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THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

Investing in Japan and the Far East

MATTHEW MCLENNAN is a Portfolio Manager for the Global, Overseas and U.S. Value Funds and Head of the Global Value Team at First Eagle Funds. Born in Rabaul, Papua New Guinea, he grew up in Queensland, Australia, received his Bachelor of Commerce with first-class honors from the University of Queensland and holds the Chartered Financial Analyst (CFA) designation. He started his career with Queensland Investment Corporation in 1991, where he subsequently managed over one billion dollars in international equity portfolios. In 1994 Mr. McLennan joined Goldman Sachs in Sydney, where he worked for a year before moving to New York to join Goldman Sachs Asset Management's (GSAM) U.S. Value Team as a Small Cap Research Analyst. In 1997 he was appointed Portfolio Manager and at the end of 1998, Senior Portfolio Manager and Co-Portfolio Manager of the U.S. Small Cap and U.S. Mid Cap Value strategies. In 2001 Mr. McLennan co-founded and was named Equity Chief Investment Officer of an investment strategy group for Goldman's private client business and in 2002 became a Managing Director of the firm. In 2003 he moved to London to become Co-Founder of GSAM's Global Equity Partners and Senior Portfolio Manager of a focused global equity portfolio for the firm's private wealth management clients. The portfolio used a value-driven approach with an absolute return focus that emphasized low turnover, downside protection and risk aversion.

TWST: Would you give us an overview of First Eagle Overseas Fund and describe your fund's investment philosophy?

Mr. McLennan: The most important thing to understand about our investment philosophy is that our long term goal is first and foremost to preserve the real purchasing power of our clients' capital, and we do so by and large through the ownership of enduring enterprise, buying businesses that we think are there for the long haul and buying them with a valuation margin of safety. We're very focused on avoiding permanent impairment of capital, that's at the core of our philosophy. We have a great deal of flexibility in that we look across the entire world for opportunities. We're also willing to look across the capital structure. Sometimes we'll make an investment in a high-yielding bond if we think we can get an equity-like return with a more senior position in the capital structure. But the majority of our investments are in businesses that we think are good companies at good prices. We have a long term holding period; we tend to own businesses for five years or more on average. We believe that is a core advantage for us in that our patience is quite different from that of most global investors, and it enables us to take a bit different perspective and to accumulate more knowledge on the businesses that we own.

TWST: If an investor is looking for exposure to the Far East in particular, would your fund be a good vehicle?

Mr. McLennan: Well, it depends why the investor is looking for exposure to the Far East. A number of people I've seen more recently

are interested in the Far East because of the price momentum that they see in markets like India and China. If that were the motivating factor, we may not be the best repository for that capital. We look across the whole of Asia for investment opportunities, but we tend to make those investments where we can find strong market positions and a wide valuation margin of safety. Therefore, we're not necessarily always exposed to the hottest areas of the market, if you will, due to our prudence gene.

TWST: I notice that while you've steered clear of China, Japan accounts for almost a third of your stockholdings. Would you explain your views on the Far East in particular?

Mr. McLennan: I think if you start out with the premise or the goal of trying to preserve real capital and trying to avoid permanent impairment of capital, having a valuation margin of safety is very important. Just when you look at the market level as a whole, Japan trades at 1.2 times book value compared to China, at about 2.6 times book value, and India, over three times book value. When we think about the value of businesses, we think that each business has a tangible component to its valuation, which is what one would pay to replace the capital whether it's factories, whether it's distribution facilities, working capital and the like. And there is an intangible component, which is what you would pay for its brands, its technology, its global distribution and the like. From a big picture standpoint, it seems to me that the value of the intangible capital stock may be higher in Japan, which is a more developed economy, than it is in China and India for the average company, given the more sophisticated brands, the technology that's resident there and the many Japanese companies that have global distribution. Yet we're barely paying a premium to tangible book value for the market as a whole. Japan has been in a two-decade bear market. So when you look at it from that standpoint, you say it's quite plausible you'll find good businesses at good prices with that valuation backdrop. When we look at a place like Japan, we're not betting on the government getting it right, we're not betting on a specific macro scenario. What we're saying is that in a market that's so out of favor, we ought to be able to find good businesses at good prices, which helps us achieve our goals over time.

Highlights

Matthew McLennan is a long term investor in international equities, whose goal is to preserve the real purchasing power of his clients' capital. He does this by identifying businesses that are there for the long haul and buying them with a valuation margin of safety. He is willing to buy into what others consider to be mundane if he can find it at the right price, and he tries to avoid the hottest pockets of high valuation and balance sheet growth. He is cautious on China because he sees higher valuations and dramatic growth in balance sheets. He has made investments in Japan, mainly pharmaceuticals and insurance companies, and he has large gold holdings as a potential hedge for when things go downhill.

TWST: I'd like to delve further into some of these names. But before I do, I couldn't help but notice that gold bullion is your single biggest holding. How long has that been true?

Mr. McLennan: We've held gold for a very long time. Gold has been a feature of the portfolio for well over a decade, and for us gold acts as a potential hedge against any unforeseen breakdown in the world monetary architecture. If you look at the landscape of history over the last century, when there has been a breakdown in faith in the system, gold has typically been quite valuable relative to the value of enterprise. So we see it as a very long-term form of a hedge against any breakdown of the system that we can't predict in advance. If we could predict it in advance, we wouldn't need the gold. So it's not a directional view on the price of gold, but rather it's a potential hedge for us that's very long dated in nature.

TWST: It has worked out very well for you, I'm sure, with gold being at an all-time high. Would you talk about when you may unwind some of that position? Given that gold is at an all-time high, what's your view on using it as a potential hedge now?

Mr. McLennan: Clearly, the events of the past couple of years have exposed some of the fragility in the global financial architecture, whether it was in some of the extreme balance of payment imbalances that we saw, whether it was in the term structure mismatch within the banking sector or the credit mismatch, whether it's the need for the central banks of the advanced economies to resort to unconventional policy measures in order to reflate the system. All of these things have raised questions about the integrity of the fiat money system we work within, and therefore gold as a potential hedge has obviously seen that premium go up during that period of time. It doesn't necessarily mean that it's now at a level where we would not want to own the potential hedge. If we look at the last century of history in the context of the United States, for example, the price of gold per ounce has traveled in a wide range relative to the unit value of the S&P 500. At times of great faith in the system, like the late 1990s, it took you five ounces of gold to buy a unit of the S&P 500; gold was 300, the S&P was 1,500. In the late 1960s, the S&P was about three times the level of the price of gold. But when the confi-

"We're very focused on avoiding permanent impairment of capital, that's at the core of our philosophy. We have a great deal of flexibility in that we look across the entire world for opportunities. We're also willing to look across the capital structure. Sometimes we'll make an investment in a high-yielding bond if we think we can get an equity-like return with a more senior position in the capital structure. But the majority of our investments are in businesses that we think are good companies at good prices."

dence in the financial architecture was low, such the early 1980s or the early 1930s, the price of gold was more than five times the level of S&P. So it was the absolute opposite. Today gold trades roughly at parity with the S&P 500. Now I don't want to make too much of just one valuation measure, but the point being that gold has traveled in the form of a potential hedge in very broad ranges over time. We think that the cost of the premium has gone up, but it's not disproportionate relative to history. What would cause us to sell our gold is perhaps an extreme set of these relativities, with incredibly low equity prices and incredibly high gold prices by historical standards. And that would enable us to convert the gold to the ownership of enduring enterprises on very attractive terms. We're not at that point today, but that would be the set of circumstances in which we would look to convert gold to business. Now, that's just one metric you can also look at gold in terms of its real price, or you can look at gold in terms of its value relative to the monetary stock of either the United States or the world. The point being that the valuation is not as cheap as it was in the late 1990s, no question about it. But it's certainly not at the peaks of what we've seen historically either.

TWST: Let's talk about your single biggest geographical exposure, which is to Japan in your stock portfolio. You have mentioned that you're not placing political bets, but there has been a historic change in the government of Japan recently, with a 50-year party in power being turned out. Does this change in government make any difference to your view on the country?

Mr. McLennan: We tend to be wary of making market views based upon political developments for the simple reason that the socio-political system is a very complex system in any market economy. There are pluses and minuses to the change in Japan. I think on the plus side, it is a landmark change in the political structure, and that could have some positive implications. You're essentially shaking up the political snow globe as it were. We're moving towards a more genuine two-party system in Japan. A more vigorous policy debate between two legitimate parties could actually be a more beneficial sort of secular backdrop for a democracy like Japan. I think it's fair to say that the Democratic Party of Japan (DPJ) also supports certain constituencies that may have been under-represented in the past and more reflective of an urban diverse culture of Japan. And the DPJ is also placing emphasis on important service sectors in the economy. Ultimately, we think a more balanced Japan long term is a Japan that has bigger services sector relative to its manufacturing sector. On the flip side, when a party comes into power, it obviously makes promises on entitlements and the like, and it has had to make those promises at a time when the fiscal position of Japan is under some degree of pressure. And so the second order implication of those promises is that Japan's medium-term fiscal consolidation may become more challenging for the economy to absorb. There are pluses and minuses. That's why it's so difficult to divine a specific outcome from the evolution of the political parties. For us, our investment in Japan therefore is more a reflection of the bottom-up, which businesses we have been able to find and at what prices, as opposed to us thinking we have a crystal ball that can predict exactly how the political landscape is going to play out over the next five or 10 years.

TWST: You seem to like the pharmaceuticals in Japan. What do you like about pharmaceuticals? Would you talk about some of your other holdings there?

Mr. McLennan: I think from a 30,000-foot perspective, if you're looking at our holdings in Japan as a whole, you really have to break them into two clusters. One would be more traditional, Ben Graham-style investments, which are businesses that may not actually be growing in intrinsic value a lot, but where the businesses are cheap relative to the runoff value of the existing cash flows. The other class of investments that we would have would be more of the sort of Buffett-style royalty businesses that we think are businesses that are relevant franchises to the world of tomorrow, that therefore may see growth in intrinsic value over time, that trade at attractive multiples of their mid-cycle free cash flow. So we have those two sorts of investments in Japan.

TWST: What are some examples of those two?

Mr. McLennan: Just to link it back to your question on pharmaceuticals, the pharmaceuticals we would think of more in the traditional Ben Graham-style investments. When we make an investment in the pharmaceutical industry, we're not like growth investors betting on the specific success of certain molecules or compounds that exist in the Phase II or Phase III pipeline. Typically we're buying into companies that are cheap on the basis of their existing cash flows. So if you were to look at the companies that we own in Japan in the pharmaceutical sector, like **Astellas** or **Ono**, these businesses trade at very, very low single-digit multiples of their EBITDA before R&D. So that would be the pretax cash flow from the existing drugs that they have on the market, their existing molecules. It's low enough that we think that we're getting the pipeline for negative value. In the case of **Astellas**, they have 18 drugs in Phase II and Phase III; they have strong niches in immunology and urology. So we think we're paying a low enough price relative to the existing cash flows that we get the future for free. In the case of **Astellas**, it also has a 4% or so of dividend yield, and both companies have net cash on the balance sheet. So there is no question of financial liability.

TWST: Where are those companies' markets primarily?

Mr. McLennan: It depends. It's fair to say that **Ono** is a more domestically focused Japanese pharmaceutical company, whereas **Astellas** has a global footprint. This is an important thing to note about a lot

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of our Japanese holdings, that they are often more global franchises. They happen to be listed in Japan, but they've got customers globally, and that comes back to the point about not necessarily betting on the local demographics or political situation, but identifying businesses that we think are relevant to a broader global economy. **Astellas** is certainly a relevant business. It's one of Japan's largest pharmaceutical companies, has a very large domestic sales force, but it has meaningful drugs that are sold globally.

"Astellas has 18 drugs in Phase II and Phase III; they have strong niches in immunology and urology. So we think we're paying a low enough price relative to the existing cash flows that we get the future for free. In the case of Astellas, it also has a 4% or so of dividend yield."

TWST: You're also fairly strong in Japanese financials, insurance and banking. What do you like about this sector?

Mr. McLennan: Mostly on the insurance side, not really on the banking side. But I would say that if you look at the property/casualty insurers in Japan, what we like about those businesses, they too are Ben Graham-style businesses. They are not necessarily growing in intrinsic value that greatly, but they are businesses where there is a lot of asset value relative to the purchase price. These are businesses that are well capitalized. In fact, they have solvency ratios greater than 500% when we look at the regulatory capital requirements. These businesses have a very wide valuation margin of safety. They trade at or below book value, and book value is conservatively stated because of catastrophe reserves. When we look at the business as well, you have a little bit of the same phenomenon that you have seen at Berkshire Hathaway in that you have an underwriting float. What do I mean by that? The businesses are insurance companies. Now often insurance companies make an underwriting loss on their insurance, and they make it up with investment profits and you get an average ROE. In the case of these companies, because the property casualty insurance industry is quite concentrated, they make a profit on their underwriting. So you have as a liability the expected case reserves for the insurance, but if you're making an underwriting profit over time it's like a negative cost liability. The net of all of that means that as an equity holder, you effectively get the economics of the entire investment portfolio and the investment portfolio itself is a multiple of the book equity. So for us it's a situation where we get a lot of asset value per unit of investment. The other thing that's going on here is that the market is consolidating. There are a series of mergers that are going on and have been going on that are really taking this down to a three-player market.

TWST: Are there moats around any of these companies? How open is the Japanese insurance market?

Mr. McLennan: It has historically been very difficult for the foreign players to penetrate this market. The role of distribution has mattered a lot, and that has provided a moat, in addition to which, as the companies are consolidating, the scale position of these companies' processing and IT platforms are quite large relative to what a new incumbent would have. So I'd say the moat, if anything, has gone up, and it has been difficult for other players to penetrate this market.

TWST: Who will be the final three?

Mr. McLennan: You've got **Tokio Marine**, which is the largest player, and there is a three-way merger being planned between **Sumitomo Mitsui**, **Aioi** and **Nissay Dowa**, and then the third player where there is planned merger is **Nippon Kom** and **Sompo**.

TWST: How are you playing that?

Mr. McLennan: We have investments in a range of the different companies that I just listed.

"If we look at China, we're having to pay double-digit multiple of cash flow to get into that market and nearly three times book value. So we would tend to look to invest in these markets at times when business conditions are perceived to be more challenging and valuations are low. We also are very sensitive to the quality of accounting data, and that sort of weighs on our process."

TWST: I'd like to return to what many people who are looking overseas consider to be the hottest area in the world, which is China. Is your view that China is too pricey for your fund?

Mr. McLennan: We do grapple with it. If we look at China, we're having to pay double-digit multiple of cash flow to get into that market and nearly three times book value. If we look at the history of urbanization and industrialization in markets over time, it's rarely been a smooth linear process. Often it's a socially tumultuous process and the business cycles can be quite wild. So we would tend to look to invest in these markets at times when business conditions are perceived to be more challenging and valuations are low. We also are very sensitive to the quality of accounting data, and that sort of weighs on our process. The other thing that's sort of tricky to think about in the case of markets like China and India is that these are markets where there has been a securely high-inflation trend. When we look at developed markets, if we look at market history in the United States, for example, at times when

inflation has been high, valuations have tended to be lower. Yet we're paying a premium valuation for China and India, where monetary growth over the last decade has been mid-teens on a compound basis and where that, if anything, is accelerating at the margin. We're paying high multiples at a time of relatively high inflation potential if we look out over next few years. These are markets that we think present long term opportunity. Clearly there is the rise of the East that's happening here and the opportunity for productivity catch-up is large. But I guess we worry that we'd be paying a lot, given the secular inflation backdrop, to participate in those markets right now.

TWST: Do you use Australia at all to participate in emerging markets?

Mr. McLennan: We haven't; we would obviously be open-minded to investment opportunities there, but Australia also is more a richly valued market than, say, Japan. And the Australian dollar has been very strong as well. So as value investors, we tend to try and identify business that will benefit from the overall economic growth trend in Asia but aren't priced for it. If you look at some of our largest holdings in Japan, we're in a range of investments in companies that own the intellectual property that Asia requires for the factory floor of tomorrow. Whether it's companies like **FANUC** that dominate the robotics industry and CNC servo motors for sophisticated multi-access machining tools, or whether it's companies like **SMC**, which is the world leader in pneumatic devices for advanced machining, or whether it's companies like **KEYENCE**, which is the world leader in electrical sensors. These companies happen to be listed in Japan, but they hold very valuable intellectual property that is going to be useful for Asia as a whole. But they trade at two times book, not three times book.

TWST: Have you been investing in European companies with the same investment theme, for example, German machine tool manufacturers?

Mr. McLennan: We do have some small investments in specialized German companies. That would include businesses like **Pfeiffer-Vacuum** technology, which creates vacuum pump equipment that is used in high-end coating and industrial analysis applications, whether it's making thin film solar or special spectrometers. The applications involve a very specific pressure environment. We own companies like **Tognum** in high-performance diesel engines. So we do own some positions in German industrials. I think beyond that, though, throughout Europe we own a range of companies that happen to be listed in Europe, but they have meaningful footprints in Asia, whether it's companies like **Nestle** in food products, for example, or **Essilor** in eyeglass lenses, where these companies have fairly dominant market positions in a range of Asian markets but aren't priced at the same premium that you may see some of the local companies being priced at.

"Our goal is to preserve clients' wealth long term and then to grow it in real terms. We've found that if we pursue a disciplined underwriting approach, if we only buy good businesses when we can buy them at good prices, or if we find a mundane business to buy at a compelling price, we have been able over the very long term to compound out at a rate of return that has been in excess of the broader markets, but we've had a lower risk of permanent payment of value along the way."

TWST: Would be fair to say that your participation in emerging markets is through primarily developed-market companies?

Mr. McLennan: Often, but not always. We do have a range of direct investments in emerging-market companies around the world. Whether it's silver mines in Mexico or gold mines in South Africa, or tobacco companies in Korea or gaming companies in Malaysia, we have a range of emerging-market investments around the world. The point I'm trying to get across though is that when people get excited about a growth scene from a macro standpoint, they feel they need to own a specific market. But for us, the rubber always meets the road at a micro level: Which businesses do we want to own? Which businesses are well positioned? Which businesses are available at a price point that incorporates a margin of safety?

"We are more cautious on China because we see higher valuations, we see dramatic balance sheet growth, and we see quite a bit of new-era thinking. We're certainly not making a negative market timing call on China, our crystal ball is just too foggy for that, but we are perhaps more prudent than most."

TWST: I take your point, and you've had an excellent year-to-date, an excellent third quarter, a 13.82% return, but you're in fact trailing the index that you use, the Morgan Stanley EAFE Index, fairly significantly. Would you tell us a little about the disparity and where you stand, what your philosophy is on that?

Mr. McLennan: It's important to understand that philosophically we don't try to run our business to the benchmark over the short term. We don't try and target a short term relative return. We're not focused on tracking error. Our goal is to preserve clients' wealth long term and then to grow it in real terms. We've found that if we pursue a disciplined underwriting approach, if we only buy good businesses when we can buy them at good prices, or if we find a mundane business to buy at a compelling price, we have been able over the very long term to compound out at a rate of return that has been in excess of the broader markets, but we've had a lower risk of permanent payment of value along the way. So this year we may have bounced less than some of the markets, but we certainly fell a lot less last year. If a tennis ball falls by half the distance it's going to bounce a little less.

TWST: How did you fare in 2008?

Mr. McLennan: It's fair to say in a year, last year, when markets and many investors were down 40% to 50%, we were down closer to 20% last year. If you're down 20%, you have to be up 25% to be whole. If you're down 50%, you have to be up a 100%. So there are a lot of markets that have rebounded very strongly this year, but when you put 2008 and 2009 together, the picture is less appealing. What we would say is if you look at our performance, you have to put 2008 and 2009 together to get the whole picture, and then you have to compound out the last decade or two to get an even fuller picture.

TWST: Let's wrap up by talking about your target customer. It's a retail customer with a fairly broad long range view, correct?

Mr. McLennan: We have a range of customers, all the way from retail investors to high-net-worth individuals, to institutions and sovereign entities. So we have customers across the board in terms of size of customer. What matters more than the size of the customer is the mindset of the customer. We adopt a very long term patient approach to capital allocation. Our average holding period is five years. So the most important thing for us is a customer that understands that we're allocating capital for the long haul, and we are not trying to zig and zag ahead of every market development. We have a very disciplined approach to allocating capital long term, and we've found that the customers that we live with the longest and we've grown with over time have been those that that really resonates for those who are long term, those who value our prudence, those who realize that in order to preserve their capital long term, they have to be owners of business. But they want to do it in a way that tries to minimize the probability of impairment of capital.

TWST: Are there any movements you've made recently that you are particularly excited about?

Mr. McLennan: We're different from most in that we have a fairly balanced temperament. We don't get too excited about too much. In fact, we tend to worry about things most of the time, and a lot of what we own is a function of what we don't own. One of the reasons that we've had less in places like India and China is not just the valuation, things that we talked about before, but the growth in the monetary stock of those economies. So we've almost backed into what we do own by a process of elimination. So you will hear many investors talking with excitement about the greatest investment they just made. Many of our biggest positions are the sorts of investments that people would look at and say looks decidedly mundane. We like it that way: mundane is beautiful for us, provided we own it at the right price. So what we feel excited about is when we look at the portfolio as a whole, and we look at the quality of the businesses we own as probably on the higher end of the spectrum of where it has been historically. We own these businesses with a valuation margin of safety; we have some deferred purchasing power and cash if markets were to have its little hiccup; we have the gold as a potential hedge. So we feel more excited about the integrity of the overall portfolio rather than a specific individual idea or theme.

TWST: What are you worrying most about, if worrying is part of your job description?

Mr. McLennan: I think I did outline some of these worries for you. If you look at the last few decades of investing that we have done, we were out of Japan in the late 1980s. We were out of Japan because valuations were high, balance sheet growth was aggressive and there was a lot of new-era thinking. We were out of tech in the late 1990s valuations were high, balance sheet growth was very dramatic and there was a lot of new-era thinking. We were out of financials by and large in 2008 for the same reasons.

TWST: Perhaps that's also why you're out of China now?

Mr. McLennan: It's why we are more cautious on China because we see higher valuations, we see dramatic balance sheet growth, and we see quite a bit of new-era thinking. Now one thing I will say that differentiates China from those other examples I just gave you is that each of those markets or sectors came apart after a window of tight policy conditions. Policy around the world is by and large still very easy today. We're certainly not making a negative market timing call on China, our crystal ball is just too foggy for that, but we are perhaps more prudent than most for the reasons that I outlined.

TWST: Do you have anything more you would like to add?

Mr. McLennan: I would just say that you can best understand our positioning by understanding that we approach the goal perhaps differently from most. It is the attempt to preserve capital in real terms over time; it's the focus on avoiding permanent impairment of capital; it's the willingness to buy into what others consider to be mundane if we find it at the right price; and it's trying to avoid those hottest pockets of high valuation and balance sheet growth and new-era thinking that's helped us steer clear of the biggest landmines historically. And we remain committed to that underlying approach.

TWST: Thank you.

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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	

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 and Overseas Funds give effect to the deduction of the maximum sales charge of 5.00%.

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