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ValueInvestor INSIGHT

The Leading Authority on Value Investing

The Many Faces of Value

Age and experience can set investors firmly in their ways. Not so Bill Fries, whose Thornburg Investment teams excel at taking what the market offers.

Bill Fries has plenty of strong opinions, but don't ask him to narrowly define an undervalued stock. "When you've been around as long as I have," he says, "you realize that value manifests itself in different ways at various times in the market."

Fries' eclectic search for value has paid off for investors in Thornburg Investment's Value and International Value mutual funds, which he launched and still co-manages. As of September 30, the combined assets of the two funds totaled \$18.6 billion – \$14.7 billion in the International Value fund and \$3.9 billion in the Value fund.

With no dearth of beaten-down stocks to choose from, Fries and his colleagues are finding particular bargains in such areas as energy, financial services, insurance, medical equipment and biotech. See page 2

INVESTOR INSIGHT

Thornburg Investment Management
(l to r) Connor Browne, William Fries, Edward Maran, Brian McMahon

Investment Focus: Seek firms that are cyclically out-of-favor, blue-chips temporarily fallen from grace and companies whose strong growth prospects are undervalued.

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Strategies for Building Real Wealth

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Investor Insight: Thornburg Investment

William Fries, Brian McMahon, Connor Browne and Ed Maran of Thornburg Investment Management describe how they keep perspective during the crisis, where they see potential in financial stocks, what non-U.S. bargains are attracting their attention, and why they see unrecognized value in Allstate, Marathon Oil, Gilead Sciences and Varian Medical.

In searching for perspective on today's financial crisis, how useful are you finding lessons from the past?

Brian McMahon: Today's environment is fairly unprecedented in the modern financial history of the United States, primarily because we're dealing with the popping of a debt bubble that in 2006 and early 2007 had inflated to a size we'd never seen before. That makes it more difficult to judge what's going happen next, particularly while all the speculative money in the market today is driving prices up and down.

But you don't have to go that far back in history to see a very similar market situation outside the U.S., the Asian debt crisis of the late 1980s. Banks and consumers over-extended themselves, a debt bubble exploded, investors panicked, stock and bond markets rapidly deflated and GDP growth just about everywhere but China went negative. In Korea, for example, the market fell more than 85% from June 1997 to June 1998.

That's not very encouraging.

BM: In fact, it is. Staying with the Korean example, the KOSPI index went from below 0.2 in U.S. dollar terms in mid-1988 to nearly 0.5 by the end of 1998. You didn't have to buy at the bottom to make out well – the average of the KOSPI was just under 0.3 for all of 1998. Over the next ten years from its low in 1998, the Korean market was up ten-fold.

So a long-term investor buying into the controversy of the debt bubble popping and living through the bad news as an entire regional economy, in essence, had to go to reform school, would have made a lot of money. We can't know how everything will play out this time, but we are confident that buying what forced sellers are selling today is likely to turn out well.

The story in Japan wasn't quite so rosy.

BM: That's true, but most other Asian markets responded similarly to Korea. We don't believe Japan is the right precedent, given how that market operates and how poorly the government and regulators responded to the crisis. We'd like to believe the authorities have learned a few things since then.

Another positive factor in the United States today is the financial strength of U.S.-listed businesses going into the crisis. With the obvious exception of many financial institutions, the balance sheets and profitability of corporate America have been quite strong until very recently and should help soften the blow of what appears to be an inevitable decline in the economy.

Does your day-to-day routine change when markets are like this?

Edward Maran: When great companies like Goldman Sachs [GS] trade as if people are questioning whether they will survive, we have to move with greater intensity because such opportunities are likely to be fleeting. That's not to say we're making snap decisions. Many of the best opportunities we see are in companies we own or have recently owned – and therefore know very well – for which the fundamentals haven't really changed but the share price is down 30% in the past two months.

BM: There has been a greater premium on upgrading our portfolios. Because we're typically fairly fully invested and this is not an environment for net cash inflows, we've had to be disciplined in moving money out of what might still be very good ideas into better ones. The fact that we don't have cash never prevents us from buying something.

Connor Browne, William Fries, Edward Maran, Brian McMahon

Capital City

Santa Fe, New Mexico isn't exactly the prototypical home for a global money management firm. Located 60 miles north of Albuquerque, the artists' colony turned chic tourist destination is far better known for New Mexico's state capitol than as a magnet for investor capital.

None of which has hindered the growth of Thornburg Investment Management, which as of September 30 managed $43 billion in a broad range of equity and fixed-income mutual funds from its headquarters one block from Santa Fe's main shopping area. "I'd like to say it's nice to take off early in the winter and go skiing," says Thornburg CEO Brian McMahon. "But who has the time?"

Key to Thornburg's growth was the arrival in 1995 of William Fries, who launched two of the firm's most successful equity funds and has played a primary role in training the firm's next generation of portfolio managers. "Bill is as enthusiastic as a kid in a candy store when he's learning about a new company or industry," says one such manager, Connor Browne. "All investors should have that kind of curiosity and openness to learning new things."

Stepping back, describe your basic strategy, focused on finding what you call "basic value" stocks, "consistent earners" and "emerging franchises."

William Fries: Many value investors are primarily focused on price and valuation, which we obviously think are important, but we also believe that when constructing a portfolio you should have companies with promise beyond just going from undervalued to fairly valued.

My goal in setting up the Value and International Value funds was to have the flexibility to capture more of the different value opportunities the market presents over time. We think that allows us to benefit from any market environment and outperform narrower strategies that can fall out of favor for long periods at a time.

Basic-value stocks, which generally make up about 40% of the portfolio, are those that would attract traditional deep-value investors. They're typically cyclical and trade at valuations that can appear the most attractive at the peak of the cycle. Here we focus on the company's business model, its market position and how well it's managed to arrive at what we think the stock should be worth at a normalized level of earnings. People don't think about these companies this way, but during their periods of cyclical ascension, these companies can have very rapid growth.

Consistent earners, which also make up around 40% of the portfolio, are blue-chip companies that tend to have long records of steady organic revenue and profit growth, with high returns on equity, not much debt, strong brands and strong corporate cultures. Not surprisingly they usually trade at premium multiples, but every once in a while they become out of favor due to a change in their industry, fears over things like litigation or management turnover, or a slowdown in results for any number of reasons. The challenge is pinpointing why exactly the shares are disliked and how temporary or permanent that is. These are the toughest to buy because they can always look a little too expensive, but the payoff can be very high and very long-lived if you pay the right price.

We limit the last category, emerging franchises, to no more than 25% of the portfolio and it's usually less than that. These are typically younger companies with excellent growth prospects. Because they often have a narrow product lineup, they fall out of favor when one or a few important products suffer from inevitable hiccups in growth. I often say the only small company we want to buy is one that can become a big company – that's what we're looking for in emerging franchises.

ON INVESTING IN ENERGY:

The entire sector appears to be attractively priced right now, so our focus is on the stocks offering the best relative value.

Do you have a single valuation approach for the different types of companies?

WF: Five people can give five different answers on how to define intrinsic value, but we try to choose the appropriate valuation measure for the company, the business model and the industry in question. That could be the present value of discounted future cash flows, private-market value, relative valuation, absolute P/E, whatever. We don't take the European approach, where they might use three different valuation methods and then divide by three to say a stock is worth $42.30. Our target prices are our estimate of what we think a stock would be worth under normal circumstances, typically with a time horizon of 12-18 months.

Connor Browne: For every stock we research, we create a one-pager that outlines the specific aspects of the investment thesis, the risks and opportunities, our valuation methodology, our upside price target and our downside price estimate. The spread can be tighter or wider, but we generally want to see absolute upside of at least three times the downside.

Setting downside estimates has likely been quite difficult of late. How do you do that?

CB: We'll look at multiples over the past ten years to see how pessimistic the market can be about a company and then adjust from that, if necessary, based on our judgment about sentiment over the next 12-18 months. We'll then apply that pessimistic multiple to a downside earnings estimate. That estimate, particularly with consistent earners and emerging franchises, tries to incorporate what would happen if the one or two items we've identified as crucial to our thesis didn't pan out.

What basic-value opportunities are you finding most prominent today?

EM: The entire energy sector appears to be attractively priced right now, so our focus is on the stocks offering the best relative value and those that may have other catalysts than oil prices that will cause the share prices to move. ExxonMobil [XOM], for example, has so much free cash flow that it can create considerable shareholder value just from dividends and share buybacks.

WF: Our general enthusiasm for energy companies hasn't really changed even as oil prices have fallen off a cliff. The world consumes roughly 85 million barrels of oil per day. The U.S. consumes roughly 20 million barrels per day, while only producing around 7 million. Our dependence on imported oil, certainly in my lifetime, isn't going away. We think that, plus the long-term demand and supply curves for fossil fuels, creates a fertile long-term environment for all types of energy assets, including oil, natural gas, clean coal, nuclear power, other alternative energy sources, and even power-generating capacity.

How are you approaching opportunities today in financials?

EM: We're placing, as you might expect, a very high premium on transparency.

AIG obviously didn't, but most insurance companies give very good detail on exactly what they own and the investment risk attached to that. Bank transparency is also getting better, with more detail on the extent of lending in different risk and geographic categories.

We're also focused – again, no surprise – on companies with manageable financial leverage. Strong companies with even modest leverage should be able to deliver good rates of return going forward.

One bank we own is JPMorgan Chase [JPM], which we believe is well positioned to capitalize on the current environment and come out the other side in an even stronger competitive position. We also see opportunity in the property/casualty insurance sector, in companies like Allstate [ALL], Ace [ACE] and Cincinnati Financial [CINF], partly because we don't see their businesses as particularly economically sensitive, and partly because the mark-to-market declines in their fixed-income portfolios have been greater than what we think the reality will turn out to be.

For such a large fund, you have more smaller-cap names than one might expect. Why?

EM: Our aspiration is to go wherever we find value, but because we don't typically want smaller than 1% portfolio positions and we don't want to give up liquidity by owning more than 5% of a company, we don't usually pursue companies that are less than $2 billion in market cap. When we go smaller than that, it's usually because the risk-reward is particularly attractive.

Give us an example.

CB: One company we believe has built a better mousetrap in its industry is Life Time Fitness [LTM]. The company runs an expanding chain of health clubs, which hasn't historically been a great business, but we think Life Time can become the Best Buy of the industry. Their centers are much larger and provide a high-quality and broad level of service, which they're able to offer at a competitive price because their membership volumes tend to be so high. They generate above-40% EBITDA margins from mature clubs and have all the room in the world to grow the store base 15-20% annually for several years. There's obviously some short-term risk going into a bad economic environment – which is why it's a relatively small position – but we see considerable upside for the company over the next few years.

ON SELLING:

If our original thesis turns out to be wrong, we ignore the temptation to keep a stock just because it's so cheap.

Thornburg as a firm has considerable international expertise. Is the opportunity set you pursue outside the U.S. in any way different?

WF: Not really. In emerging markets we may focus even more on premier, market leaders than might be the case in the U.S., but we're looking for the same set of basic-value, consistent-earner and emerging-franchise types of businesses.

How do you address political risk in a country like Russia, where you've been relatively active?

EM: We pay considerable attention to political risk, not so much as a general concept, but in terms of how it might impact a specific company's operating and pricing flexibility, its earnings or its dividends. We're comfortable owning [natural-gas giant] Gazprom [OGZPY], for example, because we don't see political risk as a threat to its business. The government wants new exploration for natural gas in Russia, it wants gas prices in Russia to rise and it wants the company to earn a high return on its export sales to Europe. It's certainly true that investors put a higher discount rate on Russian companies' cash flows because of political risk, but in the case of Gazprom we don't think the actual risk warrants that.

Has the dramatic pullback in Chinese shares created any bargains that have caught your attention lately?

EM: We still see great potential in China, but clearly the expectations have been scaled back as the global economy suffers. One holding we picked up after an already significant price correction was Hong Kong Exchanges & Clearing [388:HK], which runs the Hong Kong stock and futures exchanges. The exchange business model is one we know and like, producing very high profit margins and returns on capital. In this case, Hong Kong Exchanges' stock is down by two-thirds over the past year, but we believe it has significant growth potential over time as new Chinese companies list in Hong Kong, trading volumes continue their secular increase and Hong Kong becomes more and more of a global financial center.

Describe your selling discipline.

EM: If subsequent events indicate our original thesis is wrong, we make every attempt to ignore the temptation to keep a stock because it's so cheap or because we can come up with new reasons to own it. That rarely works out well.

Particularly with cyclical basic-value stocks, we sell at price targets, which – if set correctly – should be relatively good indicators that you're at or near the top of a cycle. Our consistent earners have more of a moving price target as the business grows, but that moving target also triggers the decision to sell. For emerging franchises, we're more inclined if the fundamentals are still working to trim but still own the stocks even if the valuation gets somewhat beyond our comfort range. Of course that means you have to watch the fundamentals particularly closely.

Turning to some specific ideas, describe the investment case for Allstate.

EM: Allstate is a personal-lines property/casualty insurer with large market shares in both home and automobile insurance. It's the second-largest auto insurer, a business we believe has high barriers to entry and large economies of scale, both of which should allow the leading players to increase their market shares over time. Such companies have more underwriting experience and better models, so they should be able to price their policies more effectively and profitably. For Allstate, that has translated into a lower-than-average combined ratio [insurance losses and expenses, divided by earned premiums], averaging 93% over the past five years.

Home insurance is riskier than automobile insurance because of potential losses from natural disasters, but Allstate is well diversified by product and geography and has a culture of conservative underwriting focused on profits over growth – even if it means not writing business in higher-risk markets. All that should be obvious, but historically the best way to lose money in this business has been to underprice policies in the name of growth.

The investment case here is relatively straightforward. We consider personal-lines insurance to be a stable, recession-resistant business that has tended to grow over time as the number and value of automobiles and houses increases, and we expect Allstate to capture greater market share as it takes advantage of its size. Given that, we think the sharp fall-off in the shares has resulted in an unusually attractive valuation relative to projected earnings, book value and its peers.

How comfortable are you with the company's investment portfolio?

EM: We actually think it is fairly transparent and indicates the company has been prudent with its investments and owns mostly high-quality fixed-income securities that don't pose significant risk of permanent loss. That's not to say the market isn't concerned about it, but that's a big reason the shares are so cheap.

How are you valuing the shares, which at a recent $24.70 have fallen 45% just in October?

EM: Assuming a normalized combined ratio of 93%, we estimate earnings per share for 2010 of around $6.50, which is somewhat higher than Wall Street's consensus estimate of $6.05. So on our normalized earnings estimate, the stock is trading at a less than 4x multiple.

Looking at it another way, for a company that we expect to earn a 14% return on equity over time, we think the stock should trade for 1.5x book value. That's not at all aggressive for a relatively stable, low-risk business with a mid-teens ROE. But the stock today trades at only 80% of book value. Just getting to 1.5x book would imply a nearly 90% gain in the shares, and we believe book value will continue to grow as earnings are reinvested in the company.

How big is the risk Allstate will need to raise capital?

EM: That's obviously something to look at very closely in this environment. We

INVESTMENT SNAPSHOT

Allstate
(NYSE: ALL)

Business: Provider of property/casualty insurance, life insurance, retirement and investment products, sold through agents to individuals in the U.S. and Canada.

Share Information (@10/30/08):

Price	**24.72**
52-Week Range	22.30 – 55.50
Dividend Yield	6.5%
Market Cap	$13.39 billion

Financials (TTM):

Revenue	$33.49 billion
Operating Profit Margin	9.4%
Net Profit Margin	6.3%

Valuation Metrics (@10/30/08):

	ALL	S&P 500
Trailing P/E	6.6	19.6
Forward P/E Est.	4.5	11.2

Largest Institutional Owners (@6/30/08):

Company	% Owned
Axa	5.0%
Massachusetts Fin Serv	3.7%
State Street Corp	3.6%
Barclays Global Inv	3.4%
Vanguard Group	3.1%

Short Interest (as of 10/10/08):

Shares Short/Float	1.0%

ALL PRICE HISTORY

THE BOTTOM LINE

The market is underestimating how stable and recession-resistant the company's business is, say Edward Maran, while overestimating the risks of permanent loss in its investment portfolio. The shares trade at less than 4x his $6.50 estimate of normalized EPS and at barely half the 1.5x multiple of book value he believes they deserve.

Sources: Company reports, other publicly available information

don't expect them to need additional capital, but even if they do – as a result of some shock to the investment portfolio or a big natural disaster of some kind – we don't expect any dilution to be high enough to derail the investment thesis

One risk in auto insurance would appear to be share erosion from direct-sales competitors like Geico and Progressive. How is Allstate responding to that?

EM: Online auto insurance sales are growing faster than the overall market, so the company is investing in its Internet platform and has gotten smarter about competing with Geico and Progressive. If Allstate stumbles on that front, that could be a risk. Overall, though, we believe the agent relationship is highly valued by customers who choose to buy that way, and that relationship gives Allstate a leg up as it looks to sell other related products.

In an entire sector you consider attractively priced, what makes Marathon Oil [MRO] stand out?

EM: Marathon was traditionally a refiner, but in recent years it has built out its upstream exploration and production assets. It's done that primarily through acquisition and by making itself a preferred partner with major operators in things like long-life Canadian oil sands projects, oil shale assets and deepwater projects in the Gulf of Mexico and Norwegian continental shelf. All in, we expect Marathon to increase production 7% per year from 2007 through 2012.

Is its still-significant exposure to refining a positive or a negative?

EM: There is some diversification benefit from having both E&P and refining assets, but with oil prices falling while there's continued excess supply in refining capacity, that diversification won't be particularly helpful in the near term. The way we think about it is that in the next two to three years we'll have another tight refining market and margins there will go back up again. That business is highly cyclical – at the trough independent refiners often lose money, while at the peak they perform spectacularly. Right now the market is pricing refiners – and by extension, Marathon – as if that business will never recover, which is just highly unlikely.

Do you expect increased M&A activity among energy companies and how could that affect Marathon?

EM: The company is studying whether separating its upstream and downstream assets would result in a higher valuation. I'm not convinced it would – integrated companies like Marathon have actually held up better than most of the sector's pure-plays. We do expect consolidation, and the fact that Marathon's assets are in world-class projects makes it more attractive to the big integrated majors who are likely to be buying. The many companies out there with lots of small-scale projects are not likely to be as attractive.

At around $27.75, the company's shares are off 55% so far this year. What potential upside do you see?

EM: By either a sum-of-the-parts valuation or putting a normalized multiple on

INVESTMENT SNAPSHOT

Marathon Oil
(NYSE: MRO)

Business: Houston-based energy company organized around four operating segments: Exploration/Production, Oil Sands, Refining/Marketing and Integrated Gas.

Share Information
(@10/30/08):

Price	**27.73**
52-Week Range	21.50 – 63.22
Dividend Yield	3.8%
Market Cap	$19.56 billion

Financials (TTM):

Revenue	$69.51 billion
Operating Profit Margin	6.7%
Net Profit Margin	4.6%

Valuation Metrics
(@10/30/08):

	MRO	S&P 500
Trailing P/E	6.1	19.6
Forward P/E Est.	4.8	11.2

Largest Institutional Owners
(@6/30/08):

Company	% Owned
Capital Research	5.3%
Wellington Mgmt	5.3%
State Street Corp	3.6%
Barclays Global Inv	3.5%
Capital World Inv	3.5%

Short Interest (as of 10/10/08):

Shares Short/Float	0.9%

MRO PRICE HISTORY

THE BOTTOM LINE

In an entire sector offering bargains, Edward Maran believes Marathon's refining and exploration and production assets are uniquely undervalued. If oil prices return to even $100 per barrel, he estimates the company would earn around $8.80 per share. At that point, with a "reasonable" 12x multiple, the shares would trade for $105.

Sources: Company reports, other publicly available information

normalized earnings, the upside share price is dramatically higher than the current one.

In what we consider a moderate downside scenario of $60-per-barrel oil and $7-per-mcf natural gas, we'd expect Marathon to earn around $5 per share. Our feeling is that prices below those levels will result in major cutbacks in production, bringing supply and demand in line and taking prices at least back up to those levels. Even on that downside estimate, the shares trade at less than 6x earnings. Against consensus 2009 estimates of $5.80 per share, the multiple is only 4.8x.

What could the realistic upside be? In three or four years when this whole cycle is over, Chinese growth returns to trend and the U.S. and Europe start growing again, the concerns about oil and gas supply shortfalls are likely to resurface. It's not a big stretch to assume we could get back to oil prices above $100 per barrel. If that happens, we estimate Marathon could earn $8.80 per share in 2011, on which a 12x multiple would not be unreasonable. So a $105 share price is not out of the realm of possibility in the not-distant future.

You seem almost embarrassed to say it.

EM: I am. But this is a case where we're just questioning the rationality of a market that would price something at this level. It has to be a function of too few buyers, coupled with forced sellers having to sell at whatever price. That situation can't last forever.

Has the company been actively buying back stock?

EM: No. It isn't for a lack of cash, but because they've been investing in new assets and in a significant upgrade in refinery capacity to handle output from Canadian oil sands projects. We're expecting those to be high-return investments, but the market is giving the company no credit for them – the refinery upgrades alone could add $1 per share in annual earnings by 2011.

Describe one of your consistent-earner ideas, Gilead Sciences [GILD].

CB: Gilead is a biotechnology company that we originally bought in 2002 at a split-adjusted $9 per share. It's one of those happy cases in which one of our emerging-franchise businesses grew into an attractive consistent earner.

The company's main business – producing roughly 80% of revenues and operating profits – is selling two of the three backbone components in the drug "cocktail" treatment for HIV. In the U.S., Gilead's drugs are used in 85% of new-patient treatments and 70% of all patient treatments. In Europe, those numbers are 65% for new patients and 50% for total patients. The treatment outcomes are quite favorable: while there still isn't complete long-term data, research so far indicates that patients receiving treatment live at least 10 years longer than those that don't. As experience accumulates, that number is likely to increase.

The growth profile for Gilead's HIV-related business is still quite strong. Unfortunately, the number of HIV-infected patients continues to rise worldwide, but the good news is that more and more of them are being identified and getting treatment. The treated population is

INVESTMENT SNAPSHOT

Gilead Sciences
(Nasdaq: GILD)

Business: Research, development and commercialization of biopharmaceuticals, primarily used in the "cocktail" treatment of the human immunodeficiency virus [HIV].

Share Information
(@10/30/08):

Price	**46.71**
52-Week Range	35.60 – 57.63
Dividend Yield	0.0%
Market Cap	$43.01 billion

Financials (TTM):

Revenue	$5.00 billion
Operating Profit Margin	49.8%
Net Profit Margin	36.9%

Valuation Metrics
(@10/30/08):

	GILD	Nasdaq
Trailing P/E	24.4	17.7
Forward P/E Est.	19.7	13.7

Largest Institutional Owners
(@6/30/08):

Company	% Owned
Fidelity Mgmt & Research	5.5%
Axa	5.2%
T. Rowe Price	4.7%
Janus Capital	4.7%
Barclays Global Inv	4.0%

Short Interest (as of 10/10/08):

Shares Short/Float	2.7%

GILD PRICE HISTORY

THE BOTTOM LINE

Ongoing price increases for the company's drugs used to treat HIV, market share gains, and growth in the overall number of patients receiving HIV treatments should drive annual revenue and profit growth of at least 20%, says Connor Browne. His price target 12-18 months out is $78, or 25x 2010 estimated EPS of $3.10.

Sources: Company reports, other publicly available information

growing about 8% annually in developed countries.

Gilead also should continue to increase its market share, as evidenced by the fact that its drugs are used in a higher percentage of new-patient treatments in both the U.S. and Europe. There's also no reason it can't incrementally increase share in Europe to levels approaching those in the U.S.

Is pricing an issue as the market expands?

CB: Pricing in biotech is driven by competitiveness within the treatment area. If your drug is really important to the overall treatment, there are few alternatives that work as well, and the treatment outcomes are highly positive – all of which apply here for Gilead – you continue to have pricing power. The company has traditionally increased prices 5-10% per year. We'd expect that to continue at least at the low end of that range going forward.

From ongoing price increases, the growth of the overall treated-patient market and from increased market share, we believe Gilead can increase revenues 20% per year over the next few years, with operating leverage resulting in even better profit growth.

Is the dependence on the HIV-related business, as good as it is, a concern?

CB: To some extent, but we consider the franchise to be solid for a few reasons. The available efficacy research is very favorable for Gilead's products. Competitors are primarily focused on the third component of the treatment, which Gilead doesn't currently produce. The company has been smart about developing new pill combinations that make following the cocktail regimen even easier. Finally, in terms of patent protection, the first patents don't go off until 2017, with others in the franchise going off through 2021.

The way we look at it, if we assume each of the individual HIV-related products is cut off completely when the patents run out (which we don't believe is exactly what will happen), the present value of the discounted future cash flows of the existing HIV franchise is only slightly lower than the overall company's market value. The market is giving them almost no credit for being able to extend the HIV franchise or for their slate of existing and to-be-developed drugs.

With the shares currently at $46.70, how are you looking at valuation?

CB: We estimate the company will earn around $2.60 per share next year, so the current forward multiple is around 18x. For a company growing its bottom line at what we expect to be greater than 20% annually, we think a 25x multiple is more appropriate. That's particularly true because the visibility into revenues and earnings is relatively good, something that should be worth more in an environment like today's. If 12 to18 months from now the company has the multiple we expect on what will be forward EPS of around $3.10, the share price would be closer to $78.

ON INVESTING IN AIG:

We didn't put enough emphasis on the magnitude of the risk – we thought the chance it would blow up was so remote.

Sticking with healthcare, talk about the potential you see in Varian Medical Systems [VAR].

CB: Varian manufactures sophisticated equipment that is used in treatment programs that can last weeks or months to kill cancerous tumors by focusing beams of radiation on them. Roughly half of all incidences of cancer today are treated using radiation therapy – in conjunction with surgery and chemotherapy – and Varian has more than half the radiation-therapy market.

Our basic thesis is that Varian is the dominant player in a global market with significant growth prospects. Cancer is unfortunately a growing problem worldwide, particularly in countries like the U.S. with aging populations. There are roughly 13 radiation-oncology systems (Varian or otherwise) per one million in population in the U.S., a number we'd expect to rise to 15 per million people as Americans age.

The growth potential outside the U.S. is even more pronounced. Other developed markets have penetration levels of five to eight radiation-therapy machines for every one million people, while emerging markets like India and China have less than one machine per million people.

The types of systems Varian sells are basically computers, so as processing speeds and software improve, patients can be treated more quickly and the efficacy of the treatment improves as the radiation beams can be more precisely targeted. That should make radiation therapy even more attractive against competing treatments going forward, which should drive both new sales and sales of high-margin upgrades to existing clients.

Do the company's non-oncology products offer any similar promise?

CB: We consider this primarily a radiation-oncology story, but Varian also manufactures X-ray tubes and digital image detectors used in filmless X-ray imaging systems. The latter should benefit from increased global spending, particularly at ports and political borders, on security systems capable of detecting radioactive material.

The shares, at a recent $45.45, have not at all been immune to the market downdraft. What is the market missing?

CB: The concern, which is a legitimate one, is that orders by hospitals for machines costing $2 million a pop will be more difficult to finance in the current credit environment. Varian management says they haven't seen that to any great extent, but we imagine there will be some slowdown in order growth over the next couple of quarters. But we don't see that as a permanent issue, and believe the company can grow revenues and earnings by at least 15-20% annually going forward.

As with Gilead, we think the extent and predictability of Varian's growth should eventually result in a premium multiple of around 25x earnings. On our \$3 per share earnings estimate for next year (excluding stock-based compensation), that gives us a target share price of around \$75.

What are the most prominent risks?

CB: A competing technology could come out of nowhere to take Varian's market share, but all our field research indicates that doctors and hospitals view Varian's products – particularly with the available upgrades – as superior to the competition for most applications.

Regulatory risk is always a potential issue. At the moment, the existing medical reimbursement rates for radiation therapy are favorable and we aren't seeing any reason that will change. Even if reimbursement rates became less attractive, the payback times for hospitals on the machines will likely continue to decrease as Varian continues to roll out technology upgrades that increase patient throughput.

Investors today are sitting on what might be considered a great number of mistakes in their portfolios. Have you drawn any new insights from the ones you've made?

WF: I would fault us for being too tolerant of risks that we just didn't see as a big deal at the outset of the debacle last year. We knew AIG had a ridiculously large portfolio of credit default swaps, but we didn't put enough emphasis on the magnitude of that risk – that is, that it could take the company down – because we thought the chance it would blow up was so remote.

CB: To our credit, we did at least get out of some of the worst financial stocks, including Freddie Mac, UBS and Wachovia, in the first quarter of this year rather than more recently. We started to put much more emphasis on transparency and leverage and did what turned out to be the right thing by selling. By the way, positions that are already down 50% can be some of the hardest things for value investors to sell. Obviously we're glad we did.

EM: One thing that helps us maintain perspective through difficult times is that we outline specifically in writing what our investment thesis is and what we expect to happen. If what is happening with the business is in line with our thesis and expectations, that gives us the confidence to stick with something or buy more if the share price tanks.

CB: We're quite open and honest about our mistakes, but we have to be very careful not to take the experiences of the last year as justification for fundamentally changing how we analyze and select stocks. Our common belief is that this is a very unique environment that we probably won't see again for some time once we get through it. It's important to keep that in mind, or you may find yourself changing how you do things at exactly the wrong time. VII

INVESTMENT SNAPSHOT

Varian Medical Systems
(NYSE: VAR)

Business: Designs, manufactures, sells and services therapy and imaging systems, primarily focused on the treatment of cancer using radiation technology.

Share Information
(@10/30/08):

Price	**45.44**
52-Week Range	37.34 – 65.84
Dividend Yield	0.0%
Market Cap	\$5.66 billion

Financials (TTM):

Revenue	\$2.07 billion
Operating Profit Margin	20.3%
Net Profit Margin	13.5%

Valuation Metrics
(@10/30/08):

	VAR	S&P 500
Trailing P/E	20.7	19.6
Forward P/E Est.	15.2	11.2

Largest Institutional Owners
(@6/30/08):

Company	% Owned
Sands Capital	7.4%
Capital Research	4.8%
Thornburg Inv	4.4%
Vanguard Group	4.1%
Barclays Global Inv	3.9%

Short Interest (as of 10/10/08):

Shares Short/Float	4.1%

VAR PRICE HISTORY

THE BOTTOM LINE

As its computer-based radiation-technology systems provide greater efficacy and patient throughput in the treatment of cancer, the company should be able to increase revenues and earnings by 15-20% annually, says Connor Browne. His target price for the shares – 25x the \$3 per share he expects the company to earn next year – is \$75.

Sources: Company reports, other publicly available information

Disclosure

The views expressed by the portfolio managers reflect their professional opinions and are subject to change. Securities, countries, and industries mentioned are presented to illustrate companies, countries, and industries in which the fund may invest. Portfolio holdings are subject to change daily. Under no circumstances does the information contained within represent a recommendation to buy or sell securities. Assets in the funds mentioned are subject to change daily.

There is no guarantee that the Funds will meet their investment objectives.

Thornburg Value Fund Top 10 Holdings, as of 9/30/08: 1) Exxon Mobil Corp. 4.5%; 2) Comcast Corp. 4.0%; 3) AT&T, Inc. 3.8%; 4) ConocoPhillips 3.7%; 5) DIRECTV Group, Inc. 3.7%; 6) Eli Lilly & Co. 3.5%; 7) Microsoft Corp. 3.5%; 8) Toyota Motor Corp. 3.3%; 9) Allstate Corp. 3.2%; 10) Ace Ltd. 3.1%

Investments in the Fund carry risks including possible loss of principal. Investing outside the United States involves additional risks, such as currency fluctuations. Additionally, the Fund may invest a portion of the assets in small capitalization companies, which may increase the risk of greater price fluctuations. Investments in the Fund are not FDIC insured, nor are they deposits of or guaranteed by a bank or any other entity.

Carefully consider each Fund's investment objectives, risks, sales charges, and expenses; these are found in the prospectus, which is available from your financial advisor or www.thornburg.com. Read it carefully before you invest or send money.

The book value of equity can be defined as the value of assets carried on the balance sheet minus the company's liabilities. The value of assets take into consideration original cost minus any depreciation.

EBITDA is an indicator of a company's financial performance and is calculated as follows: EBITDA = Revenues - Expenses (excluding interest, tax, depreciation and amortization)

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability.

Price/Earnings ratio (P/E ratio) is a valuation ratio of a company's current share price compared to its per-share earnings. P/E equals a company's market value per share divided by earnings per share.

ROE, or return on equity, is a measure of a corporation's profitability. The ROE is useful in comparing the profitability of a company to other firms in the same industry.

The KOSPI Index is a comprehensive, capitalization-weighted index that tracks the continuous price performance of all common stocks listed on the Korea Stock Exchange.

The performance of any index is not indicative of the performance of any particular investment. Unless otherwise noted, index returns reflect the reinvestment of income dividends and capital gains, if any, but do not reflect fees, brokerage commissions or other expenses of investing. Investors may not make direct investments into any index.

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