



Abhay Deshpande
Portfolio Manager
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Intrinsic Value & Margin of Safety

We are long-term, bottom-up investors, whose responsibility is to help our clients maintain and build their wealth. At the same time, we know that our shareholders are not 40 or 50 years old any more. Our typical client is in or approaching retirement, and these people can't afford 50% draw-downs. Maybe they could have afforded that a few years ago, but going forward, it will be much more difficult as the population ages and our client base ages. It's important for us to not only have an eye on trying to build wealth for our clients, but to try, as much as possible, to preserve wealth and that is one of our primary goals.

So, you invest with us to take risks, which we do. Therefore, you should expect a return that is greater than you would receive in a money market fund, over time, which given that rate is zero, sets a pretty low benchmark. With our efforts focused on minimizing permanent impairment of capital, we also do not promise to make you the most amount of money in any short period of time. You have seen that in our results. Look at the late '90s where we lagged and we were punished for it, but as Jean-Marie said famously back then, in that lagging period we did not change what we did or how we approached investing. In fact, he said, "I'd rather lose half my shareholders than half of my shareholders' money." We did lose half our shareholders; we did not lose half our shareholders' money.

In 2006 we also experienced a period of lagging. But for each period in which we lag, I think we make up for it over time. We've eventually been right. That is the expectation we hope you have. We are not meant to keep up or beat an index in any given period of time, but hopefully, over the long term, over multi-cycle periods, we can provide you with a very attractive risk-adjusted rate of return and help your clients meet their own goals, over time.

A great part of our jobs is the day-to-day act of analyzing businesses. That is what we do. That is what we spend 99% of our time doing. It's fun. It's rewarding. It's challenging. One thing we especially enjoy doing is visiting with the companies we invest in. It is the opportunity to connect the dots between what you may see on a piece of paper and what it is that may make them unique or special. While most of the analysis is done from the 44th floor of a tower in Manhattan, there's only so much you can learn reading an annual report or modeling things on a spreadsheet. So, we spend a lot of time on the ground. Matt Lamphier, Al Barr, both Senior Analysts, and I were in Japan recently, and one of the things we like to do is take factory tours. So Al and I visited a company called **Shimano**. Shimano makes bicycle parts, specifically derailleurs, the most important part of a bike. Shimano has about a 50% to 70% market share of all derailleurs. They also make bike brakes, gears, frames and they make fishing reels, which is about a quarter of their business. It's a great business: on paper, they generate a very attractive rate of return. They generate incrementally more profit and cash flow every year on a declining capital base. It's the very definition of a good business. It requires very little capital to run it and every year they have a pretty stable market share. There are, at times, inroads from a competitor, but somehow they maintain the market share, the cost structure and the profitability of that business. On paper it looks great, but for us to understand it and be really comfortable with it, it's always good to go see how they do what they do. The factory tour is a great way to do that. When we're at the factory, we can connect the dots between the financial statement and their operations. You get a sense of how their very singular focus on a core business over a long period of time has generated outsized returns, an increasing competitive advantage vis-à-vis their competitors and also a very cost-efficient structure that they have stayed with over time. I think one of the most important characteristics for them, is that they recognized that they were good at one thing and they did that one thing better than anybody else.

A while back I visited **Lindt**, a chocolate company. When Jean-Marie originally bought it, it was run by a guy named Rudy Sprungli, who was the grandson of the founder of the business. It was a quirky little company. I heard stories of the board room being infiltrated by some cult and all kinds of random, wacky stories. But the stock traded at a very low price and, at the same time, despite all the management distractions, they had a very stable market share, especially in their core market of Switzerland. There's something about the chocolate, that people liked. I started as an analyst with the Global Value Team in



2000 and, at that time, I took over the Lindt position and became perhaps even more impressed with the business and we became the largest shareholder. We owned almost 7% or 8% of the business.

I took a trip out to the factory and, again, on paper, they had good margins, decent returns on capital, a growth business and they allocated capital wisely. I thought, "Why are people willing to pay this much more for premium chocolate?" As I was let into the factory I felt like I was in the story of *Abbey and the Chocolate Factory*. I was the first person in ten years allowed into the chocolate factory. Finally, I could connect the dots between what makes this a great company and why the chocolate is so great. That is essentially what makes it a great company. Rudy Sprungli's grandfather invented a process called conching. Conching is, very simply, the process of a vat turning around and around in circles. They place the raw ingredients for chocolate (cocoa butter, sugar, a little bit of milk solids) and this churning process, conching, is done over a period of 18 hours. Slowly and methodically it agitates the particles and creates just a little bit of friction, just enough to create a very, very smooth texture. It is that time that is required to make the best chocolate in the world. You cannot hurry that process along. If you taste Cadbury's or Hershey's chocolate bar and then have a Lindt dark chocolate bar, you will immediately notice the difference. No grittiness, it's perfectly smooth and that's why they can charge a premium for it. Without my being there on the ground and understanding what makes the chocolate business so special, it would be hard to complete that analysis. The factory tours are always great.

It's an example of what makes a business a great business. They identified something they were good at. They stuck with it and have fortified their market position. They found growth opportunities in their core business and they continued, organically, to pursue those opportunities.

Looking at the subject of long term investing, people are a little upset that buy and hold hasn't worked for the last ten years. If you bought in 1999, your annualized return is at approximately minus 2% for ten years. But the buy and hold approach over the long term is wholly dependent on the price that you pay for something. If you bought **Cisco** at 100 times earnings in 1999, over the long term, you will lose money. If you bought **3M** at eight times earnings, with a 4% dividend yield over ten years, there's a high degree of likelihood that you'll make money over the long term. But it all depends on what you pay. Buy and hold is not dead.

We owned a company that Jean-Marie bought a few weeks after the '87 crash, called **Shaw Brothers**, a broadcast business. Shaw Brothers is a Hong-Kong-based company that was run, managed and owned by a man named Sir Run Run Shaw. In 1987, Run Run Shaw had just turned 78 years old and the stock was trading at a 50% discount to its NAV. Jean-Marie believed, it's at a 50% discount to its NAV, Shaw is 78 and he's probably going to do some estate planning at some point, so maybe they'll have to wind up this vehicle. We can capture the arbitrage opportunity at that point. But he was also told, which was discouraging at the time, that there were no investors in Hong Kong, that they are all day traders and you're never going to get that money back. Well, for the next 13 years nothing happened. I started in 2000, and just like Lindt, I took over this business as an analyst and became very enthused and probably did a lot of the same things that Jean-Marie and his analysts did earlier, which was to try to get the CFO to fix the arbitrage. Let's say the value was \$15 for example, then the CFO would offer us a \$12 or \$13 price for it, which in our opinion was too low. The next year we'd have the same discussion, they'd try to take it over from us. We'd say, "No, it's too low." Finally, we stopped talking about it. But in December of last year, 22 years after Jean-Marie first bought it and ten years after I started following it, the CFO called and said, "I want to have a conversation." So we set up a conference call. He said, "Here's our offer. We're offering you \$12 a share for Shaw Brothers, which, at the time, was trading at maybe \$6 or \$7." I responded with, "No, \$13.35. We've been through this before. Here's our price, don't offer any less." An hour later, he called back and said, "You've got a deal, \$13.35." It turns out Sir Run Run Shaw, who was 78 in 1987, had turned 100 and he was moving to Singapore to do some estate planning.

There are a lot of lessons here. One is that, over the 22-year holding period the stock that Jean-Marie purchased annualized at a rate of 17%. The S&P annualized at mid-single-digits. Another interesting lesson is that within that 22-year period we had the bubble in 1993 followed by a bear market in 1994 in Hong Kong, another bubble going into '97, the Asian crisis in 1998, the handover of the entire country from an democratic nation to a Communist one in 1996, 1997, a roughly eight-year decline in house prices starting in 1996, the dot com crisis and the latest financial upheaval around the world. During that whole 22-year period, the management at Shaw Brothers was only fixated on how to make their business better, how to



improve their competitive advantage, how to increase the value of their business and, sure enough, almost mechanically, year after year, the intrinsic value of that business would go up. Despite everything that happened from a top-down macro perspective that would have potentially shaken us out of that position, the right thing to do was to keep your eye on the fundamentals of that business and to make sure that if you own it at a price that's below its intrinsic value, to hold on to your investment. Those are our very principles.

I'm not so conceited as to compare ourselves to those three companies, but there are some similarities between us and each of them. We stick with what we know. We have a long term orientation and we continuously learn how to improve. We're pretty simple. We take our cue from Ben Graham. He wrote a great book called, "The Intelligent Investor." It's the bible for value investors. Notice the name of the book is not "Value Investor," it's "The Intelligent Investor." It's a clue perhaps that value investing is, at its heart, all about common sense investing. In particular, there are two chapters, the same chapters that Buffett talked about. One is Chapter 8 called, "The Investor and Market Fluctuations" and Chapter 20 is called "Margin of Safety." The first chapter I mentioned deals with the concept of intrinsic value. Intrinsic value being what a knowledgeable buyer would pay for a business in its entirety in cash. To put it simply, if you're out shopping for an antique cabinet, how do you know that the dealer's price is the right price? You don't know unless you go see the prices for similar cabinets at other stores or what you think other people have paid for similar cabinets in the past. You get a sense of what the true value is. If that cabinet is worth \$1,000, and you see it at a store for \$995, maybe it doesn't represent such a good deal for you. If you see it priced at a dealer for \$800 or \$700 or \$600, maybe that is a better deal for you. Why do you think it's a better deal; because, you might have been wrong in your analysis. You want to buy it at a price lower than what you think it's worth. That is your margin of safety. So when we buy a security, not only do we try to determine what the intrinsic value is, but we try to buy it at a low price versus its value, at a great margin of safety.

And finally, to those very simple concepts that Graham introduced to us and Buffett developed and Jean-Marie applied on an international stage, we've layered our own sort of attentiveness to loss avoidance. Buffett said it best when he said that the two most important rules to investing are, "Rule number one, don't lose money. Rule number two, see rule number one." When he said "lose money," he didn't mean you buy a stock at \$20 and it goes to \$15. He means if you buy a stock at \$20 and you later find out it's only worth \$15, that's what is to be avoided at all costs. We spend our time avoiding very aggressive management teams, bad balance sheets and bad business models. Sometimes that's easy to identify. A bad business model may be a newspaper company. Sometimes frauds are presented to you by management in an annual report. A great example of not fraud, nor a bad business, but a bad balance sheet, is **Lehman Brothers**. If you read page four of the 2007 Lehman Brothers annual report - that's the thing about these blow-ups, you get a clue on page four, you don't even have to go to the financial statements - Lehman has a chart called "Total Capital." There's a bar chart that shows increasing lines that are going higher at increasing rates implying that total capital is increasing at an exponential rate. The caption says, "Total capital is equal to shareholders' equity plus total debt." And then it reads, "We believe that total capital is useful to investors as a measure of our financial strength." Think about the absurdity of that statement: the more debt we have, the stronger we are.

Enron's 2000 Annual Report, on page four - there's something about page four - reads, "We have stretched ourselves beyond our imagination." Foreshadowing what would happen nine months later. Then on page five, they talk about their market opportunities, energy derivatives, trading. Now keep in mind, five years before, this was a utility company. Now they're saying, five years later, that their market opportunities total \$4.5 trillion, and that's when trillions meant something. That was 60% of GDP at that time. Management is telling you, with a straight face, not only have they stretched themselves beyond imagination, but that their business, which was a utility five years before, was now going to grow into 60% of U.S. GDP. That's just fascinating. Beyond that, it just takes a little bit of a jaded eye to have some cynicism when you reach the financial statements.

So, keeping our eye on capital preservation and on the long term, that is our secret sauce. It's really not that complicated. We are, in the end, rather simple as Ben Graham cautioned, it's all about common sense.



Average Annual Returns as of 06/30/2010	Year to Date	1 Year	5 Years	10 Years	Expense Ratio
First Eagle Global Fund - Class A (w/o sales charge)(SGENX)	-1.43%	15.39%	7.25%	11.94%	1.19%
First Eagle Global Fund - Class A(w/sales charge)(SGENX)	-6.35	9.62	6.16	11.36	
First Eagle Overseas Fund - Class A (w/o sales charge)(SGOVX)	0.15	14.69	7.46	11.91	1.20%
First Eagle Overseas Fund - Class A (w/sales charge)(SGOVX)	-4.85	8.95	6.37	11.34	
First Eagle Gold Fund - Class A (w/o sales charge)(SGGDGX)	10.07	33.21	21.14	24.16	1.26%
First Eagle Gold Fund - Class A (w/sales charge)(SGGDGX)	4.57	26.55	19.90	23.52	

	Year to Date	1 Year	5 Years	Inception 09/04/01	Expense Ratio
First Eagle U.S. Value Fund - Class A (w/o sales charge)(FEVAX)	-2.29%	13.95%	3.85%	8.26%	1.26%
First Eagle U.S. Value Fund - Class A (w/sales charge)(FEVAX)	-7.18	8.25	2.79	7.63	

The performance data quoted herein represents past performance and does not guarantee future results. Market volatility can dramatically impact the fund's short term performance. Current performance may be lower or higher than figures shown. The investment return and principal value will fluctuate so that an investor's shares, when redeemed may be worth more or less than their original cost. Past performance data through the most recent month end is available at firsteaglefunds.com or by calling 800.334.2143. The average annual returns for Class A Shares "with sales charge" of First Eagle Global, Overseas, Gold and U.S. Value Funds reflect the maximum sales charge of 5.00%.

There are risks associated with investing in funds that invest in securities of foreign countries, such as erratic market conditions, economic and political instability and fluctuations in currency exchange rates. Funds whose investments are concentrated in a specific industry or sector may be subject to a higher degree of risk than funds whose investments are diversified and may not be suitable for all investors. Investment in gold and gold related investment presents certain risks, and returns on gold related investments have traditionally been more volatile than investments in broader equity or debt markets. The holdings mentioned herein represent the following percentage of the total net assets of the First Eagle Global Fund as of June 30, 2010: Shimano Inc. 1.46%, Lindt & Sprungli AG 0.66%, Cadbury 0.00%, Hershey Co. 0.00%, 3M Co. 1.39%, Shaw Brothers 0.00%, Lehman Brothers Holdings Inc. 0.00%, Enron 0.00%. The portfolio is actively managed and holdings can change at any time. Current and future portfolio holdings are subject to risk.

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