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Intrinsic Value & Margin of Safety

First let me begin by saying that Matt is truly an extraordinary partner in this endeavor. There are many transitions that could have happened, but we got the best transition possible when we were trying to find the right person to head the Global Value Team. To find good characters, to find people who, as Matt was talking about in his speech, can actually say, 'Maybe I'm wrong, maybe the analyst is right,' or maybe, 'Something has changed and I'm not committed to this security just because I found it. I'm able to change my mind and do what's best for ultimately our clients, not for us.' And, we are shareholders as well so it's very important that you understand that we are invested alongside of you.

The intrinsic value and the margin of safety concepts embody our approach to investing. And, I recognize that many of your questions are about the dollar, government debt, pensions, and there are a lot of topics the media talks about everyday. We have obviously thought about these topics very deeply, but as Peter Lynch said years ago, 'If you spend ten minutes on macro, you've wasted nine minutes.' What we do is bottom-up in nature. We're investors, we buy securities. Stocks, bonds, you name it. We have a potential hedge against uncertainty in the form of gold.

But we have, in our veins, a commitment to securities analysis and the concept of intrinsic value. So, what is intrinsic value? First of all, we're value investors, but the term itself is actually kind of nonsense. No one wants to buy something for more than they think it's worth. And the value investing school was founded by Ben Graham. Ben Graham wrote the great book, *Intelligent Investor*. It is the Bible for value investors. And you'll note that the Bible for value investors is not called *Value Investor*, it's called *Intelligent Investor* which is a clue that intelligent investing is common sense investing.

If we just to refer to it as 'value investing,' it's a school of thought that's been applied to a variety of different approaches ranging from that of Ben Graham himself, who was a very statistically oriented investor, to Bruce Greenwald, who has inherited the chair of Ben Graham at Columbia University.

But there's that school and there's another school that was developed by Munger and Buffett at Berkshire Hathaway, which is based on investing in franchise, high-quality businesses. In a sense value investing is a spectrum between quantitative and qualitative. Quantitative meaning you can buy a stock for less than book value, less than net assets and you can just look at a balance sheet. On the qualitative side, you have the Buffett-type of companies. So, on the one hand may be a boiler company in Japan who's worth the net assets of the business and on the other hand may be Coca-Cola, which is not worth the net assets of the business. The net assets don't capture the huge intangible value that's been created, the franchise [Coca-Cola] that's been created over a long period of time. So in a sense, the real value of our analysts is in their ability to identify and correctly value the qualitative elements of a business. That's what separates good from average analysts.

There's a spectrum from quantitative to qualitative. The discounts that we would pay would vary depending on what kind of company we are analyzing. A statistical Ben Graham-type company typically has an intrinsic value that does not grow over time. In that case, if we buy it at \$0.60 on the dollar, we're going to sell it at \$0.90 or \$1.00 on the dollar. In a good business, a Buffett-type of business, there is sometimes value in the growth of the intrinsic value itself. There's value in the franchise, there's value in the duration of the business.



Let's say I am considering buying Scotch tape and let's say that earnings were down 30% this year because there is a recession, but I know that it has an 80% market share, there's no technological advances going on and there's no real competitive threat on the horizon and no one is more cost competitive than they are with that product.. Now, what if earnings are down 30% next year? Do I care about next year or do I care about the other 80 years that business is going to be around? A high-quality business, typically, we're not going to spend too much time on the cyclical nature of earnings but mostly on the earnings power, the duration of the franchise and, of course, the margin of safety, when you require less of a margin of safety because intrinsic values are growing over time.

Margin of safety, what do I mean by that? Our primary focus over the years has not been making money; it's been trying not to lose money. I think anyone invested in the stock market over the years can make money just by being there. The key, and it's been sort of crystallized for many people the last few years, the key is avoidance of loss. And it's why Buffett says, 'Rule number one, don't lose money. And rule number two, see rule number one.' When he says 'lose money,' he doesn't mean you buy a stock at \$15 and it goes to \$10. He says if you buy a stock at \$15 that you later find out is worth \$10, that's a permanent capital loss. Our goal number one is to attempt to avoid the permanent loss of capital.

And I've learned the hard way how to lose money, as have Matt and Jean-Marie. I think what separates us from others is that we don't mind learning from those mistakes. We'd much rather learn from someone else's mistakes, but we do learn and we incorporate those lessons. I think over the years, our lessons and those of others have boiled down to sort of three or four real key lessons.

One, never pay too high a price, that's obvious. But two, you're going to have an eventual permanent loss of capital in a company that's highly leveraged with a really aggressive management team or where the business model itself is eroding. The lesson of leverage we learned ourselves in 2000, 2001. We were able to apply those lessons to the financial crisis here. When we looked at Lehman Brothers or Fannie Mae and we saw a stock trading at 50% of book value, we're not looking at the statistical cheapness of the stock. We're looking at the overhang of debt that's above us and the quality of assets on the balance sheet that may become impaired, thus endangering that discount that we have there.

A great example of that is Lehman Brothers itself. The stock traded, at one point, for \$0.50 on the dollar book value, but a mere 3% or 4% change in the value of the assets would wipe out the equity value because there was so much leverage. They are also a good example of aggressive management teams. A great line out of the 2007 Annual Report, which was released March of '08, which was six months before they filed for bankruptcy, on page four, there's a column on the left-hand side with a graph. The top of the graph says, 'Total Capital,' and it shows an increasing progression of total capital. Whatever they're measuring was growing and they're proud of this. 'Total Capital Equals Shareholders' Equity Plus Long-Term Debt' it says. Then it says, 'We believe that total capital is useful as a measure of our financial strength.' If they are trying to say that equity is a small piece of the total capital, what they've essentially told you is, 'The more debt we have, the stronger we are.' That's a window into management.

Or, to go back a little bit further, Enron in 2000. Page four of their Annual Report, 'We've stretched ourselves beyond our own imagination.' And, on page five they talk about their market opportunities; Totals \$5 trillion, that's 50% of U.S. GDP back then. This is a company that five years prior was a utility and they're telling you they're going to grow to 50% of U.S. GDP. It's right there, you can still pull it up and look at it. It doesn't take much; it doesn't even take financial analysis to sometimes determine whether a management team is perhaps a little too aggressive.



So between these three or four principals, don't pay a high price, watch out for leveraged businesses, watch out for aggressively managed companies, watch out for eroding business models like media companies a few years ago, by being attentive to those things, you, or we, have been, so far, able to avoid the big risks in the marketplace. It's been a difficult last couple of years since Matt and I took the reins. One thing we're proud of is that the loss that you suffered, that your shareholders suffered, and we're shareholders as well, in the Global Fund have been recovered. Our Global Fund is at its high water mark. So \$10,000 invested with us at the peak [of the market] is now worth \$10,000 again. Unfortunately, \$10,000 invested in many index funds still have another 20% to 100% to go. So, I feel like the idea that we focus on, avoiding permanent capital loss, is the right thing to do. Over time, the key to winning is to not lose, and I think we've done that the last couple of years.

So in practice, what do we do? We establish an intrinsic value of a company, particularly one that we feel is unlikely to suffer a permanent impairment of the intrinsic value. And we buy it at an adequate discount that gives us some measure of risk control and gives us a potential return that hopefully we can give to you in a reasonable period of time.

Finally, because there have been several questions and concerns related to the macro environment, U.S. debt, your communities cutting back services, the role of unions' pension plans, the healthcare legislation, what's going on in Washington, etc., there's a lot of concern about these top-level issues. Sometimes it's a lot of noise. The economy is just a bunch of people doing stuff in productive ways and moving forward. A lot of the noise that's at the edge, the media picks on it because it sells.

But let me give you a little story about a company that we own in Hong Kong. And talk about long term. (Last year we had 8% turnover.) This year, early last year, we sold a company that we had held for 22 years. Jean-Marie had bought a business called Shaw Brothers in the week or two after the '87 crash. It's a holding company, whose main asset is a company called Television Broadcasts, which is a publicly-listed company in Hong Kong. It's the number one broadcaster in Hong Kong. So Jean-Marie bought this at say \$0.40, \$0.50 on the dollar and the main guy who ran it owned 75% of it and he was 78 years old, Sir Run Run Shaw. Jean-Marie thought, 'Well the guy is 78, he's going to retire at some point. He'll just do some estate planning. We'll capture that discount.' This was 1987. Thirteen years later, I start as an analyst and I notice this peculiar security and I get excited just as he probably did back then, and went on the same exercise as he and his analysts probably did back then. I said to the CFO, 'Let's get something together.' I was 30 years old back then, had all these fancy models and gave it to him. And he said, 'Well sure, I'm willing to listen. Here's the price.' And it was 20%, 30% below what we thought it was worth. I said, 'No way.'

He'd come back again, and always offer a discount. Finally we stopped talking about it. He was a nice guy, we kept on talking about the business, but we just put that to the side. So by that point, of course, the business was humming along. And in late 2008, he calls me and says, 'Can I have a video conference call with you and Jean-Marie? I want to buy your stock from you.' So we're waiting for the low ball bid and he says a number that's within 10% of what we wanted. And I thought, 'Well we still have our principals.' I said, 'No, \$13.35 or nothing. Give me a call in an hour.' And he calls me in a half an hour and basically says, 'You've got a deal.' It turns out the guy that Jean-Marie had hoped would do his retirement planning, Sir Run Run Shaw, has turned 100, he's moving to Singapore, he's going to do some estate planning and they need to get this stock out of our hands. So after 22 years, we finally got our catalyst. So there are several lessons here though regarding what I was commenting on in the focus on macro and so on.

That is, a lot happened to Hong Kong in that 22-year period. They had a bubble and a bust. (And when I talk about a bust, a stock market bust in Hong Kong is not 30% decline, it's a 70% decline.) They had a bubble and a bust in '93/'94, another bubble and a bust accompanying the Asian crisis, another bubble and bust during the



high tech boom and bust and then the most recent environment. During that 22-year period, the entire country changed hands from a Democratic nation to a communist nation and housing prices peaked in 1996 and didn't bottom until 2002. So the six, seven year decline in housing prices sounds kind of familiar. All kinds of bad things happened, and at any time you may have been shaken out of that stock. During that 22-year period we annualized 16.5% on that stock, on that first piece of paper that we bought over 22 years ago. [Compare that to] a single digit return on the S&P 500 Index during that period of time. So what was the right thing to do? Get concerned about the housing crisis or communist turnover? Or was it really to make sure that the business is evolving in a way that suits us investors, that they continue to focus on their core business, that they allocate capital wisely? And most importantly, is the price is below what we think it's worth? That was the right thing to do and that's what we did, and that's how we captured return over that long period of time.

So there's the economy, there's the stock market and there's the bond market. They're not always linked. Sometimes it's best, even in the worst possible environments politically and so forth, to just pay attention to the fundamentals. So that's us.



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	

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