

## Our Investment Philosophy

I've been looking at the television from time to time lately; and often come stories of the swine flu pandemic and other similar concerns. I remember SARS several years ago, but what few of us realize is that the biggest pandemic that faces us in our own industry is something I'd refer to as "crystal-ball-itis."

We live in an industry that's populated largely by intelligent people, people who studied for quite some time to come into this industry, and, almost as a means of protecting their own ego, they feel the need to be able to project with crystal clarity some view of the future, to be somewhat of a soothsayer. I call it "crystal-ball-itis" because people in our industry like to think that they hold a crystal ball: it gives them the feeling of having some unique insights into the future; it tells them a little bit about which company is going to be the winner of tomorrow; it tells them a little bit about which market will be going up the most over the next 12 months. But the reality is, no one has a crystal ball.

Someone I respect said, "Ignorance is bold, knowledge reserved." That same person said, "Very few things are brought to successful conclusion by impetuous desire, but most by calm and prudent forethought." Now those comments were not made by Warren Buffett, although they could have been, not even by Ben Graham. Those comments were made over 2,000 years ago by a Greek historian, Thucydides. When I reflect on those comments, and reflect on what it is that we do, something that strikes me deeply is that in the last couple of thousand years, the tapestry of human endeavor has been rich and interesting. Technology has grown manifold, but human judgment has not really changed. The wiring of our machinery has not really changed that much. The kinds of mistakes that we make are similar.

I read a book some years ago by Josh Waitzkin. Josh Waitzkin is an interesting man because he was a world champion both in chess and in martial arts; he mastered two domains. His book was called "The Art of Learning." One of the things he talked about in "The Art of Learning" is that a common mistake people make when they're learning chess is that they learn many, many opening games. For those who have played chess, you have probably seen many textbooks that tell you all about the hundreds of different openings of the game but people then lose their way in the middle game. One of the things that he spent most of his early career in chess doing was studying the end game, knowing what he wanted the board to look like in the last stages of the game. There are two things that one needs to accomplish in chess: one wants to get a checkmate, capture the opponent's king, but perhaps most importantly, one doesn't want to lose one's own king.

If you think about our goal in investing, I would argue to you that most investors are very focused on the opening game: they go through college, they learn about discounted cash flows. So the first thing that they're wired to do is to think about making projections about the future and discounting those back. There's almost a false sense of scientific precision about their ability to do that. If someone is an intelligent and thoughtful person, they almost feel some entitlement to be able to predict that future and then discount it back. What that person is probably also likely to learn is that markets are relatively efficient, so you want to structure your portfolio so that you don't look too different from the market.

Then, I think back to the last three decades and the major bear markets over those three decades -- Japan, 1989 to 1999 and the last decade, as well, technology in 1999 and the financial services in 2008. These were events that had devastating wealth destruction consequences, yet each of those sectors was the largest component of the market before the bear market set in. So, if you started your career in investing by analyzing the opening game, by thinking about what you had been taught, to project the future and discount it back and to not stray too far from the market, than you probably made a lot of the mistakes that Thucydides would have cautioned you against making 2400 years ago. You would have been bold in your ignorance and you would have been encouraged to do things that were only capable of being described as impetuous desire in buying tech stocks at 100 times earnings or buying Japanese equities at 60 times earnings or buying "black box" highly leveraged financials at 4 or 5 times tangible book.

If you look at the way we have managed money over the last few decades, we have tried to think closely about what we want the end game to be for our clients. The first and most important end state that we want for our clients is we want to preserve the real purchasing power of their capital. Forget projecting a certain state of the world, forget looking like the market. Our first goal, the way we want to end up, is preserving the real value of our clients' money.

Now near term, people may suggest that the path to doing that is all about owning low-volatility securities. Well, again, they are coming back to their wiring and their education that the risk-free instrument is the lowest volatility, short duration Treasury bond. But, in our opinion, that is wrong. As you extend your time horizon, as you think beyond the opening game of the next month, or the next two months and you focus on the next five years, or the next ten years or the next generation, one thing you know for sure is that net of inflation and taxes, the ownership of cash is going to erode one's real purchasing power.

The Arnhold's were very successful commercial bankers during the period of the Weimar Republic in Germany. That was a period of hyperinflation. The ownership of government securities during that period, which represents an extreme set of history, but a set of history that actually transpired, produced real returns of close to negative -100%. The family survived as bankers by virtue of their ownership stakes in real businesses, in the porcelain, the brewing industry.

So, if you start with the right time horizon, if you think about what you want your capital to look like, not in the next month or quarter, but in the next five or ten years, you realize that you have to be an owner of something that is going to scale, over time, with nominal income if you want to preserve your purchasing power. The only two things that scale over time with nominal income are businesses, because you own slices of the world's nominal spending pool, and scarce real assets like gold that can't be produced, can't be printed and that people compete for based upon their purchasing power.

We realize that our goal is not about minimizing short term volatility, but it's about preserving purchasing power long term, which means that we know, in advance, that we need to be owners of enterprise. Now, if you know that you need to be an owner of enterprise, the second question that one poses, if one is a thoughtful student of history, is, "How do I reconcile that with the fact that there are very volatile cycles, 'the animal spirits', as Keynes said?" The Austrian economists also talked greatly about credit crises. We know, over centuries, that the path of humanity has been on an upward trend, but that equilibrium has been punctured on many occasions. The question is, "If we know we've got to be owners of enterprise, how do we structure ourselves to survive those inevitable punctures so that we can preserve capital for the long term?" Well, as I intimated, the answer is not in having a crystal ball and trying to zig and zag ahead of every anticipated market move, because we can't do that. If you think about all of the experts that you've listened to in the last couple of years, who told you to zig at certain times and then zag at other times, and even if you think about your own thoughts and confront that reality, how many were right? How often were you right? For us, it's not about trying to zig and zag successfully ahead of every twist and turn in the market. What we try to focus on is controlling our own emotional state, our own temperament. Going back to the words of Thucydides, "Ignorance is bold, knowledge reserved."

Jean-Marie has always said, "The future is uncertain." Recognizing that the future is uncertain is the first path towards allocating capital successfully, because as Ben Graham said, if you're a long term investor and you know that you want to be an owner of enterprise over time, just recognizing the fact that the future is uncertain is hugely liberating, because you don't have to be prescient. You don't have to predict the market action before it happens. You can simply wait and take advantage of it after it happens. So when markets boom, you can be a little bit more cautious than the crowd, you can sell those businesses you own that meet your sense of intrinsic value, you can let your cash levels drift up a bit, because you're underwriting, not for the next six months, but you're underwriting for the next decade.

On the flip side, when things feel awful, you have the willpower to say, I'm going to be a buyer in this environment, because I know that long term, in order to preserve the purchasing power of my capital, I need to be an owner of enterprise. Is it better to be a buyer of enterprise in a time of ebullience and high prices or at a time of distress and low prices? It's as simple as that. You don't have to predict prices in advance; you just have to bring to the table the right mental frame of mind to take advantage of whatever it is that the world delivers to you.

If we go back to what Josh Waitzkin said about the end game in chess, you also have to have a crystal clear view of what you don't want things to feel like, the state that you don't want. If you are a chess player, you hate to be in that state where your king is under threat and you have very few pieces to defend yourself. As an investor, I have a very clear emotional template for what I want to avoid. I call it the "Angst Quadrant." It's that period in time when you feel forced to sell at a loss, when you realize that what you bought may not be what you thought. A business may have undue leverage and all of a sudden you realize that. Then, I might be forced to sell at a very low price because of the dilution risk. We have a clear sense of what it is that we don't want and that informs our perspective. We call it "Winning by not losing." It's incredibly hard to recover from a situation where you're down 75% or down 80%. The laws of compounding mean that if you're down 50% you have to be up 100% to break even. When we think about underwriting, part of our thinking from a macro perspective is being willing to take advantage of market moves after the fact, but from a micro perspective, it's having a crystal clear sense of what we want to avoid. By and large, what we want to avoid is buying stocks that trade at high multiples of their historical cash flow for a very simple reason: if we're paying a high multiple of historical cash flows, that is "crystal-ball-itis." We're paying for our view of the future. Price is objective; your view of the future is subjective. So if we buy securities that we think have a discount on historical cash flows, we're not paying anything for our view of the future, and that's a decent place to start, because you can't be disappointed. Happiness is outcomes divided by expectations.

The second thing is that we avoid imprudent management behavior. If you look at our portfolios, we don't have much exposure to highly leveraged balance sheets, we don't even have much exposure to companies that are growing their balance sheets quickly. We like to align ourselves with prudent entrepreneurs. What we have found over time is that if we buy companies at low prices and if we buy companies that aren't levered, if we're aligned with prudent entrepreneurs and if we've identified businesses that we think will be relevant in five or ten years time, than very rarely do we get ourselves into the "angst quadrant" that I referred to before.

We underwrite to avoid certain exposures. It's as simple as that. By doing so, we end up owning good businesses at good prices, value-creating businesses at value prices. The source of our returns, therefore, is the compounding of low prices and decent businesses. We're quite happy to own mundane businesses, as long as we can buy them at compelling prices. That's the core of what we do. Now in order to do that, we have to be willing to look very different from the markets. We don't define our goal as tracking error; tracking error is dispersion from the market. We've defined our goal as "avoiding the permanent impairment of capital," and if we avoid the permanent impairment of capital, we will, over time, have a higher chance of compounding out our returns attractively.

By thinking about the world that way, we are willing to be out of very large sectors of the market in order to preserve capital. When people talk about portfolios that look different from the market, they think about portfolios that are making big bets on certain themes for tomorrow. For us, the biggest differences we would have with the market have been made in an attempt to preserve capital. I mentioned the three main bear markets of the last three decades. We were largely unexposed to Japan in the late '80s, tech in the late '90s and financial services in 2007. At each of those points in time, those sectors were the biggest in the market. So if your goal was to minimize tracking error, you would have felt obliged to own those sectors of the market. But if your goal was to avoid the "angst quadrant," if your goal was to avoid the permanent impairment of capital, to not have your king taken, then it makes a lot more sense to be out of some of the big sectors of the market sometimes.

If you look at our portfolios, because we underwrite on a security-by-security basis, we don't buy exposure to countries because we want a thematic exposure. We buy one security at a time and we buy it at 50, 60, 70 cents on the dollar, depending on the quality of the business. For us, the rubber meets the road at the micro level, even though we might have a macro perspective. So when you look at the kinds of companies we own, they're an eclectic bunch of companies. We have royalty-like businesses that we see participating in a franchise-like way in certain slices of the world's consumption basket. Whether it's companies like **FANUC** in robotics, or whether it's businesses like **Grupo Televisa** in Hispanic media content or whether it's businesses such as **SMC** in pneumatics. These are businesses that we think have a royalty-like character to them, because they have a dominant position in an industry that's going to be relevant to tomorrow.

On the other hand, we have more mundane businesses. Our portfolios own businesses where we see them being resilient and having staying power, and the stocks are very cheap relative to their existing cash flow. This could include business like **Cintas** in uniform rentals or **Secom** in Japan in home alarm systems. But whether it's the **Shimano**'s in bicycle components that are well known, or whether it's a small company in Japan that makes boilers, if you look across our portfolio, we own a range of eclectic businesses that we don't own because we're trying to look like an index, but that we own because each individual security makes sense at the current price. That's a very important distinction.

We've been willing, as well, to look across the entire capital structure. Sometimes when our analysts are looking at certain parts of the market, they might find a company they like, but a balance sheet they don't like. Often the right thing to do in that case, is to buy the debt, not the equity. So if we can find an investment in a corporate debt instrument that provides an equity-like return but a more senior position in the capital structure, we'll take that lower-risk route. Now it doesn't happen very often, but when we find those situations, we have the flexibility and the open-mindedness to go after them.

As Ben Graham advised to take advantage of market movements after the fact, we're different from most in that we don't feel the need to be fully invested at all times. If we can't find businesses at good prices, we let the cash build as we are selling businesses at intrinsic value. On the flip side, as was the case in the fourth quarter of last year and the first quarter of this year, if the stress in the world produces a higher frequency of good businesses at good prices, we let the cash level come down, and become more fully invested in enterprise. Because our goal is not to get the next three months right, our goal is to preserve capital over the next decade. Patience is core to what we do.

Think back to what Thucydides said, "Very few things are brought to successful conclusion by impetuous desire. Most are by calm and prudent forethought." We sometimes have to be willing to look different from the market for years at a time, as was the case in the 1990s. Jean-Marie said something back then that has defined us ever since and that is, "I would prefer to lose half of my shareholders than half of my shareholders money." We are willing to look different and, if you think back to what Josh Waitzkin said about analyzing the end game, an incredibly important part about our ability to execute on our underwriting philosophy is to be in the right corporate environment. If you were practicing investment underwriting along the lines of what we do wrapped up into a conglomerate, you may not be given the patience or the time horizon to stick to your discipline. Jean-Marie did lose over half of his clients. This is the time when the Arnhold family purchased his business. There's an incredible peace of mind achieved in being part of an organization that understands value investing, has lived it for the last century and is willing to take the time horizon to let things take their natural course.

We're a private company. We don't have to manage for the next quarter. So in this downturn, not only have we been able to sail a steady course and increase our ownership of enterprise at an advantageous time, but the firm that we work within was willing to invest in the team at a time when others were laying off. Today we field what we believe is the most experienced team the organization has ever fielded. I'm very proud to be a part of this team. I work alongside Abhay Deshpande, my co-portfolio manager. I have the benefit of being able to take advice from Jean-Marie, who's been

investing since the early '70s, 40 years of investing experience. I have the benefit of learning from Bruce Greenwald as our Director of Research. Bruce is the head of the Heilbrunn Center for Value Investing at Columbia University, filling the role that Ben Graham filled originally. Bruce is at the center of a large network of value investors. I have the great privilege of working with a very talented group of analysts. In our business, there's not much distinction between being a portfolio manager and an analyst. We're all researchers at heart. We're all looking for the asymmetry between price and prospects. I work alongside people like Elizabeth Tobin, who Jean-Marie hired originally back in 1986. I work alongside people like Kimball Brooker, who prior to joining us, was the Chief Investment Officer at Corsair, the private equity spinout of J.P. Morgan that did largely un-levered transactions in the financial services arena and investment holding companies with a very successful long term track record. I have partners like Matt Lamphier, who has a decade and a half of investing experience; Alan Barr, two decades of investing experience; Rachel Benepe, the Gold Fund Portfolio Manager; Rob Hordon, Omar, Oanh, Mark and our two new recent hires, Manish and Giorgio. We have a dedicated research associate, Debbie Lusman, who helps coordinate our relationship with The Street. We have two very experienced traders: our head trader, Doug DiPasquale, who has over two decades of experience and works with Frank Woglom, with three decades of experience. This year, behind the scenes we've added value for our clients on the trading front. Our commissions are down nearly 50%, but we're getting better execution.

The team itself is what makes this all possible and the organizational environment that we exist within. The one thing that is most hard for you to judge from the bios of this team, but that we've worked hardest to produce, is the temperament. Experience doesn't get you very far unless you have the right temperament. We have tried to put together a group of people who don't have any hubris, who are very open-minded, who are flexible, who don't think they have a monopoly on the truth, who are patient and who are willing to look for two, three or four ideas a year. That's the way we've structured our environment and we've structured it that way for the long term.

When people analyze the crisis of the last two years, I think there's a tendency to myopically focus on what's under our own noses, the sub-prime cycle, poor lending practices and the like. I've spent my life traveling around the world and so have most of the team members that I work with, and we look at the current crisis through, perhaps a somewhat different prism. We view it as part of a global systemic phenomena. The world changed in the late '80s and the early '90s. I remember some of my personal travels during that time. In 1987 I visited Checkpoint Charlie in Berlin, I went to the Wall and it seemed like this great, permanent edifice that would be there for time immemorial. You've heard the stories of people who successfully escaped from East to West Berlin. I remember in 1988 going to Guangdong Province in the south of China and seeing quite abject poverty, but the seeds of development were there. In your mind you have this picture of modern Europe, but divided, and an Asia on the cusp of something, but that something that was hard to define. Well, then all of that changed quite dramatically over the next few years.

My wife is Polish and I had to make several trips to Poland to win favor with her grandmother before having the permission to propose. On one of those trips I made, in fact the first trip I made, was at the end of 1989. Traveling as students, we couldn't afford a direct flight out of Warsaw so we had to take the overnight train back to Berlin, and we happened to be in Berlin at the time the Wall was falling. All of a sudden, this edifice that you assumed was permanent started to change and you lived that moment. Also in 1989, we also had Tiananmen Square, but a few years after that we had Deng Xiaoping's southern tour in China when he started to advocate a course of more market-based development. I think the world really changed with those two events. I also had the pleasure, a few years ago, of hearing Mikhail Gorbachev at a client function at Goldman Sachs. He was relating a story of when he'd first met Ronald Reagan and when they embarked upon the path that they ultimately did.

A lot of things happened in the late '80s, early '90s that changed the trajectory of the world. Now as we embarked upon this period of much greater productivity growth in Asia, one of the things that happened in China was that not only were they converging on a market system and therefore having more productivity growth, but they saw what Japan had achieved in the '70s and the '80s with an undervalued currency. So they worked hard, not only to create special economic

zones and to bring in more productive business practices, but they did it with the benefit of a somewhat undervalued currency. So you saw an explosion of economic activity in China and an explosion in the current account surplus. Now in economics, a current account surplus has to be invested somewhere. That current account surplus, in simple terms, became the current account deficit for the United States, capital account surplus of the United States. Capital came into the United States. That pushed real interest rates down to levels that were, perhaps, lower than they otherwise would have been and because the currency in China wasn't freely convertible, the recycling of that capital happened not through day-to-day transactions between individuals like you and me, but it happened through the Central Bank, where there was a tremendous demand for AAA securities and they ultimately were created, synthetically created AAA CDOs. To understand why we had the asset bubble in the first place, you have to understand what happened in the context of the world. There were massive capital flows as a result of the change in the structure of the world economy and the existence of certain currency pegs. The financial architecture was not perfect and, in addition, the fact that we had this period of great productivity produced a degree of confidence that led certain people to shorten the duration of their capital structures and that produced vulnerability, a credit boom and an ultimate bust.

So here we are. Today, as we look out at the world as owners of enterprise, in broad terms we don't see equities as either a bargain nor do we see them being a bubble. Valuations are pretty rational in the equity markets today. We are more fully invested than we were at the end of 2007 because valuations are lower, but we're less fully invested than we were at the end of February this year, because valuations are higher. It's as simple as that. Within our equity portfolio, we haven't been following the hottest stocks, which should be no surprise. We've tended, over time, to avoid the greatest pockets of high valuation, rapid balance sheet growth and new era thinking, so we don't have a lot of direct exposure to markets like China or India at the moment. In fact, we've backed into the inverse of that.

Where do we see low prices, conservative balance sheets and prudent behavior? Japan. Somewhat counter-intuitive, but we see a lot of good businesses in Japan. We continue to hold a position in gold. Gold for us is insurance. We don't have a directional view on gold. To have a directional view on gold, we'd have to know what was going to happen in the world, and then we wouldn't need the gold.

So our portfolio is simple. We hold roughly 25% of the portfolio in cash, shorter-dated government bonds, gold and gold securities and we have 75% of the portfolio in the ownership of enterprise. The 75% that's in enterprise, half of that 75% is in our top 35 positions. We're broadly equally positioned between Japan, Europe and the United States and we have great balance in the portfolios. We feel that the companies we own today trade at a discount to our sense of intrinsic value. Those that are close to our sense of intrinsic value, we're trimming, and those opportunities that we see at 50, 60, 70 cents on the dollar, we're cycling capital into. It's business as usual for us.

Throughout this entire turbulent period, our annualized turnover has been less than 20%. We're continuing to allocate capital in a disciplined fashion for the long term and that's how we're dealing with the current environment. Our secret sauce, our touchstone, is our temperament, and you don't need an advanced degree in rocket science to grasp temperament. You have to study the wise people of centuries and millennia gone by, you need an environment that enables you to operate with that temperament and you need a team of people who embody that temperament. That is what I believe we have.

Average Annual Returns as of 09/30/2009:	Year to Date	1 Year	5 Years	10 Years	Expense Ratio
First Eagle Global Fund - Class A (w/o sales charge)(SGENX)	20.31%	7.49%	9.69%	12.86%	1.14%
First Eagle Global Fund - Class A(w/sales charge)(SGENX)	14.29	2.11	8.57	12.43	
First Eagle Overseas Fund - Class A (w/o sales charge)(SGOVX)	19.92	11.51	10.30	13.13	1.15%
First Eagle Overseas Fund - Class A (w/sales charge)(SGOVX)	13.92	5.93	9.18	12.70	
First Eagle Gold Fund - Class A (w/o sales charge)(SGGDX)	31.83	32.99	16.13	19.50	1.21%
First Eagle Gold Fund - Class A (w/sales charge)(SGGDX)	25.23	26.34	14.94	19.04	

Average Annual Returns as of 09/30/2009:	Year to Date	1 Year	5 Years	Inception 09/04/01	Expense Ratio
First Eagle U.S. Value Fund - Class A (w/o sales charge)(FEVAX)	19.25%	-0.90%	5.47%	8.75%	1.21%
First Eagle U.S. Value Fund - Class A (w/sales charge)(FEVAX)	13.29	-5.85	4.39	8.07	

The performance data quoted herein represents past performance and does not guarantee future results. Market volatility can dramatically impact the fund's short term performance. Current performance may be lower or higher than figures shown. The investment return and principal value will fluctuate so that an investor's shares, when redeemed may be worth more or less than their original cost. Past performance data through the most recent month end is available at [www.firsteaglefunds.com](http://www.firsteaglefunds.com) or by calling 800.334.2143. The average annual returns for Class A Shares "with sales charge" of First Eagle Global, Overseas and Gold Funds give effect to the deduction of the maximum sales charge of 3.75% for periods prior to March 1, 2000 and of 5.00% thereafter. The average annual returns for Class A Shares "with sales charge" of First Eagle U.S. Value reflect the maximum sales charge of 5.00%.

There are risks associated with investing in funds that invest in securities of foreign countries, such as erratic market conditions, economic and political instability and fluctuations in currency exchange rates. Funds whose investments are concentrated in a specific industry or sector may be subject to a higher degree of risk than funds whose investments are diversified and may not be suitable for all investors. The holdings mentioned herein represent the following percentage of the total net assets of the First Eagle Global Fund as of September 30, 2009: Fanuc Ltd. 2.54%, Grupo Televisa S.A. 0.52%, SMC Corp 2.44%, Cintas 1.74%, Secom Co. Ltd. 2.52%, Shimano Inc. 1.58%. The portfolio is actively managed and holdings can change at any time. Current and future portfolio holdings are subject to risk.

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