March 31, 2014

Value Investor INSIGHT

The Leading Authority on Value Investing

Updating History

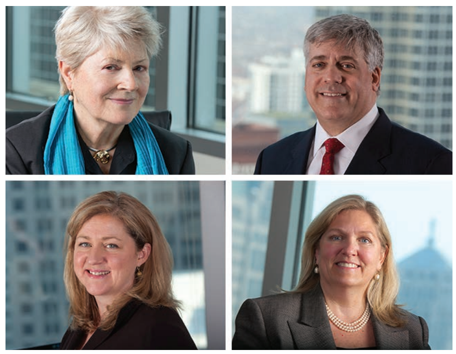
The market's dislike of adversity can be universal and indiscriminate. Thyra Zerhusen has excelled as an investor by often taking a more nuanced view.

Turned down for a job in Harris Bankcorp's economics department in 1976, Thyra Zerhusen was directed to equity research, a field brand-new to her. "The simple answer to how I got into investing is that I fell into it," she says.

She's certainly made the most of the opportunity. Her Chicago-based Fairpointe Capital now manages $7.5 billion and the mid-cap strategy she has run since 1999 has earned a net annualized 13.9%, vs. 9.6% for the Russell MidCap Index.

As comfortable investing in high-growth technology as in down-and-out industrials, Zerhusen and fellow portfolio managers Bob Burnstine, Marie Lorden and Mary Pierson see upside today in such diverse areas as network infrastructure, tires, specialty membranes and snack food. See page 2

INVESTOR INSIGHT



Fairpointe Capital
(clockwise) Thyra Zerhusen, Bob Burnstine, Mary Pierson, Marie Lorden

Investment Focus: Seek companies whose prospects appear much better than the expectations built into their stocks' absolute and relative valuations.

FAIRPOINTE CAPITAL

Performance as of March 31, 2014

	1 Year	3 Year	Annualized 5 Year	10 Year	Since Inception (3/31/99)
Fairpointe Mid-Cap Equity Mid-Cap Core	31.98	15.74	29.36	11.53	13.88
S&P 400 Index	21.24	13.37	24.86	10.14	10.68
Russell MidCap Index	23.51	14.39	25.55	10.05	9.50
S&P 500 Index	21.86	14.66	21.16	7.42	4.46

	1 Year	Annualized 2 Year	Since Inception (7/31/11)
Fairpointe Focused Equity All-Cap Value	26.50	24.37	23.87
S&P 500 Index	21.86	17.84	17.50
Russell 1000 Index	22.41	18.35	17.66
Russell MidCap Index	23.51	20.37	17.77

Performance is net of fees. See last page for additional disclosures.

Inside this Issue

FEATURES

INVESTMENT HIGHLIGHTS

Other companies in this issue:

Investor Insight: Thyra Zerhusen

Fairpointe Capital's Thyra Zerhusen, Bob Burnstine, Marie Lorden and Mary Pierson explain why their opportunity set has turned out to be narrow, why they own technology companies other value investors avoid, why their portfolios bounce back so well from adversity, and why they see upside in Juniper Networks, Cooper Tire, Polypore and PepsiCo.

Your mid-cap portfolio has an interesting mix, from new-economy stocks like Akamai Technologies [AKAM] to old-economy ones like Alcoa [AA]. What are the common denominators?

Thyra Zerhusen: We construct the portfolio stock-by-stock, regardless of industry, sector or style box. We don't target a specific percentage of what would be considered value or growth stocks, but just invest where we see the greatest opportunity.

The common denominator signaling opportunity tends to be valuation. We look at a variety of measures, but focus on Price/Earnings, Price/Sales, Price/Cash Flow, the P/E relative to the company's consensus expected annual earnings growth rate over the next three to five years, and the P/E relative to the S&P 500. Over the long-term when stocks trade on the low side of their historical ranges and relative to peers on these metrics, we've found that to be a good indicator of value.

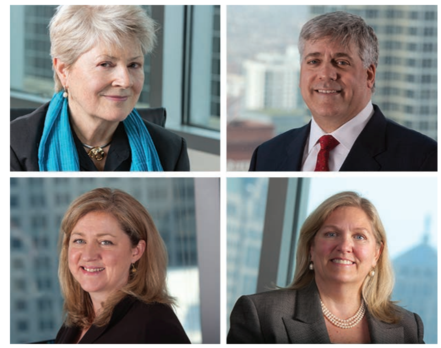
We have a strong preference for companies with must-have products or services that make their customers more efficient and profitable. We like growth a lot, but aren't willing to pay much for it. Even companies like Akamai, which will continue to be a key beneficiary of explosive Internet-traffic growth, go out of favor from time to time. Maybe a new competing product gets everyone worried, or needed investments in product development or sales and marketing hurt short-term earnings. We try to take advantage when growth stocks become value priced.

At the same time, when the market is offering up bargains in more traditional "value" areas, we want to take advantage of those as well. Alcoa shares last fall were back to recession levels as pricing and volumes were cyclically weak and it was kicked out of the Dow. Our view was that the company's increasingly value-added products would reduce its exposure to commodity pricing and that it would record strong revenue and earnings growth as worldwide economies recovered. We also expected it to be a beneficiary of the manufacturing comeback underway in the U.S., driven by comparatively low energy prices. [*Note:* Trading below $8 last quarter, Alcoa shares now trade at $12.50.]

On the subject of old-economy names, we recently bought shares in U.S. Steel [X]. We recognize the problems in the steel industry today, but the new CEO who took over last summer is aggressively working to restructure the company to improve results independently of a cyclical rebound. At today's share price [of just over $27], we don't believe the potential upside from that effort – or of a rebound – are accurately reflected in the share price.

Is cyclicality often to blame for the types of depressed valuations that attract your attention?

Bob Burnstine: It can be, but often the issues are more company-specific and cause uncertainty that the market dislikes. A good example that is still one of our larger holdings is Hospira [HSP], the world's leading provider of injectable drugs and infusion technologies, with $4 billion in annual revenue. What attracted our attention was the stock going from $50 to $30 in a short period of time in late 2011 after the FDA issued a warning letter due to manufacturing problems at the company's Rocky Mount, N.C. facility. We concluded that while the remediation efforts would likely depress margins, cash flow and earnings for some time, the issues were fixable and at some reasonable point in the future attention would get refocused on the company's very strong market position in injectable pharmaceuticals and its excellent growth potential both in international markets and in producing generic equivalents of biologic drugs.



Fairpointe Capital

Do-It-Yourself Investing

One big appeal to investing for many who practice it professionally is the ability to operate without a large organization. Case in point: Fairpointe Capital. Having run since 1999 the same mid-cap strategy for different firms, Thyra Zerhusen started Fairpointe in early 2011, signing a new contract to continue managing the Aston/Fairpointe Mid Cap mutual fund marketed by Aston Asset Management. To start the firm, she teamed with Harris Associates' alum Bob Burnstine – who would manage a new all-cap Focused Equity strategy – and her co-managers on the mid-cap fund, Marie Lorden and Mary Pierson. For managing what was then $3 billion in assets, that was it for the investment team. With assets now above $7 billion, the ranks have swelled by one with the addition of a research director in 2012.

Burnstine notes that this do-it-yourself ethic translates into how Fairpointe's two strategies are managed. His more-concentrated all-cap Focused Equity fund follows a similar value strategy, but has full leeway to own mid-cap stocks – recent examples being Legg Mason [LM] and VCA Antech [WOOF] – that his colleagues don't own. "We share a philosophy," he says, "but we believe it's also important that the lines of responsibility are very clear."

Has that happened yet?

BB: They don't yet have an all-clear signal from the FDA, but the issues continue to be resolved and remediation costs are winding down. That hasn't shown up yet in the financials – gross margins are in the mid-20% range and operating margins are less than 10%. But revenues have remained stable throughout this process and there's no structural reason why Hospira shouldn't get back to at least 40% gross margins and operating margins at a high-teens to low-20% level. If that happens, we think there's considerable upside from the current share price of $42-43.

Marie Lorden: For another example of a company-specific issue that might get our attention, we own Nuance Communications [NUAN], the leader in speech recognition technology enabling speech-to-text voice transcription. We first came across it as an app for the iPhone, but we believe it has significant growth potential across a variety of applications in the mobile, PC, automotive, healthcare and customer-care markets. One issue weighing on the stock is that the company is transitioning to an on-demand subscription business model. That's not only disruptive to the sales process, but it also results in an artificial revenue cliff as perpetual licenses that were recognized as revenue up front become on-demand subscriptions recognized month to month. The underlying business hasn't changed, but this impacts the numbers in a way the market doesn't seem to think is as transparent as we do.

This isn't anything we count on, but we often find our stocks also tend to attract the attention of activist investors. In Nuance, Carl Icahn has taken a large stake, which at the end of the year was more than 19% of the shares outstanding.

How generally do you define your mid-cap opportunity set?

ML: Our universe is stocks traded in the U.S. with market capitalizations between $1 billion and $12 billion. While that's something on the order of 2,000 stocks, we actually went back to when Thyra first took over the portfolio in 1999 and found that we've owned only a total of about 160 different names.

Mary Pierson: That's important when it comes to idea generation. We screen, talk to people in the industry, talk to other investors – all the things people do to spark ideas – but often it's just a company in an industry you know well having a product or manufacturing problem that results in a bad quarter and the stock becoming inexpensive on a historical and relative basis.

For example, we've been interested in water-related opportunities, and last year the stock of Xylem [XYL], a big player in water treatment and purification, went down 15% after what was perceived as a weak quarter. Our view was that nothing fundamental had changed except the stock price, so we were able to get an attractive entry point into what could be a long-term holding. In this case, the next quarter beat expectations and the stock [now at $36] has moved well beyond where it was even before the supposed troubles last year.

ON INVESTING IN TECH:

You get comfortable based on experience whether a company will see and react to changes in the market.

You've historically been much more active in the information-technology sector than the average value investor. Why?

TZ: You do find in the technology area a lot of the types of companies we like, with products and services that are must-have and make their clients more productive and efficient. They tend to have relatively good balance sheets, which we value. They tend to be benefitting from very large secular trends that provide a long-term tailwind. They also can be volatile, so if they stumble or are a few pennies short for a quarter, you can get a good entry point. It's a combination of all those things.

MP: The key risk is the threat of technological obsolescence. Here management's focus on the company's core strengths is critical. We are in effect relying on them to intimately know their customers and markets and stay ahead of the competition with best-of-breed products. We'll speak later about Juniper Networks [JNPR], one of our largest holdings, but we believe the current management team is focused and experienced and doing the right things to position the company to prosper as Internet usage and bandwidth continues to grow rapidly. It helps here that a high-profile activist investor, Elliott Management, is involved and that the company has recently named some new board members with deep industry experience.

If you've been involved with an industry for a long time, you can get comfortable based on past experience whether a given company will be able to see and react to changes in the market. If you're right and it's also in a megatrend kind of environment, it can obviously make for a very good long-term holding.

Spending time with management appears to be important to your research process. Why? Where else do you put emphasis?

TZ: Our direct contact with management is focused typically on the business outlook, competitive position and company strategy. In mid-cap we're often a top-20 shareholder and have a long-term perspective, so we can get to know management teams fairly well. That's important for the reasons Mary described, but also in providing context when issues arise. Earlier this month, for example, the FDA sent Hospira another warning letter related to the production of a device at its Rocky Mount facility. We got management right on the phone and were able to better understand what was happening, how the company was responding and what the disruption might be. In this case it helped us conclude that the issue wasn't going to have a material impact on the business.

Because our interest is so keyed to valuation being historically low, much of our research revolves around how a company, industry and competitive situation may have changed in ways that might make the historical experience less relevant. Sometimes things have changed for the worse and the current valuation levels are completely justified. But maybe they've made smart acquisitions and are positioned in better growth markets. Maybe they've restructured the product portfolio. In these cases we might conclude that the high side of the valuation range has shifted up, making a beaten-down idea that much more attractive.

Do you have a discount hurdle rate that must be cleared before you buy?

TZ: There's no hurdle set in stone. We generally look to buy at the lower end of the historical valuation range and sell at the higher end. Based on those same variables, we also look at the upside potential relative to the downside, but don't have a firm rule about the upside being X times the downside. There's art as well as science in valuation, and we tend to make decisions on what's attractive or not one stock at a time.

What sparked your initial interest in Juniper Networks?

TZ: About a year ago I was in Germany and I couldn't get through by phone to our office in Chicago. A few days later I read an article about how the whole telecom system had gone down for an hour and that it was partly a result of protracted underinvestment in telecom capital spending in Germany. As we looked further into that, we discovered that this underinvestment was more of a global problem. We also concluded that given the new demands being placed on telecom infrastructure by growing Internet traffic, this lack of investment couldn't go on. That pointed us toward Juniper, a leading supplier of high-performance network hardware, software and security solutions, which would benefit shorter term from an improved capital-spending environment, and longer term from the continued growth in Internet traffic.

The stock was trading at the low end of its valuation range and we were able to get in about a year ago around $17. We caught it right around the time when telecom spending started to pick up, which has clearly helped the stock, but we think we're probably only about halfway through that particular up cycle. The longer-term growth story as the Googles, Amazons, Facebooks and Apples of the world drive network infrastructure spending is still very much intact.

You mentioned Elliott's arrival as a large shareholder. How is the company responding to that?

ML: Whether directly tied to Elliott's activism or not, the company under new CEO Shaygan Kheradpir recently announced an "integrated operating plan" that is focused on streamlining the portfolio of businesses, reducing costs, better leveraging engineering expertise and returning capital to shareholders. One key overall goal is to increase adjusted operating margins to 25% by 2015, from around 19% last year.

INVESTMENT SNAPSHOT

Juniper Networks
(NYSE: JNPR)

Business: Provider of routing, switching and security hardware and software used to build and manage public and private computer and telecommunications networks.

Share Information
(@3/28/14):

Price	**25.62**
52-Week Range	15.62 – 28.75
Dividend Yield	0.0%
Market Cap	$12.84 billion

Financials (TTM):

Revenue	$4.67 billion
Operating Profit Margin	13.2%
Net Profit Margin	9.4%

Valuation Metrics
(@3/28/14):

	JNPR	S&P 500
P/E (TTM)	29.8	17.7
Forward P/E (Est.)	16.6	15.6
EV/EBITDA (TTM)	13.8	

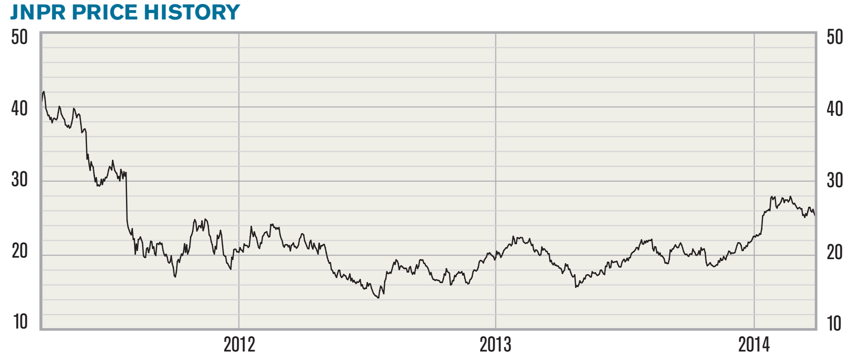
Largest Institutional Owners
(@12/31/13):

Company	% Owned
T. Rowe Price	8.3%
Vanguard Group	5.7%
Fidelity Mgmt & Research	5.6%
Manning & Napier	5.3%
Wellington Mgmt	5.0%

Short Interest (as of 3/14/14):

Shares Short/Float	9.9%

JNPR PRICE HISTORY



THE BOTTOM LINE

The company's renewed focus should result in greater earnings upside than expected as it benefits short term from high telecom capital spending and long term from ongoing growth in Internet traffic, says Marie Lorden. At a peer multiple on 2015 consensus EPS estimates – both of which are conservative, she says – the stock would trade above $32.

Sources: Company reports, other publicly available information

Nothing appears to be sacred, including a full review of the company's security business, which for years has been an underperformer relative to the core router and switch businesses. If they can't successfully integrate security more fully into the overall product offer, it should probably be spun off or sold.

While we're generally supportive of these initiatives and the renewed focus on core strengths, we might argue for a more balanced approach to capital allocation than Elliott has expressed. In a company like Juniper with a long growth runway ahead of it, we don't support returning so much cash to shareholders that you end up scrimping on investment opportunities or have to take on additional debt.

With the stock now around $25.60, how are you looking at valuation?

MP: At our entry point, Juniper's P/E relative to the S&P 500 – which Thyra mentioned is something we consider an important indicator of value – was 0.9, an absolute low over the past ten years. That metric is now 1.1, still at the very low end of the range.

The stock trades today at 13.5x the consensus 2015 earnings estimate of about $1.90 per share. If we look at a basket of peers like Cisco, Ciena, Riverbed Technology and Alcatel-Lucent, that basket trades at an average P/E on 2015 estimates of nearly 17x. We believe Juniper's various operating initiatives give it greater earnings upside than the consensus expectation, and because it's likely to grow faster than the market, that its stock should trade at a premium valuation to the market. If those things happen, there's still plenty of upside in the stock over the next year or two and beyond.

From the Internet to tires, explain your thesis for Cooper Tire & Rubber [CTB].

TZ: What brought this into focus was a botched takeover attempt of the company last year by India's Apollo Tyres, which originally agreed to pay $35 per share for Cooper and then couldn't pull it off, so tried to cut the price. At the same time that was going on, one of Cooper's joint venture partners in China shut down due to a strike, which was partly in protest of the potential acquisition. As this all played out, the stock went from around $24, up to nearly $35, and right back down to $24, which is about where it is today.

It's fair to say that tires are not a great business. Input costs are high and there's a great deal of domestic and foreign competition. Cooper is the #4 player in the U.S. market, focusing primarily on replacement tires at mid to low price points. Roughly 70% of sales come from North America, with the rest fairly well diversified around the world.

So what's to like?

ML: There are potential positives we don't think the market is fully recognizing. The U.S. replacement-tire market has been down in four of the past six years and we believe is poised to improve as the economy does. The Chinese strike has been disruptive, and while not all the issues between Cooper and its partner have been resolved, the plant involved is up and running again and selling into an attractive

INVESTMENT SNAPSHOT

Cooper Tire & Rubber
(NYSE: CTB)

Business: Design, manufacture and marketing of passenger-car, light-truck, medium-truck and motorcycle tires sold primarily in the replacement market.

Share Information
(@3/28/14):

Price	**23.74**
52-Week Range	20.55 – 34.79
Dividend Yield	1.7%
Market Cap	$1.55 billion

Financials (TTM):

Revenue	$3.44 billion
Operating Profit Margin	7.5%
Net Profit Margin	3.2%

Valuation Metrics
(@3/28/14):

	CTB	Russell 2000
P/E (TTM)	13.7	74.8
Forward P/E (Est.)	10.9	19.0
EV/EBITDA (TTM)	4.0	

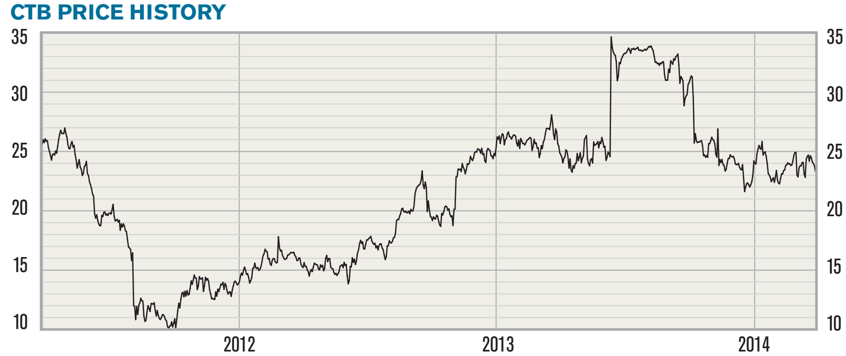
Largest Institutional Owners
(@12/31/13):

Company	% Owned
BlackRock	8.4%
Morgan Stanley	5.7%
AQR Capital	5.5%
National Rural Electric Co-op	5.2%
Vanguard Group	5.2%

Short Interest (as of 2/28/14):

Shares Short/Float	9.4%

CTB PRICE HISTORY



THE BOTTOM LINE

After a year of relative upheaval, the company is poised to rebound from cyclical market improvements in the U.S., a recovery from a strike in China, and growth from a joint venture in Eastern Europe, says Thyra Zerhusen. If EPS were to return just to 2012 levels and the P/E were at a historical midpoint, she says, the stock would rise more than 40%.

Sources: Company reports, other publicly available information

and growing market. The company is also very excited about the prospects for its Serbian joint venture in expanding sales in Eastern Europe. Finally, Cooper has had recent success in cracking the original-equipment market in the U.S. with a contract to supply tires for the Ford Focus.

How could all this benefit the shares, now trading at $23.75?

TZ: The stock is currently cheap on an absolute basis, at around 11x forward earnings. Its trailing P/E relative to the S&P 500's is about 0.7.

This is a business that has earned $3.40 per share as recently as 2012, and there's no fundamental reason it can't return to that level if some of the positives Marie mentioned come through. The P/E range over the past five years has been between 5x and 15x, and if the earnings do come back we could see the P/E moving back toward the upper end of that range. Things won't likely improve in a straight line, but we consider the risk/reward from today's price to be very attractive.

There's also been controversy around your next idea, Polypore International [PPO].

BB: Polypore manufactures specialized microporous membranes used in separation and filtration processes. Last year it generated about $640 million in revenue, roughly 50% of which came from supplying makers of vehicle lead-acid batteries, 30% of which came from supplying membranes for healthcare and other specialty applications, and 20% of which came from supplying manufacturers of lithium batteries used in electric vehicles and consumer electronics.

While 80% of the business is stable and growing at nice organic rates in the mid-single digits, the controversy is centered on the lithium-battery business. In addition to demand for electric-vehicle batteries not meeting the company's or market's expectations, Polypore is also in the middle of a nasty fight with one of the big makers of those batteries, LG Chem. LG Chem has stopped buying from Polypore and says it's looking for a new supplier of separator material, but Polypore argues that any other supplier will have to infringe on Polypore's intellectual property to meet contract specifications and will thus owe it royalties.

We assume you're taking Polypore's side.

BB: We expect Polypore's intellectual property rights to win out, but our bigger point is that the market has gotten so caught up in the LG Chem battle that it's missing the forest for the trees. The business outside of electric-vehicle batteries is healthy and growing, and while the electric-vehicle-battery business may not be meeting lofty expectations, it's a very fertile growth area going forward. We don't think either of those things is accurately reflected in the current share price.

MP: We've had success in somewhat similar situations investing in companies like Cree and First Solar, where there was a feeding frenzy about an emerging technology, followed by product demand not coming through as expected and short-term investors fleeing the stock. When that happens, we can often find opportunity.

INVESTMENT SNAPSHOT

Polypore
(NYSE: PPO)

Business: Global provider of microporous separation and filtration membranes used for a variety of healthcare applications as well as in lead-acid and lithium batteries.

Share Information
(@3/28/14):

Price	**33.73**
52-Week Range	29.39 – 48.41
Dividend Yield	0.0%
Market Cap	$1.51 billion

Financials (TTM):

Revenue	$636.3 million
Operating Profit Margin	13.8%
Net Profit Margin	12.8%

Valuation Metrics
(@3/28/14):

	PPO	Russell 2000
P/E (TTM)	33.8	74.8
Forward P/E (Est.)	23.9	19.0
EV/EBITDA (TTM)	14.1	

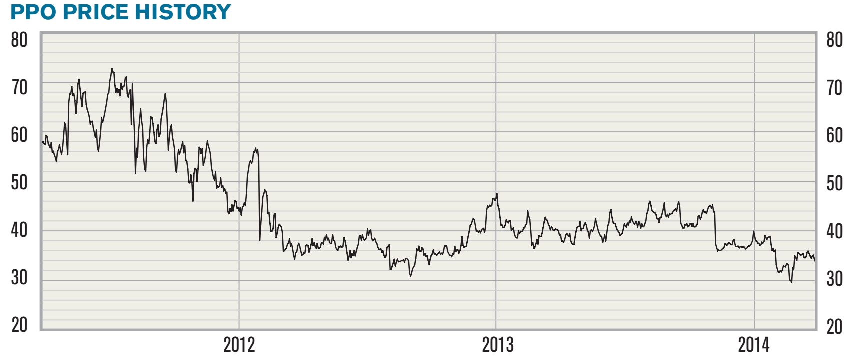
Largest Institutional Owners
(@12/31/13):

Company	% Owned
Capital Research Global Inv	11.2%
Primecap Mgmt	9.7%
Janus Capital	7.5%
Wasatch Adv	7.0%
Waddell & Reed	6.8%

Short Interest (as of 2/28/14):

Shares Short/Float	43.6%

PPO PRICE HISTORY



THE BOTTOM LINE

The market is fixated on controversy in the company's business tied to electric-vehicle batteries, says Bob Burnstine, ignoring the fact that 80% of revenues come from other solid, nicely growing businesses. Justifiably moving from the lower to higher end of the stock's five-year valuation range, he says, would result in a share price of around $60.

Sources: Company reports, other publicly available information

We're comfortable that electric vehicles will eventually earn a meaningful share of that market and that Polypore is in an excellent position to benefit from that. At the same time the LG Chem relationship was going south, the company announced new supply relationships with both Samsung and Sumitomo, which are important suppliers to Tesla and Nissan. Several other deals are in the works as more and more car manufacturers advance their electric-vehicle plans.

The shares at a recent $33.75 go for less than half their mid-2011 high. How are you looking at upside?

BB: The stock over the past five years has traded between 1.5x and 6.5x revenues, while the P/E has been mostly in the high-20s. Today it trades at less than 2.5x revenue and the P/E on consensus 2015 estimates is around 18x.

If the LG Chem issue is resolved satisfactorily and the lithium-battery business rebounds even modestly, we could imagine the Price/Sales multiple moving back up toward 5x and the P/E going back to where it has been. That would result in a stock price in the high-$50s to low-$60s.

Given the short interest here, now around 44% of the float, many investors would seem to disagree.

ML: Despite its relatively small impact on the financials, the LG Chem issue does raise questions. Again, we expect Polypore's technology to continue to be dominant in the market for lithium-ion batteries.

Turning to an idea from your all-cap strategy, what interests you in PepsiCo [PEP]?

BB: This is a great business, with 22 brands that generate over $1 billion in annual revenue and another 40 that produce $250 million to $1 billion. The company has the #1 market share in the global snack business and the #2 share in beverages. Its vast distribution network is both a competitive advantage and a barrier to entry. Operating margins are high, 15% currently, and we think are on the way up as the company continues to grow.

Things like Michael Bloomberg cracking down on large sodas strike us as a lot of noise. We believe demand for salty snacks and for packaged beverages will continue to grow. We're expecting top-line growth at least in the mid single digits annually, as Pepsi innovates on the product side and expands its business in emerging markets, where growth is at twice the rate of developed markets.

An activist, Nelson Peltz, is at work here as well. Do you agree with his agenda?

BB: Common sense would indicate to us that the food and beverage businesses benefit from being together and leveraging the overlapping distribution and cost bases, so we wouldn't advocate splitting them up. That said, we fully support the company's increased emphasis on controlling costs, the results of which have so far been quite impressive. We're confident management can continue to improve margins while spending what it takes to support organic growth.

At a recent $83, how inexpensive do you consider the shares?

INVESTMENT SNAPSHOT

PepsiCo
(NYSE: PEP)

Business: Manufactures, markets and distributes snack and beverage products globally under such brands as Pepsi-Cola, Frito-Lay, Gatorade, Quaker and Tropicana.

Share Information
(@3/28/14):

Price	**82.95**
52-Week Range	77.01 – 87.06
Dividend Yield	2.8%
Market Cap	$126.29 billion

Financials (TTM):

Revenue	$66.42 billion
Operating Profit Margin	14.9%
Net Profit Margin	10.1%

Valuation Metrics
(@3/28/14):

	PEP	S&P 500
P/E (TTM)	19.2	17.7
Forward P/E (Est.)	16.9	15.6
EV/EBITDA (TTM)	11.8	

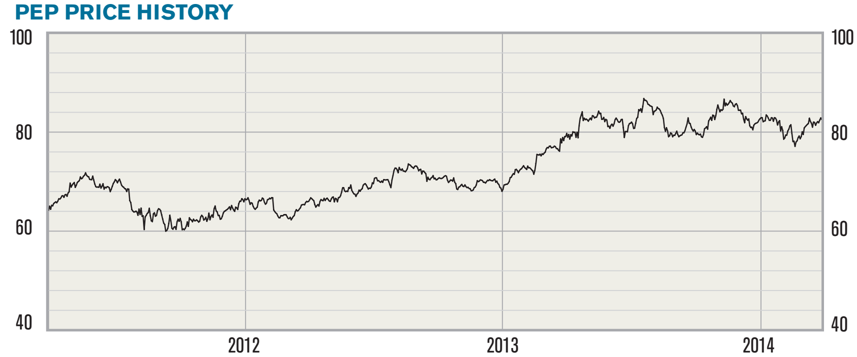
Largest Institutional Owners
(@12/31/13):

Company	% Owned
Vanguard Group	5.7%
State Street	4.3%
Capital World Inv	3.6%
BlackRock	2.6%
Yacktman Asset Mgmt	2.1%

Short Interest (as of 2/28/14):

Shares Short/Float	0.7%

PEP PRICE HISTORY



THE BOTTOM LINE

Despite the market's multi-year indifference to its shares, the company is doing the right things in reducing its cost structure and leveraging its vast distribution network and product-innovation skills to fuel growth, says Bob Burnstine. From EPS growth and a return to historic-average valuation levels, he would expect the stock to hit $115 within two years.

Sources: Company reports, other publicly available information

BB: The stock has badly lagged the S&P 500 over the past five years, to the point where in a fairly valued market, you have an iconic brand trading well below historic averages on such metrics as EV/Sales, EV/EBITDA and forward P/E. We think the stock today is worth around $100 – at historic-average levels of 2.5-2.6x revenue, 13x EV/EBITDA and 20x earnings – and just from EPS growth over the next two years should move closer to $115.

This is one where we don't profess to have a great information advantage. We just think the sentiment has gotten too negative for what is still an extremely high-quality company.

What's something you've sold recently for reasons other than it hit fair value?

ML: One that comes to mind would be Denbury Resources [DNR], a U.S.-based oil and natural gas producer that specializes in pulling up resources from old wells that other firms no longer want. One reason we had owned it was because we thought its almost exclusive U.S. focus would make it more competitive with imported oil as energy demand rose in the U.S. But with the huge increase in U.S. supply from new drilling techniques, that's provided little incremental benefit to Denbury. Coupled with the fact that it was expecting to spend heavily on capex and acquisitions to sustain and grow its business, we decided to move on.

Any illustrative mistakes of late?

BB: One I made last year was Walter Energy [WLT]. It produces metallurgical coal for the steel industry, most of which is exported. I'd watched the stock fall from $140 a couple years ago to $18 last spring and concluded – apparently along with the Chairman, CEO and CFO, who were all buying at around that price – that I had plenty of margin of safety even in such a volatile commodity business.

What I failed to adequately assess was the impact on pricing of increased Australian met-coal supply meeting continued weak met-coal demand, primarily from China. As prices continued to drop, my concern rose that the leverage the company had taken on to make acquisitions when times were good might call into question whether it would even survive. The stock went from $18 to $11 in less than three months and I sold rather than risk a permanent loss of capital. [*Note*: After rebounding to almost $19 in November, WLT shares have since fallen to below $8.]

ON MISTAKES:

There's a reason we focus on companies with barriers to entry, scale, pricing power and balance-sheet strength.

I clearly misread the supply/demand situation, but the fundamental lesson here is that there's a reason we focus as much as we do on companies with strong franchises, barriers to entry, scale, pricing power and balance-sheet strength. I was seduced into thinking those things were less important because the stock appeared so cheap. I'll look at it as a healthy reminder.

We thought you might mention Staples [SPLS], which has been the go-to mistake example we've heard from many value investors lately.

BB: We initiated our position in August 2012 at around $11, and after the share price hit $17 last August it's now back to around where we bought it. While that's frustrating, we ask ourselves if we'd buy the stock today if we didn't own it and the answer is still yes.

Our basic thesis is that as the largest global office-products company and second-largest Internet retailer behind Amazon, Staples should be able to offset secular and cyclical headwinds through growth in adjacent product categories, market-share gains, stabilized international operations, aggressive downsizing of the retail footprint and cutting overhead. If that proves to be the case, the shares should be worth far more than the current 0.3x revenues and less than 11x forward earnings. In the meantime, the company generates a lot of free cash flow and we're collecting a better than 4% dividend yield.

You've cited the active trading you do around positions as an important reason you've beaten the market so handily. Explain what that entails and why you think it's a competitive advantage?

TZ: One important part of our discipline is making sure the portfolio is attractively valued relative to the benchmark. For the mid-cap portfolio, we always want the overall average Price/Earnings, Price/Sales and P/E-to-long-term-growth-rate ratios to be lower than the averages for the S&P and Russell mid-cap indexes. Whenever that isn't the case, we'll rebalance in order to correct that.

MP: On a stock-by-stock basis we're also constantly adding to positions when the price is down and trimming them when the price is up. That sounds simple, but is actually quite contrary to human nature and difficult to execute well.

Marie mentioned earlier that we've owned 160 or so different stocks over the past 15 years. That's reflective of the fact that we only own companies whose history and prospects we understand very well and for which we've developed a clear sense of what they should be worth. If what the market says they're worth at any given moment is different from that intrinsic value – which happens more prominently in the higher-growth tech stocks we own – we've been successful in taking advantage of that.

TZ: Each time we've had a down year, we followed it with a year in which we substantially outperformed. That requires justified confidence in your convictions and a willingness to add more to your most down-and-out positions. Again, that sounds straight-forward, but judging by what many investors do in tough times, it obviously isn't so easy to do. VII

Additional Disclosures

Mid-Cap Composite contains fully discretionary equity accounts that follow the mid-cap style. Mid-Cap Composite represents portfolios that seek long-term total return through capital appreciation by investing primarily in mid-cap stocks. For comparison purposes the composite is measured against the S&P MidCap 400 and Russell MidCap indices.

The Focused Equity Composite includes fully discretionary portfolios that invest in both mid and large cap equities, has 80% or more in equity holdings, has no more than 10% in short term duration fixed income instruments (2 years). Portfolios with low cost basis holdings will qualify as long as the total of those holdings are less than 10% of the total portfolio, are not on the FFE Approved List, and all other criteria are met. The Focused Equity composite represents portfolios that seek long-term total return through capital appreciation by investing primarily in both mid and large cap stocks. For comparison purposes the composite is measured against the S&P 500 and Russell MidCap indices.

The S&P MidCap 400 is a market value weighted total return index that represents the performance of the medium-capitalization sector of the U.S. Securities market. The Russell MidCap is a market value weighted total return index that represents the midcap segment which measures the performance of the 800 smallest companies in the Russell 1000 index. The S&P 500 is a market value weighted total return index that represents the performance of 500 widely held large cap stocks held in the U.S. Securities market. The Russell 1000 is a market capitalization-weighted index made up of 1,000 large cap stocks that account for upwards of 90% of the market capitalization of companies traded in the U.S. The indices are representative of the types of equity assets invested by Fairpointe Capital. Market indices are unmanaged and do not reflect the deduction of fees. You cannot invest in an Index and the performance of the Index does not represent the performance of any specific investment.

Past performance is not indicative of future results. Market, economic, company, and industry specific conditions are considered during the investment selection process. This was a period of generally rising security prices. Returns include the reinvestment of all dividends, capital gains, and other earnings.