Wealth*, Wiley, 2008.

Gaps in the same day. "They all have different stuff" is what I hear, but it looks the same to me...

Not sure if you know this feeling, but ever stand just outside the women's underwear area at Banana with like 5 other guys - that's a camaraderie probably not unlike boot camp..."

But Dr. Burry not only talks about his position in Gap Inc (GPS), he also comments on other clothing companies such as Abercrombie & Fitch (ANF) or American Eagle Outfitters (AEO):

SI 7-Aug-2000: "Gap, we all know Buffett liked it enough to buy some. It definitely has been in a sweet spot, extended temporally by its addition of economic tiers. **But what I wonder is why everyone says it's 4-tiered structure appeals to all ages.** I definitely see it appealing to nearly all income levels. But not all ages. My wife is a Banana freak, and she will often visit Gap because they are usually in proximity. **And of all the hundreds of times I've been in these stores** (trying desperately to think of something interesting to avoid developing a frown), **I definitely do not notice a geriatric population.**

And in the case of Gap, the clothes are nearly as unappealing as those of Abercrombie. **I don't think it is a crazy stretch to say Abercrombie could be the next Gap,** because I think Gap is as much a beneficiary of a trend as Abercrombie - and it is primarily the kids-to-young adults crowd. But I also would double or triple discount my DCFs if somehow it had become stuck in my mind that something was "the next" big thing. **One of the oldest rules in the investor's handbook - there is NEVER a 'next' big thing.**

Gap is like any retail organization. The gravy train has passed, and it will not give and give to investors for decades to come. What growth has not yet been realized has been fully discounted. So that's where ANF's advantage lies. If it can become half the next Gap and grow 4 times in size, we've got a winner."

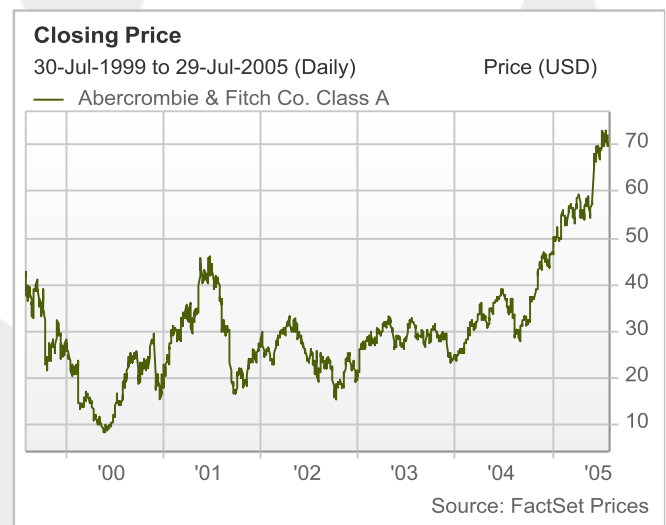
And, what is the biggest risk in the fashion retail industry? The risk tied to fashion itself -- all companies are fashion-driven, 'trend is king':

SI 30-Aug-2000: "I think we're learning something about Gap and fashion in retail. **Basically, it's but then of course you get into past performance issues -driven.** In a post earlier on this board, I brought up that from my store visits, **Gap didn't**

seem any less exposed to fashion risk than anyone else in the industry. Now ANF and AEOS are rallying because experts are saying they had the right fashion mix for this fall. **BUT I would still say that this just cements the fashion fate even more so.** A while ago, **we were talking about ANF being the next GAP. Well, let's hope not.**

BTW, I've completed a review of Buffett's holdings, and doesn't appear that he has any GAP. Not the last few years."

SI 1-Sep-2000: "**All I see is a lot fashion risk.** That say nothing to how cheap the stocks are. ANF was way too cheap. But I've read a lot recently how it and AEOS are riding the benefits of being in fashion this back-to-school season. While ANF was a value, how far it has come in such a short time has a lot to do with this. **The stock was out of fashion when the clothes were out of fashion.** ANF retooled and now the stock is in fashion as the clothes are in fashion."



The *in-fashion-out-of-fashion-cycle* is a recurrent situation in the retail clothing industry, especially in the 'affordable luxury' or 'middle premium' segments. A company gets to the #1 position and a few years later a new company takes the lead when it creates or starts the latest 'fashion trend'. In recent years, we have seen how some company starting from scratch ended up leading the market, as for example, Gap, Abercrombie & Fitch, Coach Co and Michael Kors. These companies' charts show that the fashion cycle is not in sync with the general economic cycle. As we observed in early 2000, tech might also be a fashion-driven sector. According to Dr. Burry -- and other investors -- the value investing method for maintaining capital is avoiding those companies that are on everyone's lips.

TBS: "When he (Dr. Michael Burry) started Scion, he'd told potential investors that, because **he was in the business of making unfashionable bets.**"

Investing is also about understanding how information works. When everybody is saying 'Under Armour is the next Nike', the investing momentum has already gone, so Dr. Burry is probably right in saying that "there never is a 'next' big thing".

Looking for value, Dr. Burry usually talks about small or mid-capitalization companies. Running a concentrated portfolio with mid-cap companies may lead to an illiquid situation:

"The fund maintains a high degree of concentration – typically 15-25 stocks, or even less. **Some or all these stocks may be relatively illiquid.**"

In fact, the illiquidity of holdings was a common issue in Scion's portfolio. Low capitalization stocks tend to be more undervalued and more unfashionable.

MBL: "**I guide the (Scion) Fund to a net long position** by investing in a concentrated manner and by **frequently taking relatively illiquid positions** in undervalued situations."

MBL 1Q 2001: "**The bulk of the opportunities remain in undervalued, smaller, more illiquid situations that often represent average or slightly above average business** – these stocks, having largely missed out on the speculative ride up, have nevertheless frequently been pushed down to absurd levels owing to their illiquidity during a general market panic"

Sometimes a set of circumstances present the opportunity of taking a big position at a good price. This is what Dr. Burry describes in his 2001 Q3 letter to investors:

MBL: "First and most important, **the Fund has been averaging down in a stock**, purchased during the quarter, which has fallen tremendously out of a favor over the past couple of month. (...) **Very few investment funds would want this stock on their books** at the end of the quarter. Indeed, as the quarter came to a close, the stock came under renewed selling pressure, presumably as other investment funds worked to 'window dress' their portfolios for public viewing. Some element of early tax-loss selling may have played a role. As well, **it appears a very large institutional investor, having used the stock as collateral for a loan**, has disclosed that it is dumping several weeks' worth of volume -

with apparent disregard for price. **All of these factors were detrimental to reported third quarter performance and quite beneficial for the Fund.** This position now ranks as among the largest in the Fund.

At quarter end, however, **the position sat a low point, trading at a valuation of just ¾ the free cash flow** of the trailing twelve month. And unlike many businesses that have faded rapidly during 2001, this business achieved record free cash flow yet again during the first half of 2001."

In the same letter, Dr. Burry talks about his own volatility management strategy. With a highly classical value standard, he identifies volatility with opportunity:

MBL: "**Finally, the portfolio has generally held relatively illiquidity stocks** for the balance of the year. The logical reason for this is that the more liquid, larger capitalization stocks had remained stubbornly overvalued since inception of the Fund. The logical consequence, however, is that the portfolio is a susceptible to short-term downside volatility in times of rampant market fear. (...) **such volatility in no impacts the intrinsic value of the portfolio, and rather provides opportunity.** In one case, this allowed the fund to build a smaller stock position into significant size as free cash flow yield approximating 20%."

When you are constantly looking for value opportunities wherever the markets are going, you need to be able to buy at any time. At times, Dr. Burry's portfolio was largely in cash, as he explains in the 2001 annual letter talking about his current portfolio:

MBL: "**The Fund's cash position – hovering around 40% or so for most of the fourth quarter** – prevented the Fund from participating to the fullest extent possible in the recent general price appreciation across most categories of stocks"

Of course, a big cash position that leaves you out of the market represents an incredible cost of opportunity, but at times Dr. Burry values the optionality of cash more than an investment opportunity.

Financial markets are rife with epic stories. Dr. Burry's colossal bet against the subprime mortgage market perfectly described in 'The Big Short' is not the only story about the Scion Value Fund worth telling. During the first half of 2001, the Fund's net asset value appreciated by 22% year-to-date while the S&P500 depreciated by 6,68%. Within the next

three months, Scion Value lost more than a half of its year's performance and yet was up 10,98% year-to-date, while the S&P 500 did terribly, dropping by 20,39% in the same period.



So, what happened? Dr. Burry's letter to investors explaining the nine-month results for 2001 was written just 18 days after the worst terrorist attack in US history -- 9/11. What were Dr. Burry's hedge fund positions on that fateful day? The answer is mind-blowing:

MBL: **"the largest holding in the Fund on September 11th was an airline stock.** Breaking with tradition, I feel I should explain this position in a bit of detail. For no matter how strenuously I emphasize that this was a rational decision, buying an airline stock rarely looks like a good idea – especially in retrospect, after the seemingly inevitable monstrous loss has been realized. (...)

The effect of our rational tragedy on the market value of the portfolio was not limited to this one airline holding however. **The Fund held two hotel stocks on September 11th – one of which was, and is, among its top five holdings.** I will not reveal the name of this company here, as I do hope it continues to fall – thereby providing the Fund an opportunity to add to the position. Hotel Stocks ranked with other travel-related industries and airlines as among the worst performers in the wake of the September 11th tragedies. **In several cases, the short-term reaction was entirely unjustified, as long-term intrinsic value was not significantly impaired.** The Fund's largest hotel holding is one such business, and I expect the Fund to receive full value for the shares in the future, such recognition had simply not arrived by quarter's end.

As well, another hotel stock held in the fund's portfolio, though not among the top 5 holdings, fell over 30% in the aftermath of September 11th. **It now trades at the value of free cash on its books.**

Despite this, the Scion Value Fund still outdid its benchmark year-to-date. At those lowest market moments, the Fund fell by 11 points while the S&P 500 fell by almost 14 points. Dr. Burry overperforms ups and underperforms downs.

Choosing a benchmark can be somewhat complicated, but as he usually does, Dr. Burry picked his benchmark in an attempt to try and keep things simple. When he started investing his own money, he chose the S&P 500 as his benchmark, and for good reason:

SI 20-Jul-2000: **"Wallace, you particularly task. There are no good value benchmarks. There are benchmarks. S&P Barra. Russell. You could even use the Vanguard or Schwab Value Index funds for un-managed but more realistic performance. BUT all these do is take the slowest growing, most depressed big-caps and through them together. I think most value investors would agree that there is not much reason to call that value investing.**

Your best bet is to pick some active managers in the value category and pit them against your manager. Say Legg Mason Focus Trust. Say Third Avenue Value. Say Tweedy Browne. Say Sequoia. There's a bunch of them. Maybe you can take an average of 10 or so of these over different time periods.

I just use the S&P 500 to benchmark myself. The simple reason is that it is by far the easiest, cheapest index to invest in, and it has shown its ability to pound into the ground just about every mutual fund manager out there over time. And you're just as likely to find a correlation with what true value investors do as you are by picking a big so-called value index.

To me benchmark means alternative. Any number of active managers, individually or as a group, could be. But then of course you get into past performance issues and that whole mess."

Benchmarks are the only way to assess an investment strategy's track record, but before they start investing, investors must develop their own style, especially when it comes to learning the basics. Indirectly, Benjamin Graham has served as Dr. Burry's mentor -- they are merely

connected through Graham's books and articles – providing him with a source of inspiration:

MBL: *"It is my belief that one constant in the stock market is human nature. For this reason, while I do not believe history provides a precise blueprint for the future, I also do not believe that those who blithely ignore history will have much success understanding the present."*

Dr. Burry continues his letter with a quote by Benjamin Graham from a 1932 Forbes magazine article, written a few years after the speculative asset bubble burst -- much like the late 1990's or mid-2000's bubbles:

"A study made at Columbia University School of business (...) covering some 600 industrial companies listed on the New York Stock Exchange, disclosed that over 200 of them have been selling. Over fifty of them have sold for less than their cash and marketable securities alone (...) Business have come to be valued in Wall Street on an entirely different basis from that applied to private enterprise. In good times the prices paid on the Stock Exchange were fantastically high, judged by ordinary business standards; and now, by the law of compensation, the assets of these same companies are suffering an equally fantastic undervaluation."



These ideas were important to Dr. Burry as he talks about 'learning from history' before becoming a professional investor.

SI 10-7-2000: *The ability to learn from history without repeating it travels with the ability for abstract thinking, and there are varying levels of these abilities distributed among individuals within the population. For one to judge another as somehow lacking this ability assumes that one has an unsurpassable ability in this regard. "If it happened to me, it will happen to you." One of the*

unfailing beliefs of humans. But not always correct."

He also understands learning as an acutely personal introspection process, something someone does on their own. As Michael Lewis says in *The Big Short*, Dr. Burry has a tremendous ability to focus and learn:

SI 10-Jul-2000: *"The learning curve before one finds one's groove varies. I am positive there are those with the good fortune to have very steep learning curves over short time frames. How short one can only imagine. Exceptional individuals do exist. Self-aware individuals will realize that such individuals can be even more exceptional than themselves."*

It is through such a process, with extensive in-depth thinking, that he came up with the idea of how to short the subprime mortgage market – "inspiration exists, but it has to find you working":

TBS: *"He wanted a more direct tool for betting against subprime mortgage lending. On March 19, 2005 (...) Burry was reading an abstruse textbook on credit derivative, and he got an idea: credit default swaps on subprime mortgage bonds."*

For Dr. Burry the use of credit derivatives was not a deviation from value investing. He saw it as an additional weapon in his pursuit of value investments:

TBS: *"Credit default swaps remedied the problem of open-ended risk for me. If I bought a credit default swap, my downside was defined and certain, and the upside was many multiples of it".*

When asked by one of his institutional investors about his new CDS strategy against subprime mortgages, he even answered:

TBS: *"I don't take breaks in my search of value. Seeking value is what I do"*

Value investors don't traditionally have a market view, rather they have a public one. In his first letter to investors, Dr. Burry did not seem to break this rule:

MBL: *"I have no view on whether the market, broadly defined, will fall or rise during the coming year. (...) The prudent view, in my opinion, is no view."*

This no-market-view-at-all contrasts with what Dr. Burry does in later letters, where he introduces a section called

'Market Overview'. These specific quotes are from the Q1 2001 letter to investors:

MBL: "I see very few others doing the same (as me). Many stocks remain overvalued, and speculative excess – both on the upside and on the downside – is embedded in the frenzy around stocks of all stripes. And yes, I am talking about March 2001, not March 2000."



Dr. Burry was good at analyzing market perspective (look at March 2001) and with excellent timing indeed. But, after this statement, he returned to the fold:

MBL: "Several investors have asked me to specifically outline my view on the market. I have generally responded that it is neither my policy nor my interest to attempt to predict broad stock market levels to any degree of precision over any useful time frame. Rather, **I will respond to the opportunities that the stock market provides no matter the prospects for or level, the general market.** That said, certain current market characteristics are worthy of comment in light to the history of our financial markets."

Second guessing the market's thoughts is a virtually impossible task but in 2001 Dr. Burry attempts to elucidate the dynamics of the end of the cycle, and as usual, he does so looking to the past:

ID: "**I can only conclude that it is quite possible we have not yet seen the bottom. Speculative booms like the 1920s and the 1960s were followed not only by steep stock declines, but also by stocks falling to absurd values.** The aftermath of the speculative boom of the 1990s has seen ostensibly

severe stock declines, but never during the April lows did I find stocks, generally speaking, go on sale.

There was no sale in tech, but neither was there a sale in the financials, consumer products companies, cyclicals, etc. Gilt-edged brand names like Coca-Cola and Gillette have seen their valuations reduced slightly, but they remain quite highly priced.

Indeed, by my calculations -- taking into account the massive corporate governance abuses borne of the bull market -- many of the biggest tech names and some of the biggest non-tech names that did fall fell only to fair value at worst. No fire sale in a fundamental sense at all. **What is fair value? I use an annual 10% return to shareholders after dilution, slings and arrows.**"

Five years later, in the third quarter of 2005 and facing another future stock market correction, Dr. Burry warned of a potentially extremely dangerous situation, with central banks ruining company valuations and making a bad situation worse. He then talks about where investor flows could go:

MBL: "As for liquidity, where may it head next? **Well, if the stock market wishes to value the Wal-Marts and Ciscos at fifty times earnings again, that would certainly accommodate a good amount of liquidity. But additional liquidity into stocks would have limited rationale, and rousing speculative excess requires a rousing excuse...** Rousing excuses abound for gold and other precious metals. Big bullion dealer Kitco cites the return of central bank buying, and I would cite forthcoming dollar trouble stemming from a Federal Reserve program to reduce interest rates to offset housing-affected economic weakness. **All the gold ever mined in the history of the world is only worth roughly the amount of U.S. dollars held by Asian central banks – a story unto itself.** And this speaks nothing of the froth that could build should the **world's citizens begin to move precious metals off the market en masse.**"

But good investors not only look for market cycles, they follow economic and business activity indicators as well. Dr. Burry has a profound vision of how business cycles work and clearly expressed his views. In his 2006 Q3 letter, he explains why he believes it is the end of an extremely expansive and untenable boom cycle:

MBL: "Take (the company) Nordstrom, a higher-end retailer benefiting from most every macro trend today. **Its 11,5% pre-tax margin in 2005 surpassed 10% for the first time since the company went public in 1971, and its margins rose from 1,5% to greater than 7% in the last four years. Net income is five times what it was in 2001, and return on equity rose nearly fourfold. Similar stories abound, though not necessarily to all to this degree.**

If this is not a peak in a dramatic debt-fueled economic boom, well, it certainly looks like one. Over half the S&P's earnings are derived from financial businesses benefiting directly from global liquidity being as it is. Another huge chunk of S&P earnings come from retailers, and yet another huge chunk from commodity-related and heavy industrial companies. With remarkable synchronicity, nearly every such group is experiencing high margins."

But 2006 was not the first time Dr. Burry used microeconomic examples to describe the risk involved in the evolution of the whole macroeconomic environment. In his 2004 Q3 letter to investors, he talks about the legal frameworks of Freddie Mac and Fannie Mae and why he thinks they are committing fraud:

MBL: "I recently watched Mr. Franklin Raines, CEO and Chairman of Fannie Mae, defend himself before a House subcommittee against allegations of fraudulent financial reporting brought by its regulator, OFHEO. I have already read OFHEO's interim report on the matter, and you know from prior letters that I have had a dim view of Fannie Mae and its CEO for some time. **My impression: Fannie Mae is unregulated, and they are very likely committing fraud.**

An entity is not being regulated if it takes subpoenas and threats from the Department of Justice in order to obtain management's cooperation in a regulatory review. Too, an entity is not being regulated if a Congressional investigation cannot be performed due to wholly inadequate knowledge of the business at issue on the part of the investigators. Watching our representatives flail at questioning Mr. Raines was rather shocking. They were in no manner capable of getting past the headline issues, and even those were covered only in superficial fashion. Remarkably, these particular representatives were members of the House subcommittee specifically charged with regulating the GSEs."

In the same letter, Dr. Burry anticipates the 'Too Big to Fail' phenomenon:

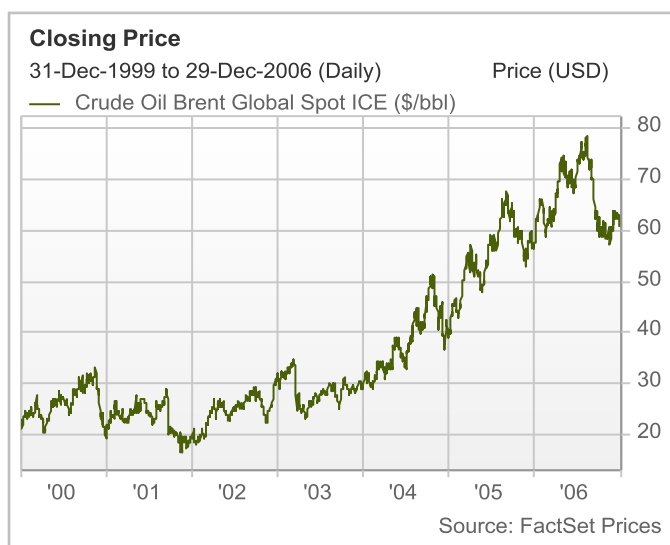
MBL: "I have written before of my similar belief that **many of our financial institutions are simply becoming too big to save without consequence.** Moreover, as they raced to become too big to fail, many grew at rates that outstripped internal accounting and audit controls as well as regulator resources."

And in earlier letters to investors, Dr. Burry talks about other market issues. He likes to bring up situations others are unaware of – e.g. the mortgage market, and specifically its interest rates. His understanding of the whole system is laid out in the final paragraph from the 2003 Q2 letter:

MBL: "A common argument today concerning adjustable rate mortgages is that if the homebuyer plans to move before the adjustable rate kicks in, then the obvious choice is to choose an adjustable rate mortgage, lock in the lowest current payment, and achieve a more expensive house. Washington Mutual reports that one quarter to one third of home loans originated over the last year possess an adjustable rate feature. **Such a program is good for the lender, the loan officer, the mortgage broker, the real estate agent, and nearly every party involved in the home purchase transaction. But the two major risks facing an adjustable rate mortgage borrower - that home prices and easy credit potentially both collapse during the fixed rate period – are precariously correlated**".

A few months later, Dr. Burry shows that he applies his contrary views not only in company or mortgage market analysis, he also discusses macroeconomic issues which is unusual for a value investor. In 2004, amidst market disturbances, he is able to detect and anticipate a noteworthy trend in oil prices, which he first mentions in the first quarter letter of that year:

MBL: "Oil has been in a nominal trading range for so long that the market apparently feels prices cannot escape above \$40/barrel. In truth, adjusted for inflation, oil prices have been on a decades-long slide and are not even half what they were in the 1970s. **A rapid rise in oil prices above \$40 has a reasonable fundamental basis, and would be almost a universal surprise.**"



Two quarters later, as oil prices start to go up, Dr. Burry continues his explanation:

MBL: *“Within the first quarter’s letter, I expressed my sentiment that “very high oil prices were not only possible but probable.” I defined “very high oil prices” as being in excess of \$50 per barrel. I believe now as I did then that there is a reasonable fundamental basis for these higher oil prices. Speculators are being widely blamed for these higher prices, but I would say that to the extent fundamentals-be-damned speculators are involved, they are in for the luckiest ride of their lives... Since earlier this year, the Funds have held long equity and distressed debt investments, both domestically and abroad, that should benefit significantly from these higher oil prices.”*

As you can see, Dr. Burry’s major contributions do not solely apply to investment and finance, he also teaches bankers, regulators and politicians a lesson about the financial system and its fragility. In his 2007 final letter to investors, Dr. Burry was boastful as most, if not all, of his predictions had been fulfilled. Yet his sharp and inquisitive spirit drove him to continue asking, “what’s next?”:

*“2008 is going to be an interesting year. The full impact of the subprime mortgage-induced contagion is hitting Wall Street and Main Street simultaneously. American consumers who had relied upon their ever- appreciating homes as fountains of cash have neglected to save even a penny for years...What does the American consumer have to spend now? **The American dollar ended 2007 in a fast-accelerating descent against most of the world’s commodities and currencies.***

So prices are rising even as the American consumer is pulling back. Stagflation? No, I worry about something worse, and something somewhat unprecedented. Do I foresee yet another black swan? Damn birds cloud my skies.”

In 2010, Dr. Burry wrote a piece for the New York Times about how he had seen the housing crisis coming. Specifically, the title was: ‘I Saw the Crisis Coming, Why Didn’t the Fed?’. In the article, he poses what he believes is a valid question. The establishment’s reaction came as a surprise. Not only did no member of Congress, or no member of Government for that matter, ever reach out to him for an open discussion on what had happened in the pre-crisis years, or what could be done, but within two weeks, all 6 of his now defunct Scion Capital funds were being audited.

The Congressional Financial Crisis Inquiry Commission requisitioned all of Dr. Burry’s emails and a list of people with whom he had conversed going back to 2003. A little later the FBI opened an investigation. One million dollars in legal and accounting costs and thousands of hours were wasted in the auditing and investigation process. Dr. Burry himself explained it all during a 2012 commencement address at UCLA, at the end of which he lamented:

“Just because I asked questions”.

That summer, the Federal Reserve put out a paper which concluded that ‘nothing in the field of economics or finance could have predicted what happened with regards to the housing bust and the subsequent economic fallout’. Absolute nonsense. Going back to the investment issues we would like to retrieve what Dr. Burry wrote in his Q1 2001 letter, where he discusses a highly topical subject, the huge amounts of employee stock options normally used by famous and top tech companies:

MBL: *“One area that is particularly perplexing is the accounting for options compensation. (...) In a coldly calculating market rather than a speculative one, the stocks of companies governed with so little respect for shareholders will suffer. **It is no limited to Adobe, Seibel or Xilinx. Cisco, Intel, Microsoft and many of the greatest technology-related ‘wealth creators’ of the last decade are in the same boat.** (...) Now that bubble is burst, it is not my expectation that we will see any lasting rebound in the stocks of companies in the hands of such reckless management teams. Indeed, it is quite certain that public expectations regarding these companies.”*

Stock options are a controversial issue in tech start-ups, especially in cases when investors cannot see any profits or cash flow generation. A year ago, Barron wrote an excellent article: ‘How Much Do Silicon Valley Firms Really Earn?’¹⁴. Reading Dr. Burry’s statements on the subject, it is clear that stock options and their masking -- as a cost -- to investors continues being an issue sixteen years on. Just to highlight this argument, we will quote Barron’s article that specifically talks about GAAP and non-GAAP accountability differences:

“It’s true that tech companies also report GAAP earnings, which require the expensing of stock compensation. However, many companies highlight the non-GAAP numbers that exclude stock compensation and other expenses (...) Stock compensation at Twitter is off the charts, relative to the company’s size, at a projected \$770 million this year - a third of its revenue.” June 2015.

Another, less controversial, accounting issue is that of goodwill amortization. As a team, we don’t have a homogeneous opinion on the subject. Some of us are pro while others are against. We look at it as a philosophical issue. For Dr. Burry what seems to be important is to keep goodwill visible, as a public record of acquisition performance:

*“I am a big fan of the proposal to eliminate the amortization of goodwill. **Let the goodwill stay on the balance sheet for all to see. This way we can tell exactly how much money the company has wasted in the past by simply looking at what the company is earning now and looking at what the company has invested to get to the now. Goodwill amortization hides mistakes.** When the goodwill amortization doesn't hide mistakes fast enough, you see extra charge---offs, as we saw with Cisco earlier this week. Shareholders should not want mistakes hidden.”*

2. Dealing with investors’ complicated behavior

Hedge fund management is not just about investing. It involves the creation of a sound operational structure with the proper incentives. Keeping investors happy and cool may be harder than managing their money.

When Dr. Burry started his business, Scion Capital, LLC, he enlisted two major partners: Gotham Capital V, LLC, the Joel Greenblatt fund, and White Mountains Management Company. The second was a subsidiary of White Mountains Insurance Group, Ltd led by Jack Byrne, a Warren Buffet associate and insurance guru. Gotham Capital V, LLC had a 5-year option to acquire Scion Capital’s 22,50% share and White Mountains had the option to acquire up to 15,44%.

By taking his first steps with big partners, Dr. Burry secured part of his career. Commissions and incentives are largely a reflection of Dr. Burry’s sincere character. He was acutely aware of management incentives, including his own. This transpires clearly in this quote from The Big Short:

TBS: “He disapproved if the typical hedge fund manager’s deal. Taking 2 percent of assets off the top, as most did, meant the hedge fund manager got paid simply for amassing vast amounts of other’s people money. Scion Capital charged investors only its actual expenses-which typically ran well below 1 percent of the assets.”

Scion Value Fund shows excellent performance results.

Year	Gross Return	Net Return	S&P 500
2000	8,20%	6,61%	-7,45%
2001	55,44%	44,67%	-11,88%
2002	16,08%	13,10%	-22,10%
2003	50,71%	40,81%	28,69%
2004	10,77%	8,86%	10,88%
2005	7,81%	6,49%	4,91%
2006	-18,16%	-18,16%	15,79%
2007	166,91%	138,27%	5,49%
2008 Q1	3,83%	4,09%	-9,45%
Since Inception	696,94%	474,40%	5,20%

Note: 2000 data covers November and December only. Net returns are after 20% performance fee and expenses.

Let us look at Scions Value’s fee and expense structure. First of all, it did not charge any management fees. In order to keep the expense ratio low, it only charged for the fund’s running costs, always under one percent. It had a success fee of 20% subject to conditions – only when the Fund’s annual performance return exceeded 6% did the company take its 20% fee.

¹⁴ Bary, A. *How Much Do Silicon Valley Firms Really Earn?* Barron’s online edition, June 2015. <http://www.barrons.com/articles/how-much-do-silicon-valley-firms-really-earn-1435372718>

MBL: *"I do not earn an income unless your annual return exceeds 6% net of expenses (...) my financial incentive to have an income give me every reason to rationalize expenses in favor of return."*

In 2006, the only year with negative performance, Dr. Burry decided not to charge any expenses. He probably was under some pressure not to charge the Fund's costs to investors and he didn't like the idea of increasing his clients' losses. The fees were calculated using the High Water Mark method where the manager only receives the performance fee if the net asset value of the fund has reached a new peak. This avoids charging the fee if the clients are losing money over the long term. At the time, his CDS subprime strategy was called into question by his investors:

TBS: *"I had all these people telling me I needed to get out of this trade, and I was looking at these other people and thinking how lucky they were to be able to get into this trade."*

Since the start of the Fund, Dr. Burry also invested the vast majority of his net worth and the wealth of his family -- his mother and his brother were among his early investors -- in the Scion Value Fund to ensure that his interests were aligned with those of its investors. He did not keep any personal securities and as he said in the final part of many of his letters to investors:

MBL: *"As long of the Fund exist, it will be my only investment."*

Dr. Burry was aware that incentives could lead organizations to success or disaster. In order to have as little interference from his investors as possible, he encouraged a controversial behavior, the lack of transparency:

MBL: *"The Fund is structured to allow its managers to ignore these secondary inputs. The less definition offered, the less positions revealed, the less statistics applied."*

Along the same lines, in another letter he states:

MBL: *"The Fund does not generally offer portfolio transparency"*

This may seem strange at first, but it does make sense considering that Dr. Burry had some difficulties talking to other people, probably because Asperger's syndrome which he realized he was suffering from after his own son was diagnosed with it. He says that when people first read his posts or letters and they meet afterwards, the meetings go well. In the reverse case, things turn out to be more

complicated. This is why he loves to express himself in his blog or through his quarterly letters:

TBS: *"He could explain himself online and wait for investors to find him. He could write up his elaborate thoughts and wait for people to read them and wire him their money to handle. "*

During market downturns, Dr. Burry's investors have been known to rush into him like an avalanche. He is bemused by investors changing their minds:

TBS: *"Early on, people invested in me because of my letters, and then somehow after they invested, they stopped reading them. (...) Burry's long-term success was no longer relevant. He was now being judged monthly"*

He complained to his wife about the complete absence of long-term perspective in financial markets:

TBS: *"I do my best to have patience. But I can only be as patient as my investors. The definition of an intelligent manager in the hedge fund world is someone who has the right idea, and sees his investors abandon him just before the idea pays off."*

Despite what one might think, Dr. Burry has a very good reason for not talking to investors about his investment decisions. And unlikely as it might seem, it is not because of his personality:

TBS: *"I hated discussing ideas with investors, because I then became a defender of the idea, and that influences your thought process. Once you became an ideas defender you had a harder time changing your mind about it."*

This idea sounds revolutionary to us. Thousands of money managers know the feeling of confronting their investment choices to their clients' perception. The idea of dangerously changing their beliefs by defending them is extremely interesting. Focusing on investment theories only and practically forgetting the rest is part of what Dr. Burry understands as incentives construction.

Ultimately, what history will remember about a money manager is their track record, not whether they had a charming personality or whether they were talkative. But in the short term things are different.

TBS: *"No business could be more objective than money management, and yet even this business, facts and logic were overwhelmed by the nebulous"*

social dimension of things: *I must say that I have been astonished by how many people now say they saw the subprime meltdown, the commodities boom, and the fading economy coming."*

In an effort to try and avoid these situations, in the first paragraphs of every letter, undifferentiated from body text, Dr. Burry wrote the same disclaimer:

MBL: *"I fully expect and recommend that members of this investment **vehicle judge my performance over a period of five years or greater.**"*

Going back to his posts in Silicon Investor, we find a long essay about investor experience and track record evaluation. This is a much debated issue, and Dr. Burry was not alien to it. First, he talks about comparing money managers from different times:

SI 10-Jul-2000: *"About this "experience" issue and notches in the belt, what a crutch. The two are not equivalents. Buffett did not live through the Depression, but somehow was able to anticipate and profit from the 1970s. **His returns have been steadily the same in the 1990s as in the 1950s. I don't recall in any of what's written about him that he claims the 1970s - the market's gyrations - made him a better investor. In fact, I don't recall this argument being made by any of the value strategists that I admire.***

I will give that experience may be measured in years. But for any person to claim that he/she is somehow a better investor - or to belittle another investor - because of this experience is ridiculous, petty, and ignorant. Evidently age is not certain to confer at least one quality - the ability to differentiate between population-based generalization and individual outcomes.

*This will inevitably become a battle between the young and the old. After all, how can an older investor not take comfort that his 40-50 years of experience is somehow better than 10 years of experience? **And how can someone with 10 years of experience not think that the 10 years mean something?** That would take an incredible amount of self-invalidation that is generally not humanly possible. Certainly if one lost a lot of money in the early 70's, then self-invalidating those dues would be even less humanly possible.*

But Paul and Jeffrey, you should be ashamed of your snide and snooty smears on the ages of contributors

*here. You two should have more self-control and self-awareness. **Part of that awareness should be that there are indeed people who can adapt, learn, and apply better than you. Believe it! Time in the market does not qualify you to stand at the top of the mountain,** and pushing others down exposes yourselves and creates an environment where you too will be pushed down. It is all extremely unproductive.*

*And the younger contributors might want to consider not touting their experience, as it will most surely not measure up to some of the older members' experience, and will invite ridicule, whether deserved or not. **Let the arguments, ideas, and strategies stand on their own.** On those, we will be rightly open to attack. But at least the personal angle will not have been introduced.*

*I've appreciated the insights of Senior and Bash when it comes to analysis and strategy points. But the overly confrontational and too-personal tone reflects their surnames too often, is not necessary and is one of the major reasons this thread has been criticized as too clubby. A newbie gets at most two strikes, and I'm sure a few have browsed the thread only to not post because of the personal attack that sometimes greets certain posts. **I will forever remember Paul's welcome message to me - to the thread that I started: "You're a doctor, ipso facto a lousy investor."** What a neat but perfectly ignorant and completely unproductive judgement. Can we keep this stuff to a minimum?"*

Dr. Burry's frustrations go well beyond difficult communication with investors. In October 2006, as his CDS subprime strategy was already underway, spurred by opportunity expectations he tried to launch a specific-purpose hedge fund exclusively dedicated to short mortgages via credit default swaps. The name of this unborn investment vehicle was Milton's Opus. He made this idea public in the Q3 2006 letter to investors, and it was not well received:

TBS: *"He (Burry) couldn't raise money for Milton's Opus. (...) Milton's opus died a quick death."*

This is how he describes the difference between raising money and managing it:

TBS: *"While Capital raising may be a popularity contest, **intelligent investment is quite the opposite.**"*

Scion Capital Fund's activity ended in the second quarter of 2008. Although it performed remarkably in 2007 and did well despite a difficult fourth quarter, Dr. Burry's experience as a money manager left a bitter taste in his mouth. The last two years at the head of Scion Capital where awful, the worst problem being having to deal with a credit default swaps' 'fake market':

TBS: *"The fate of Scion Capital turned on these bets, but that fate was not, in the short run, determined by an open and free market. It was determined by Goldman Sachs, Bank of America and Morgan Stanley, who decided each day whether Mike Burry's credit default swaps had made or lost money. (...) there was no hard evidence what these things were worth – so they were worth whatever Goldman Sachs and Morgan Stanley said they worth. (...) The world's single biggest capital market wasn't a market."*

Dr. Burry tried to buy some securities at prices advertised by Wall Street banks, but more than 90% were unavailable.

TBS: *"When you talk to (negotiation table) dealers, you are getting the view from their (position) book."*

This situation was increasingly stressful because it was putting the Fund's survival in danger:

TBS: *"If the value of the credit default swaps fell by half, Scion registered a mark-to-market loss of 20%. More alarmingly, his credit default swap contracts contained a provision that allowed the big Wall Street firms to cancel their bets with Scion if Scion's assets fell below a certain level. There was suddenly a real risk that that might happen. Most of his investors has agreed to a two-year 'lockup' (...) But of the \$555 million he had under management, \$302 million was eligible to be withdrawn either at the end of 2006 or in the middle of 2007, and investors were lining up to ask for their money back."*

Dr. Burry was put in an extremely difficult position by his counterparts and his investors. He therefore decided to 'side-pocket' the entire CDS subprime trade. 'Side-pocketing' most of your clients' funds obviously is a decision with huge consequences, unlike a typical side-pocket for a small investment that has become indefinitely illiquid.

All the related legal problems and day-to-day pressure made victory bitter. The lack of recognition by his clients, other investors and money managers took its toll on Dr. Burry's

mood. Here are two enlightening quotes from *The Big Short* we could not but reproduce. The first is a statement by Michael Lewis:TBS: *"What had happened was that he had been right, the world had been wrong, and the world hated him for it."*

The second one is a thought by Dr. Burry himself:

TBS: *"Even when it was clear it was a big year and I was proven right, there was no triumph in it. Making money was nothing like I thought it would be."*

But this great trade's 'side-pocketing' was not Dr. Burry's only such instance. With only some of his letters available, we have come across three cases in total and the amount of information we were able to extract on the specifics is limited.

The first case of side-pocketing was Livedoor, a Japanese financial services and internet company that allegedly made fraudulent maneuvers to inflate earnings. In Japan, Livedoor was a national scandal. The stock was delisted and Dr. Burry simply decided to side-pocket the investment.

The other two cases involve companies that were taken private by their controlling shareholders. The first one was Blue Ocean Re, which wound up with some profits. The last one, Symetra Financial was expected to be listed again in the first quarter of 2008 when Dr. Burry decided to end the Scion Value Fund.

3. A few conclusions

Dr. Burry is, from our point of view, one of those investors who have reached the Financial Markets' Hall of Fame. As everyone else in this honorable imaginary room, he has a light and a dark side. We hope that this essay will have shown you what they are.

Dr. Burry's investment philosophy is an extraordinary combination of classical value views with an analytical approach to *free cash flow* valuation, behavioral finance concepts, financial and business cycle tracing and the incorporation of the latest financial innovations.

We have learned a lot going through all this material in an effort to understand Dr. Burry's thinking. As a result, we have incorporated some of it into our investment approach.

We hope this journey has been helpful.

4. Dr. Michael Burry' operations from August 2000 to February 2002

The table below provides a list of all the operations, including shorts, made by Dr. Burry and included in the MSN Money Articles document. As you will see the price of some of them was not available.

Date	Price	Company Name	Ticker	Order
01-Aug-00	\$7,97	Senior Housing Properties	SNH	Buy
02-Aug-00	\$8,49	Paccar	PCAR	Buy
03-Aug-00	\$17,51	Catterpillar	CAT	Buy
03-Aug-00	-	Healtheon	HLTH	Buy
04-Aug-00	-	Clayton Holmes	CMH	Buy
07-Aug-00	\$19,78	Carnival	CCL	Buy
08-Aug-00	\$4,72	Huttig Building Products	HBP	Buy
09-Aug-00	-	Axent Technologies	AXNT	Buy
11-Aug-00	\$4,63	Huttig Building Products	HBP	Buy
12-Aug-00	\$11,63	Healtheon	HLTH	Buy
13-Aug-00	\$24,00	Axent Technologies	AXNT	Buy
14-Aug-00	\$33,75	Pixar Animation Studios	PIXR	Buy
15-Aug-00	\$13,75	Deswell Industries	DSWL	Buy
09-Mar-01	\$14,75	DiamondCluster	DTPI	Buy
09-Mar-01	\$4,75	GTSI Corporation	GTSI	Buy
09-Mar-01	\$0,75	Criimi Mae	CMM	Buy
09-Mar-01	\$10,00	Senior Housing Properties	SNH	Buy
09-Mar-01	\$6,65	London Pacific Group	LDP	Buy
16-Mar-01	\$4,88	GTSI Corporation	GTSI	Buy
16-Mar-01	\$0,80	Criimi Mae	CMM	Buy
16-Mar-01	\$10,10	Senior Housing Properties	SNH	Buy
16-Mar-01	\$5,00	Grubb & Ellis	GBE	Buy
16-Mar-01	\$4,10	Huttig Building Products	HBP	Buy
16-Mar-01	\$3,63	ValueClick	VCLK	Buy
28-Mar-01	\$7,85	Spherion	SFN	Buy
29-Mar-01	\$22,00	Standard Pacific	SPF	Short
29-Mar-01	\$36,50	Adobe	ADBE	Buy
29-Mar-01	-	London Pacific Group	LDP	Sell
29-Mar-01	-	Spherion	SFN	Sell
29-Mar-01	\$4,88	GTSI Corporation	GTSI	Buy
02-Apr-01	\$3,03	ValueClick	VCLK	Buy
12-Apr-01	-	DiamondCluster	DTPI	Sell
12-Apr-01	-	Criimi Mae	CMM	Sell
12-Apr-01	-	Kohl's	KSS	Short
13-Apr-01	-	General Electric	GE	Short
13-Apr-01	-	Krispy Kreme	KREM	Short
13-Apr-01	\$11,00	Delphi Automotive	DPH	Buy

Date	Price	Company Name	Ticker	Order
25-Apr-01	\$16,25	Standard Pacific	SPF	Cover Short
25-Apr-01	\$16,50	American Physicians Capital	ACAP	Buy
25-Apr-01	\$15,15	IBP inc	IBP	Buy
27-Apr-01	\$46,00	Krispy Kreme	KREM	Stop Buy
27-Apr-01	\$22,00	Standard Pacific	SPF	Stop Buy
27-Apr-01	\$62,00	Kohl's	KSS	Stop Buy
27-Apr-01	\$51,00	General Electric	GE	Stop Buy
27-Apr-01	\$4,00	ValueClick	VCLK	Sell
23-May-01	\$16,40	Wellsford Real Properties	WRP	Buy
30-May-01	\$3,20	ValueClick	VCLK	Sell
30-May-01	\$16,45	Wellsford Real Properties	WRP	Buy
13-Jun-01	\$20,40	American Physicians Capital	ACAP	Sell
13-Jun-01	\$9,00	Cascade Corporation	CAE	Buy
13-Jun-01	\$16,45	Wellsford Real Properties	WRP	Buy
20-Jun-01	-	IBP inc	IBP	Sell
22-Jun-01	\$6,25	Grubb & Ellis	GBE	Sell
10-Aug-01	\$8,80	Mesaba Holdings	MAIR	Buy
28-Dec-01	\$29,50	Magma Design Automotaton	LAVA	Short
08-Feb-02	\$12,70	Elan	ELN	Buy
08-Feb-02	\$36,25	kindred Healthcare	KIND	Buy
08-Feb-02	\$8,50	Industrias Bachoco	IBA	Buy
08-Feb-02	\$25,00	Magma Design Automotaton	LAVA	Short
15-Feb-02	\$46,00	Reuters Group	RTRSY	Buy
15-Feb-02	\$6,75	National Services Industries	NSI	Buy
15-Feb-02	\$13,25	Elan	ELN	Buy
15-Feb-02	\$22,50	Magma Design Automotaton	LAVA	Short
18-Feb-02	-	Elan	ELN	Sell
18-Feb-02	\$22,00	Magma Design Automotaton	LAVA	Short
18-Feb-02	\$6,85	National Services Industries	NSI	Buy
20-Feb-02	\$42,00	Reuters Group	RTRSY	Buy
20-Feb-02	\$40,00	Reuters Group	RTRSY	Buy
20-Feb-02	\$38,00	Reuters Group	RTRSY	Buy
20-Feb-02	\$7,00	National Services Industries	NSI	Buy
20-Feb-02	\$26,75	Canadian Natural Resources	CED	Buy
25-Feb-02	\$9,00	Industrias Bachoco	IBA	Buy
25-Feb-02	\$9,00	Magma Design Automotaton	LAVA	Cover Short
25-Feb-02	-	Reuters Group	RTRSY	Cancel

Why is investing in agriculture not just about money?

Among the things that caught our attention, Dr. Burry's latest bet in agriculture as an indirect investment in water stands out. Some time ago, as we were looking for businesses to diversify our portfolio¹⁵ we discovered the world of agricultural public companies. We found it so fascinating that we spent the following months getting to know it better, reading and researching it extensively and eventually deciding to create a fund exclusively dedicated to investing in agricultural and water companies. We were happy to discover that our investment theory was in agreement with Dr. Burry's. In a recent interview¹⁶, Dr. Burry himself explains the idea clearly:

*"Fundamentally, I started looking at investments in water about 15 years ago. Fresh, clean water cannot be taken for granted. (...) **What became clear to me is that food is the way to invest in water.** That is, grow food in water-rich areas and transport it for sale in water-poor areas. This is the method for redistributing water that is least contentious, and ultimately it can be profitable, which will ensure that this redistribution is sustainable."*

We have invested up to 20% of the fund in water-oriented companies. We believe that water also is an important part of the agriculture industry. In addition, none of the existing European agriculture funds included water companies in their portfolios, which is essential for us.

The agriculture industry is among the most largely overlooked by the financial industry, which is odd given that financial services originally emerged to address the needs of agriculture. There are references to early forms of future contracts for agricultural trades Aristotle's *Politics*¹⁷, and banks -- originally sacred Babylonian temples -- started out as storage facilities for crops during winter and times of drought.

With the birth of cities and the industrial revolutions (1760 and 1840), finance started to disconnect from agriculture to focus on the latest, highly disruptive, industrial innovations. The agriculture industry is poised to face massive challenges in the coming decades with unstoppable growth in food demand on the one hand and strong restrictions on the supply side on the other. The industry needs heavy investment in production and research and financing will be key in helping it achieve a new state of affairs. We aim to funnel a growing share of savings into research, production

improvements, storage and transport for the agricultural and water industries. **We also want to retrieve and strengthen the connection between the financial and agricultural industries.** Dr. Burry bet on agriculture as a very long term investment, and these are some of our reasons for going into it.

By 2050, world population is expected to have an extra 2 billion people. This increase will almost entirely be accounted for by Asia and Africa. The United Nations estimates world population to reach 9.6 billion in a best case scenario. We are certain that global growth of the middle classes will contribute to an agricultural, water and food revolution.

In the past 50 years, the world's overall life expectancy has gone up by more than 30%. The Asian economic revolution has been driven by improved diets, hygiene and medical progress. In that time, Asia's standard of living has improved to reach Western levels. It is estimated that China's calorie intake per capita has the potential of increasing about 74% (assuming > \$27,000 per capita income in 2040). Per capita protein consumption in India is on the same track as China's. A second wave of growth in demand for agricultural products is expected.

In that same period of time, the global number of cultivated hectares per capita has been halved. This ratio explains the need for continued improvements in agricultural productivity. Advances in chemical fertilizers, pesticides and irrigation contribute to increasing productivity per hectare.

Today, there are about 1,420 million hectares of arable land in the world, just 11% more than in 1960. Meanwhile, world population has increased by a factor of 2.4. High agricultural productivity in the 70's and 80's has helped respond to the sharp increase in world population. Currently, the increase in global crop yield is estimated at between 0% and 1%.

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¹⁵ The members of the Panda team have over 25 years of experience in financial markets and as mutual fund managers.

¹⁶ Pressler, J. *Michael Burry, Real-Life Market Genius from The Big Short, Thinks Another Financial Crisis Is Looming*. New York Magazine, Online edition, 28 December 2015.

<http://nymag.com/daily/intelligencer/2015/12/big-short-genius-says-another-crisis-is-coming.html>

¹⁷ Poitras, G. *The Early History of Option Contracts*. Faculty of Business Administration, Simon Fraser University, September 2008.