

Into the Spotlight

Here's a detailed look at how Chip Rewey is managing the difficult task of stepping into the spotlight at a firm whose founder casts a long shadow.

In an effort to ultimately be proven right in his research, Chip Rewey approaches the task in a somewhat counterintuitive way: "We're actively seeking out the data points that would make our case wrong," he says. "If we can disprove those, we're a much stronger-conviction holder. If we can't, we have no business in the stock."

Rewey's success in judging risk and reward recently landed him one of value investing's plum assignments, taking over in June a value equity team managing some \$4 billion in assets for Marty Whitman's Third Avenue Management. Fully in sync with Whitman's tried-and-true investing approach, Rewey is finding opportunity today in such areas as forest products, regional banking, agricultural equipment, and broadcast and cable TV.

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INVESTOR INSIGHT



Chip Rewey
Third Avenue Management

Investment Focus: Seeks companies meeting three criteria: creditworthiness, an ability to compound net asset value, and a share price sharply discounted from a conservative estimate of that asset value.



THE POWER OF ORIGINAL THINKING

THIRD AVENUE MANAGEMENT

Third Avenue Management LLC is a New York-based global asset manager that has adhered to a proven value investment philosophy since its founding in 1986. Third Avenue's disciplined approach seeks to maximize long-term, risk-adjusted returns by focusing on corporate financial stability, and price conscious, opportunistic security selection throughout the capital structure. The firm offers its services to private and institutional clients.

To learn more, please visit us at thirdave.com

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Investor Insight: Chip Rewey

Third Avenue Management's Chip Rewey, Victor Cunningham, Michael Lehmann and Mohammad Tabibian explain why their focus on balance-sheet strength will increasingly matter, how they're processing the decline in oil prices, why they think high market volatility is here to stay, and why they see upside in Weyerhaeuser, AGCO, Comerica and CBS.

Successful investment firms like Third Avenue often promote from within when there's a changing of the guard. Has it been difficult as an outsider stepping in?

Chip Rewey: I had known of Marty Whitman and Third Avenue for a long time prior to coming on board and there was a remarkable overlap in his and the firm's take on value investing and my own. So much so that while I had my personal equity investments in portfolios at my previous firm, I was an early investor when Third Avenue launched its Focused Credit Fund in 2009. I thought who better to take advantage of opportunities in distressed debt than Marty Whitman? The philosophy here remains clear and consistent – it was an easy decision to join.

Describe your take on value investing.

CR: We're in search of companies that combine three main features: creditworthiness, a meaningful discount to a conservatively estimated net asset value [NAV], and the ability to consistently compound that NAV over time. Our mindset is always long-term, with a targeted holding period of three to five years.

The initial focus remains on creditworthiness, which is a broader term for downside protection and a strong balance sheet. That means gaining a deep understanding of the assets and liabilities and how accurately they are rendered, on or off balance sheet. It means assessing the quality of book value, with a focus on retained earnings and on what drives book-value growth over time. We say we're far more willing to risk time than capital.

NAV is our price target, appraising what a company is worth as if we were buying the whole thing. We get at what something is worth in a variety of ways, such as buyout values, discounted-cash-

flow analysis and applying reasonable multiples to relevant current or estimated metrics. I think it's important to use various tools on every idea. When the results converge, it increases our conviction in the work. If there's a disparity, there's room for more research to understand why. There's no minimum required level of discount from the current price, but we typically want to see at least 20-30% discounts at purchase.

The last pillar of the philosophy is an ability to compound NAV. Many value investors are primarily focused on the change underway at a company to close the static discount to NAV. We're all for that, often using what Marty calls "resource conversion" – M&A, spinoffs, asset sales, share buybacks, dividends – as catalysts to realizing value embedded in balance sheets. But we're also looking for business models and management teams capable of generating 10%-plus annual growth in book value per share over time. That's the more difficult analysis, but if you get it right, it keeps you out of companies that lose market share and burn cash. It also gives you another way to make money on top of the static discount going away.

Is distressed investing still on tap?

CR: The Value Fund is the flagship of Third Avenue and is opportunistic, eclectic and can go anywhere. My job is to take the best ideas of the firm, including those in distressed debt, and make sure they're in this fund. At the moment there's just very little in that category that's appropriate. When there is, we'll own it.

To what extent is screening part of your idea-generation process?

CR: We use screens, but not the commodity price/book or price/earnings varieties in isolation. We'll screen for situations



Chip Rewey

New Tricks

When Chip Rewey describes his strategy for the all-cap and small-cap portfolios he took over in June at Third Avenue Management, the language is very similar to that of Third Avenue patriarch and value-investing legend Marty Whitman – with one subtle enhancement. Both Rewey and Whitman emphasize the importance of strong balance sheets and discounted share prices, but there now seems to be increased emphasis as well on such companies also being able to consistently grow their net asset value over time. That emphasis, Rewey says, reflects an evolution in his own thinking over his 23-year career, including ten years at Cramer Rosenthal McGlynn, where prior to joining Third Avenue he co-managed portfolios with roughly \$12 billion of the firm's \$14 billion in assets.

"Marty's 90 and here almost every day," says Rewey. "I put quotes of his on my wall, and the latest from a research meeting in September is all about the ability to grow net asset value being even more important than the discount to estimated net asset value. It's not just about closing the static discount to NAV where you're looking for a one-time gain. Yes, I've made that notion more prominent in my strategy in recent years, but the fact is, so has Marty."

where book value has grown over time and the share price hasn't. Or where margins have declined but book value has continued to grow. Or where book value is up nicely but there's minimal balance-sheet leverage. These types of screens ask the initial questions we explore when researching individual companies.

You've said there are often broader themes behind your idea generation. Can you give a current example or two?

CR: I don't know if anything will come of this, but we're exploring today the "Internet of things," which is the idea that more and more everyday devices will connect to the Internet and send and receive data. Who's involved in that? Who's staking out interesting positions? What will be the second-order effects? We'll work on many more companies than we'll ever own, but this type of research builds up our knowledge base, to draw on when a company misses a quarterly earnings report or hits a down cycle and there might be an opportunity.

More typical is when there's a thematic element in one idea that sparks ideas elsewhere. One key appeal to us of Weyerhaeuser [WY], for example, is its significant and mature timberland acreage in the Pacific Northwest, which should be valued at a premium due to high-value exports to Japan and China. Another key appeal is its strong resource position in Southern pine, commonly used for lumber, which makes it well positioned to benefit from the multiyear recovery in homebuilding we expect in the U.S. as we move back to a more normal level of housing starts.

As we researched the competition, we saw those same dynamics at play in a Canadian company, Canfor [CFP:CN]. It's exposed to the same markets and trends as Weyerhaeuser, and its stock had sold off from the high-\$20s to the low-\$20s over the summer for what we thought were short-term reasons. So we pressed the bet – we have no problem owning similar stocks if we're on to something good. [Note: Canfor shares are back near earlier highs, now trading around C\$29.]

As another example, we own AGCO [AGCO], which makes tractors and other farm equipment. Its shares have been hurt by decreasing farm incomes, particularly in the U.S., which we consider a short-term concern that overshadows the attractive long-term positives in global agriculture. In looking for other beneficiaries of those positives we uncovered Valmont Industries [VMI], the global market-share leader in mechanized irrigation equip-

ON ENERGY:

Our three primary stakes are in producers, focused on oil, with for want of a better phrase, good rocks.

ment. That business clearly benefits from global changes in food demand and the need for improved farm productivity.

At the same time, Valmont also manufactures structures used in utility transmission. There have been short-term pricing pressures, but we think the prospects for utility-infrastructure spending are excellent in North America as the aging electric-power grid is upgraded, power plants burning natural gas rather than coal come online and more renewable power is required to be connected. The company has compounded book value at nearly 16% over the past ten years and we think management and the board are first-rate. When all those attributes combine with a discounted share price, we're interested. [Note: VMI shares now trade around \$130, down from \$160 in June.]

On the subject of themes, how are you processing the decline in oil prices?

CR: We have 11-12% of the Value portfolio in energy right now, consisting of stakes in Total [TOT], Apache [APA] and Devon Energy [DVN]. All are producers, focused on oil, with for want of a better phrase, good rocks. They are in plays with multiyear production inventory that they

can scale at relatively low cost. They've been shedding assets and fortifying their balance sheets. We think they're all well managed and will not only weather this storm, but likely use their balance sheets to acquire strategic properties or companies that encounter financial distress.

As a broader view, we like oil much better than natural gas. Since the ability to export natural gas to global markets is limited, we expect the prolific production growth of shale gas to continue to dwarf demand growth and keep prices restrained. On the other hand, oil reserves will keep getting harder to find and more difficult to extract, meaning the cost of production is going up, meaning the market-clearing oil price is likely to go up. Global oil demand should continue to increase, with growing middle classes around the world becoming more intensive in their energy usage. There will be short-term fluctuations in oil prices – as we're seeing now – but that doesn't diminish our longer-term view.

In response to the oil-price decline, we've formed a working analyst group across all Third Avenue departments to put priority on identifying energy-company equity or debt that has sold off and meets our investment criteria. I don't want to use specific names, but these ideas span producing companies, service companies and even chemical companies that use natural gas as feedstock and sell their finished goods into oil-price-linked markets.

Is bad news often an impetus for looking into an idea?

CR: Yes, but beyond that it's the fact that investors because of pre-conceived notions often won't even look at something having a problem. We try very hard to keep an open, unbiased mind when presented with new information. For instance, in late September we noticed that Standard & Poor's upgraded the debt of General Motors [GM] to investment grade. Instead of dismissing the news out of hand because "everyone knows" GM is a terrible company and has big recall problems, we took a closer look. What

we found was quite different from what the casual observer of the company might expect: the huge net cash position in the automotive unit, the restructured pension, the dramatically reduced breakeven points, the much higher quality cars, the thriving China business. Had we blindly bought into the negative sentiment, we would have missed out on what we consider one of the most attractively valued large caps in the U.S.

Have you made any changes around position sizing or number of holdings?

CR: We have reduced the number of names in the small-cap portfolio to the 60 to 70 range. In the Value fund, the number of names should remain around 35 to 40, with maximum position-size limitations. We'll take position sizes close to this limit only in particularly unique and non-scalable ideas. I don't need to own an 8% position in Weyerhaeuser, say, if I can get the exposure I want by owning Weyerhaeuser and Canfor.

Does that help explain the reduced exposure in the Value fund to long-held Hong Kong holding companies like Wheelock & Co. and Henderson Land?

CR: This was an opportunistic play in which Third Avenue identified unique, undervalued situations that ended up accounting for as much as 40% of the portfolio at times. When I arrived that had already been reduced to around 17% and we have since sold into strength to take that Hong Kong exposure down to 10%. It's highly unlikely that Hong Kong, or any other region outside the U.S., would get to 40% of the portfolio again.

What else has recently come in for selling and why?

CR: We sell for two broad reasons. The happy one is when something is at its sell target or close enough to get bumped by a new idea. That was the case for us fairly recently with Intel [INTC]. Our thesis had been that the market wasn't correctly

understanding the PC-refresh cycle or giving the company enough credit for the forward-looking mobile investments it was making. As positive results seemed to change the market's perception, the stock hit our sell target and we sold.

The other main reason to sell is when our investment case is no longer valid. We have high-conviction reasons for owning something – if those change, we move on. Encana [ECA] would be a recent example,

ON HONG KONG EXPOSURE:

It's highly unlikely that Hong Kong, or any other region outside the U.S., would get to 40% of the portfolio again.

where our view on its ability to compound value going forward changed for the worse. It's heavily exposed to natural gas. It has low-cost assets in the middle of Canada that aren't well served by distribution infrastructure. They talk about getting more into oil, but it wasn't clear how profitably they could do that. The shares were up, so we got out because the upside/downside was no longer interesting.

What is the market missing in AGCO?

Victor Cunningham: AGCO is a pure-play agricultural company dedicated to farm machinery, grain-storage solutions and protein-production equipment. Its top brands include Massey Ferguson, Challenger and Fendt, and its sales footprint is global, with half the business in Europe and most of the rest split evenly between the U.S. and Latin America.

We tend to be attracted to situations with short-term dislocations but long-term secular positives. In AGCO's case, the dislocation is a function of farm incomes in the U.S. coming under pressure from record harvests and falling commodity prices. Declining farm incomes mean lower spending on equipment, which has impacted the company and all of its peers.

While we agree agricultural spending will likely be challenged near-term, the long-term trends remain highly positive. World population and income levels are growing, driving demand for beef and other protein products. As demand for protein grows, demand for agricultural commodities – and the machines to farm them – grows with it.

We also consider AGCO particularly well positioned to weather the current storm and ride the longer-term wave, in large part due to its non-U.S. presence. Farm incomes in Europe have been more stable than those in the U.S. Because American farmers were earlier to invest, potential productivity improvements from new equipment are greater today outside the U.S. than in the U.S. The company also has a vibrant business in grain-storage facilities, providing a counter-cyclical component and one that has excellent growth prospects overseas, where spoilage is a more significant issue.

There's also a self-help story here. The company's operating margins have lagged those of peers, and management has been focused on closing the gap through a number of cost-cutting and capacity-utilization measures. That's more challenging when sales growth is weak, but as the demand picture improves we expect to see incremental margin growth as well.

Now trading at around \$46.50, how are you valuing the shares?

VC: Even if we assume no revenue growth from current levels, we believe the company should earn a minimum 6% EBIT margin, which would translate into just over \$800 million in EBITDA. If we put what we think is a reasonable 7x multiple on that, the operating business is worth \$5.7 billion in enterprise value. Net out debt and add the value of other assets like a finance business and a joint-venture investment with India's Tractor & Farm Equipment, and the enterprise value goes to around \$5.8 billion. That would translate into a \$63 share price.

You wouldn't know it from the current valuation, but the balance sheet is invest-

INVESTMENT SNAPSHOT

AGCO Corp.
(NYSE: AGCO)

Business: Manufacturer and distributor of farm equipment and parts sold through independent dealers under brands Massey Ferguson, Challenger, Fendt, and Valtra.

Share Information
(@12/29/14):

Price	46.41
52-Week Range	41.56 – 59.39
Dividend Yield	1.0%
Market Cap	\$4.27 billion

Financials (TTM):

Revenue	\$10.10 billion
Operating Profit Margin	7.2%
Net Profit Margin	4.7%

Valuation Metrics
(@12/29/14):

	AGCO	S&P 500
P/E (TTM)	9.3	19.7
Forward P/E (Est.)	15.5	17.2
EV/EBITDA (TTM)	5.0	

Largest Institutional Owners
(@9/30/14):

Company	% Owned
SouthernSun Asset Mgmt	6.2%
Fairpointe Capital	5.5%
BlackRock	5.4%
LSV Asset Mgmt	5.4%
Vanguard Group	5.3%

Short Interest (as of 12/15/14):

Shares Short/Float	17.0%
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AGCO PRICE HISTORY**THE BOTTOM LINE**

The company's strong non-U.S. presence positions it well to both weather the current agricultural-spending storm and to ride the longer-term wave, says Victor Cunningham. If management succeeds in improving lagging margins and the market recognizes that success, he believes the shares would trade at \$63, a 37% premium to today's price.

Sources: Company reports, other publicly available information

ment-grade, the business throws off a lot of cash and the value growth over time has been excellent, with tangible book value increasing 4x in 10 years. With a \$4.3 billion market cap on a company doing \$10 billion in sales, we don't need a lot of things to go right in order to get paid.

How do you handicap rumors that Tractor & Farm Equipment, Ltd. [TAFE] is a potential AGCO suitor?

VC: TAFE has been buying shares since the end of 2012 and now owns a 12.2% stake. Its chairman sits on AGCO's board.

Everyone's playing it close to the vest on what it all means, but there is a general argument to be made that AGCO's healthy market positions outside the U.S. could be appealing to a larger competitor, whether TAFE or someone else. That said, it's not at all central to our thesis.

Describe in more detail your bullish case for Weyerhaeuser.

Michael Lehmann: Following the spinoff earlier this year of its homebuilding division, the company's three main businesses are timberlands, wood products and

cellulose fibers, which make up roughly 45%, 35% and 20%, respectively, of operating income.

Chip alluded to this earlier, but the company acquired Longview Timber in the summer of 2013, which added 645,000 acres of strategic Pacific Northwest forest to the company's asset base. The acquisition has not only provided operational scale in the region and cost-reduction opportunities, it also has increased Weyerhaeuser's exposure to high-margin Asian export log markets, primarily China and Japan. The trees acquired were older growth, so the company has shifted cutting to the Longview land, which has had a positive impact on profitability.

The company is also still cyclically levered to the strong recovery in the U.S. single-family housing market that we and the Third Avenue real-estate team expect in coming years. Housing starts have been running in the 500,000 to 800,000 range, while we consider the more demographically stable number to be between 1.2 and 1.3 million. Getting back to even that level – forget pre-crisis levels of 2 million – would drive higher realized timber prices and also dramatically improve results at the company's wood-products operation, which produces lumber, oriented strand board and engineered wood products.

How are you looking at NAV here, relative to today's \$36.60 share price?

ML: We value the company on a sum-of-the-parts basis. Timberlands make up two-thirds of the total, valued depending on specific location and age at \$3,000 to \$4,000 per acre in the Pacific Northwest and at \$1,500 to \$2,000 per acre in the U.S. South and internationally. We estimate the wood-products business to be worth around 15% of the total, valued at 7x the latest twelve months' EBITDA. That business has been undermanaged in recent years, but we believe is turning the corner at the right time to best take advantage of more-robust demand.

For cellulose fibers, which are used in things like diapers and textiles, we use a 6x multiple on that division's 10-year av-

INVESTMENT SNAPSHOT

Weyerhaeuser
(NYSE: WY)

Business: Growing and harvesting of trees, as well as production, distribution and sale of forest products, including lumber, pulp, paper and cellulose fibers.

Share Information
(@12/29/14):

Price	36.64
52-Week Range	27.48 – 36.88
Dividend Yield	3.2%
Market Cap	\$19.21 billion

Financials (TTM):

Revenue	\$8.66 billion
Operating Profit Margin	14.9%
Net Profit Margin	19.7%

Valuation Metrics
(@12/29/14):

	WY	S&P 500
P/E (TTM)	30.5	19.7
Forward P/E (Est.)	22.2	17.2
EV/EBITDA (TTM)	12.6	

Largest Institutional Owners
(@9/30/14):

Company	% Owned
T. Rowe Price	8.6%
Capital Research & Mgmt	7.8%
Vanguard Group	5.2%
BlackRock	4.8%
State Street	4.3%

Short Interest (as of 12/15/14):
Shares Short/Float 2.8%

WY PRICE HISTORY**THE BOTTOM LINE**

The company is levered to the healthy rebound in U.S. single-family housing starts that Michael Lehmann and the Third Avenue Management real estate team expect. On a sum-of-the-parts basis, he estimates current net asset value at \$50 per share. If the housing cycle cooperates, he believes that NAV can grow 30-50% over the next three years.

Sources: Company reports, other publicly available information

erage EBITDA. Adding in other assets, including a 430-acre campus facility and cash and equivalents, we arrive at a current net asset value of around \$50 per share. If the real estate cycle plays out as we expect, that NAV can grow 30-50% over the next three years.

We're first and foremost focused on the capital-appreciation potential here, but we like the hedge against inflation something like this brings to the overall portfolio. There's also something comforting about a company whose assets increase in value every year without doing anything to them.

Turning to something completely different, explain your investment thesis on CBS Corp. [CBS].

Mohammad Tabibian: This is a position we built when the shares sold off in September and October, likely due to the unwinding of arbitrage positions in the stock following the spinoff of its outdoor advertising unit, CBS Outdoors, as well as to short-term concerns over a softer ad market.

CBS is one of the oldest U.S. corporations still in business. It's been a leader in diversifying its sales base away from

an outsized reliance on TV and radio advertising and toward significant new revenues from content-licensing, distribution and retransmission fees. Driving that has been its position as a premier curator of content. While the specific highest-rated television shows in the U.S. change every year, over the past decade CBS has consistently placed eight to ten shows in the top 20, something no other network has come close to matching.

That position as a content leader should be extremely valuable as the landscape shifts around media distribution. The digital revolution has opened multiple new avenues of distribution to compete for quality content. That puts content providers more in the driver's seat, with an ability to sell their wares to more outlets and, because of increased competition, at higher prices.

Led by CEO Les Moonves, CBS has been at the forefront in monetizing its content. To give just one example, the retransmission fees the company earns from pay-TV providers and local TV stations contribute approximately \$500 million in EBITDA today, up from maybe \$25 million in 2008. As long-term contracts continue to be renegotiated, that number is expected to reach \$2 billion by 2020, and management says it's already well ahead of plan. For the very first time last quarter, less than 50% of CBS's total revenues came from advertising.

What would the market be missing about all that?

MT: There's an understandable difference for many investors between hearing something is going to happen and the results showing up in the numbers. There will be acrimonious negotiations, as CBS recently had with Dish Network. We've found, however, that for all the bluster involved sometimes, in almost every case the strong content provider gets the better of the new deals. We believe that will continue to be the case for CBS.

What upside do you see in the stock, now trading at around \$56.50?

MT: Putting a 10x multiple on our 2015 EBITDA estimate and adjusting separately for the value of the book-publishing business and for corporate overhead, we arrive at an estimated total enterprise value of about \$39 billion. Take out debt and adjust for announced share buybacks, and we come to a current NAV of \$66 per share.

So at today's price, you're buying in at a 15% discount to an NAV that we believe – from identified and mostly locked-in new monetization opportunities – can grow at 10%-plus per year. The potential for multiple expansion beyond what we've

assumed is also high. A business that two years from now is earning 75-80% of its EBITDA from contracted fees deserves a different multiple than one that has historically been so ad-driven and cyclical.

Risks?

MT: There will likely be short-term volatility around advertising volumes and prices, but the most material risk to our long-term thesis is if the company is unable to produce high-quality content to the extent it has. Everything gets harder if that happens.

You've described an affinity for regional banks like Comerica [CMA]. Why?

VC: Our strategy with banks has focused on strong underwriters, with excess capital, who are underearning due to relatively subdued loan demand and squeezed interest margins. Comerica fits that description perfectly.

The company started out in Michigan but over the past 25 years has built strong additional franchises in both California and Texas. Of \$47 billion in total loans, roughly 30% are in Michigan, 30% in California and 25% in Texas. Business banking generates roughly three-quarters of operating income, with the rest from wealth management and a small retail presence. They don't do mortgages. They don't do credit cards. As a result of building its brand around long-term relationships with quality business clients, it benefits from among the lowest-cost and most-stable deposit bases in the industry.

Our basic contention here is that Comerica is highly levered to improving economies in its key geographies. Excess capital on which it's earning next to nothing can be put to profitable use, and when it can't, we expect regulators to loosen the reins a bit and allow more capital to be returned to shareholders. Adding back the dividend, the company's book value grew by more than 10% in the past year, and we're looking for that to continue.

We like that the book-value growth was realized without any help from widening net interest margins. If and when rates do rise, with Comerica's low-cost funding and the fact that 85% of its loan book is floating rate, the results should be that much better.

Given the fall in oil prices, is the Texas exposure a problem?

CR: If you dig into the detail, we don't think so. Energy loans are only 7% of the loan book and the loan-to-value ratio on them is about 60%. The company estimates that we'd have to see sub-\$60-per-barrel oil for three-plus years before any material amount of those loans had to be

INVESTMENT SNAPSHOT

CBS Corp. (NYSE: CBS)

Business: Producer and distributor of media content; key business lines include CBS broadcast network, Showtime, Simon & Schuster, and local TV/radio stations.

Share Information (@12/29/14):

Price	56.45
52-Week Range	48.83 – 68.10
Dividend Yield	1.2%
Market Cap	\$29.26 billion

Financials (TTM):

Revenue	\$14.98 billion
Operating Profit Margin	21.6%
Net Profit Margin	20.1%

Valuation Metrics (@12/29/14):

	CBS	S&P 500
P/E (TTM)	22.6	19.7
Forward P/E (Est.)	15.3	17.2
EV/EBITDA (TTM)	9.2	

Largest Institutional Owners (@9/30/14):

Company	% Owned
Capital Research & Mgmt	5.3%
Vanguard Group	5.1%
State Street	4.0%
BlackRock	3.7%
Franklin Mutual Adv	3.0%

Short Interest (as of 12/15/14):

Shares Short/Float	4.0%
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CBS PRICE HISTORY



THE BOTTOM LINE

The company's proven ability to create popular content should serve it well as ongoing shifts in media distribution favor content providers, says Mohammad Tabibian. He pegs current NAV at \$66 per share, which he expects to grow at least 10% per year over the medium term due to strong growth in licensing, retransmission and distribution fees.

Sources: Company reports, other publicly available information

restructured or put on non-performing status. For the time being we don't think low oil prices are a risk to our investment case, and they might even be a positive if energy companies seek to add secured first-lien debt – resulting in potential loan growth for Comerica – to fortify their balance sheets in the current period of low prices.

How cheap do you consider the stock, now trading at just over \$47?

VC: We believe the company over the next three to five years can compound

tangible book value by at least 10% per year and take its return on assets from below 1.0% to a more normal level of 1.3% to 1.5%. If that happens, there's no reason the stock wouldn't trade at a higher multiple of tangible book, say 1.5x vs. today's 1.2x.

Just doing the math, tangible book value growing 10% annually would increase to around \$50 per share three years out. At a 1.5x multiple, the share price would be around \$75.

CR: Banks like Comerica today are classic time-arbitrage ideas. The stocks trade

around earnings revisions on a quarterly basis, but if earnings are off a penny or two because the 10-year Treasury yield backs up from 2.3% to 2.2%, it doesn't impact our investment case in the slightest. Ninety days is a very long time when you're staring at your stock price every single day. It's a very short time when you look back over three to five years.

Do you think the market volatility of recent months is here to stay for a while?

CR: We do think the popularity of “hedged” and passive strategies will continue to drive volatility at a higher level. You have hedge funds where the analysts are paid every 30 days – they may buy and sell a position 12 times over the course of our ownership period. It's a different way of looking at things, and it amplifies volatility.

The only thing passive strategies protect is relative performance. It's kind of a self-fulfilling prophecy: They take in more and more money, which they reinvest in whatever names are in their index, those names go up, performance looks good, and then more money pours in from investors. That works fine until it doesn't, and when those flows reverse, the market impact can be magnified on the downside as well. We still view our three- to five-year time horizon as a competitive differentiator, but we have to be consistently nimble in taking advantage of overvalued situations to harvest and of undervalued situations to opportunistically buy.

It hasn't been the greatest environment in the last few years for fundamental, bottom-up investors. An emphasis on balance sheets and protecting capital is much less important when money is free and even the weakest companies can re-finance their way out of trouble. But we think that game is pretty much over. Now when companies get into trouble you're going to have people moving out of them at the same time into little liquidity and with little regard for the long-term view. That's great for us – I'm very bullish on fundamental, active investing making a comeback over the next few years. **VII**

INVESTMENT SNAPSHOT

Comerica (NYSE: CMA)

Business: U.S. commercial and retail banking, with key focus on small- and medium-sized business customers; 85% of total loans are in Michigan, California and Texas.

Share Information (@12/29/14):

Price	47.31
52-Week Range	42.73 – 53.50
Dividend Yield	1.7%
Market Cap	\$8.50 billion

Financials (TTM):

Revenue	\$2.44 billion
Operating Profit Margin	34.6%
Net Profit Margin	23.0%

Valuation Metrics (@12/29/14):

	CMA	S&P 500
P/E (TTM)	15.4	19.7
Forward P/E (Est.)	14.9	17.2
Price/Book (MRQ)	1.1	

Largest Institutional Owners (@9/30/14):

Company	% Owned
Vanguard Group	7.6%
Fiduciary Mgmt	7.1%
State Street	4.9%
Invesco	4.7%
BlackRock	4.1%

Short Interest (as of 12/15/14):

Shares Short/Float	4.3%
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CMA PRICE HISTORY



THE BOTTOM LINE

Given the company's excess capital, business-banking franchises and low-cost deposit base, its performance should be highly levered to healthy economic growth in its key markets, says Victor Cunningham. At what he considers a reasonable 1.5x multiple on his estimate of tangible book value three years' out, the shares would trade at around \$75.

Sources: Company reports, other publicly available information

Important Information

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