

Around the Horn

“Our process points to where the bargains are,” says Polaris Capital’s Bernard Horn, who’s proven quite skilled at choosing the right ones in which to invest.

Having “overdosed on capital markets theory” during business school at M.I.T., Bernard Horn upon graduation in 1980 decided international value investing was his ticket into the business. “There were enough Boston firms with traditional U.S. strategies,” he says. “I had to distinguish myself.”

He’s done just that. Horn’s Polaris Capital now manages \$2.8 billion and over the past 20 years its global equity composite has returned a net annualized 9.3%, vs. 5.8% for the MSCI World Index.

Braced for a return to more normal volatility in global equity markets, he’s finding opportunity today in such diverse areas as reinsurance, energy infrastructure, healthcare, convenience foods and small U.S. banks. [See page 2](#)

INVESTOR INSIGHT



Bernard Horn
Polaris Capital Management

Investment Focus: Seeks companies worldwide trading at deep discounts to the share prices that would result in an expected 8% annual real return over time.

Safe Passage

For a small-cap manager, Eric Cinnamond is surprisingly uninterested in the sexy story or in breakout growth potential – which hasn’t hurt his returns one bit.

INVESTOR INSIGHT



Eric Cinnamond
Intrepid Capital Management

Investment Focus: Seeks firms trading at least 20% below an intrinsic value calculated assuming modest growth, “normal” cash flow and a high absolute discount rate.

Eager to pursue a career as an analyst, Eric Cinnamond was attracted to Florida’s Stetson University by its strong accounting program and the opportunity for students to help manage a live endowed investment portfolio. “That it was close to the beach also helped,” he says.

Regardless of distractions, Cinnamond has learned his craft well. After stints at First Union and Evergreen Asset Management, he joined Intrepid Capital to launch the firm’s small-cap strategy and since 1998 has earned a net annualized 9.9%, vs. 5.5% for the Russell 2000.

Shunning style for substance, he’s finding opportunity today in more prosaic businesses in such areas as energy, rent-to-own retail, convenience-store distribution and grocery stores. [See page 9](#)

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Investor Insight: Bernard Horn

Bernard Horn, Sumanta Biswas and Bin Xiao of Polaris Capital describe the “purist” aspects of their value approach, what they consider one of the most undervalued sectors in the world, why less volatile stocks can often be more mispriced, and why they see upside in Hannover Re, Technip, Greencore Group and Independent Bank Corp.

It takes chutzpah to launch an investment firm, as you did in 1980, straight out of business school. Describe how that came about.

Bernard Horn: I worked in the summer of 1979 in Donaldson, Lufkin & Jenrette’s institutional options department for Mike Gladstein, who had written a paper with Bob Merton and Fischer Black – professors at M.I.T., where I was getting my MBA – about what they called a 90/10 investment strategy. The basic idea was to put 90% of your money in T-bills and the other 10% in a portfolio of call options. It was a nice idea when interest rates were close to double-digit levels. With 90% of your money in T-bills, at year-end you’d pretty much get your money back. If the call-option portfolio did well, you made a lot more, but if it went to zero, your portfolio would still be whole. There was a unique distribution of portfolio returns, with low downside risk and a fair amount of upside potential.

During my second year at M.I.T. I worked on a business plan for a firm that would implement this 90/10 strategy for pension funds. Unfortunately, I figured out the idea wasn’t going to work, given restrictions on pension funds’ ability to buy call options. My plan B was to take the idea of minimizing downside risk while capturing upside potential and applying it to international value investing. It’s all the rage now, but at the time there were only a couple of dozen firms investing globally from a U.S. base, so I saw it as an area where I might stand out. I’ve been applying that strategy ever since.

The beginning of your investment process is quite quantitative. Explain the mechanics of how you winnow down ideas.

BH: The first step in our process starts with culling a database of 30,000 com-

panies worldwide. We’ve invested hundreds of hours defining algorithms that put the relevant financial information for each company on a more or less comparable basis. That means automatically adjusting for differences in accounting standards, financial statement formats and jurisdictional requirements. The system knows, for example, how to create a relevant cash flow statement for a Mexican company, even though Mexico doesn’t require such statements to be filed. It knows that in the United Kingdom, cash from operations is before interest and taxes, but we want to look at it after interest and taxes in comparing companies.

The next key step in the process is to deduct the appropriate level of capital spending necessary from operating cash flow to arrive at the maintenance level of cash flow, which is the key input we use to value each firm. The system looks at history and ratios of capital spending relative to things like gross property, plant and equipment, for instance, to arrive at the maintenance level of capex.

From there we can screen on any number of variables, but the primary one is maintenance cash flow to market value, where we typically require a yield of at least 8%. We do want companies that are conservatively financed, so we screen for those with total debt as a percentage of total assets of less than 50%. We will also make some more nuanced adjustments – say, requiring a higher cash flow yield for companies with higher exchange-rate risk, or giving greater preference to companies with increasing cash-flow margins over time – but the end result of this screening process is usually a list of 500 or so stocks offering us excellent value at any given time. (As an aside, that list had 2,000 names in the first quarter of 2009, which was one of the classic panic markets of all time.)



Bernard Horn

Man Over Machine

Well versed in the quantitative side of investing – his business school thesis under advisors Fischer Black and Robert Merton was on the pricing of commodity options – Bernard Horn relies heavily on computers to winnow down his investment universe. But his faith in machines as investors goes only so far: “I’ve never been comfortable letting the computer create an optimal portfolio and then investing in it without human intervention,” he says. “It takes judgment to figure out the story behind the numbers.”

Horn’s quant side still informs Polaris Capital’s focus on both minimizing downside risk and keeping portfolio volatility low. To build in a margin of safety, he follows a “purist” quantitative value investing approach, he says. His firm’s global mandate helps limit volatility: “Opening the investment universe to the entire world provides far more opportunity to find low-correlation assets,” he says.

Also inspiring his aversion to volatility: Starting his first investment firm from scratch. “In those days, a bad quarter meant trouble paying the bills. There’s no better lesson on the importance of cash flow and avoiding unnecessary risks.”

We consider this a purist value approach. We don't force the process to point us in any other direction than where the bargains are, regardless of the size of the company, its industry or its home base. The mean real return of stocks over time is about 6%, but the normal standard deviation of that distribution is about 22%. That's actually quite volatile, which almost guarantees that stock prices will often be more volatile than the underlying-company cash flows. Our screening is all about finding those stocks that have gotten pounded on too much, providing us with a prospective rate of return that allows us to outperform.

Up to this point all the input is backward-looking, correct?

BH: Yes. We're saying that with all the competitive forces in the global economy, this is what the company has been able to actually generate in cash flow, and this is what the market is paying for that. There's no hope being built into the initial valuation.

Once the computer has done its work, humans take over the more strategic tasks of analyzing financials, understanding competitive structures and critiquing management. We will typically discard companies in industries with poor dynamics or facing big secular challenges. When analyzing new companies, we will focus on potential trouble spots, ranging from non-sustainable anomalies in the cash flow to potential share dilution from stock options or convertibles.

For the companies that still make the cut – in healthy industries, with sustainable business models and good management – we'll build a financial model around a five-year forecast of revenues and cash flows. We rarely count on annual growth in real cash flow beyond a couple of percent per year – again, minimizing the extent to which hope is justifying the estimated value.

Our discounted cash flow calculation then produces two prices. Our buy price is the price at which the cash flows are being discounted to produce our required real return of 8%. Basically, the company

is priced low enough to allow us to earn in excess of the market's expected return. Our sell price is the one that discounts future cash flows at 6%, meaning the valuation no longer allows us to earn an expected return greater than the market's. All things equal, the stocks trading at the biggest discounts, or highest expected return, make it into the portfolio.

Do candidates cluster in particular industries or countries at any given time?

BH: Today it seems to be driven more than ever by industry cycles or sectors going in and out of favor. Last year when

ON TECH STOCKS:

Strong sales growth in cash-rich, well-managed firms trading at single-digit multiples should provide opportunity.

investors were ignoring consumer-staples stocks in favor of cyclicals, for example, we found some great values in companies like J.M. Smucker [SJM] and Heinz [HNZ], both of which we still own.

Last year we also bought a lot of small- and medium-sized banks in the U.S. In many cases, their shares got hit with the same credit concerns as bigger banks even though they didn't have comparable loan portfolios. On top of that, as the bigger bank stocks rebounded, smaller-bank shares have lagged on the upside. We still think U.S. small banks comprise one the most undervalued sectors in the world. I'll talk later about one example, Independent Bank Corp.

You seem to be active in healthcare. Why?

BH: We do think the negativity around healthcare is creating opportunity. For example, insurers like WellPoint [WLP] and UnitedHealth [UNH] have been cast as the villains in the ongoing healthcare debate – not without some reason – but we also see them as central players in the

evolution of the industry. It's easy to place blame for why costs seem to be out of control, but a main reason is that an aging population incurs higher healthcare costs. Any serious effort to make healthcare spending more efficient will require the active participation of viable health insurers, which have the best data and industry experience. As a result, we think the fears that insurers will keep getting squeezed to death are overstated. It doesn't hurt the investment case that at some point over the next five years you could see another 30 million people become insured. Not many industries have the potential for that kind of volume growth.

Another healthcare name that we've been buying is Quest Diagnostics [DGX], the leading test-laboratory company. The stock was already mispriced, in our view, due to general reform-induced margin concerns, but then they very recently reported an off quarter and the stock fell more than 10% over two days. Those are the kinds of opportunities on which we try to capitalize.

What's your current take on the technology sector?

BH: We haven't been particularly active in IT for several years. For the most part, big tech companies are now largely driven by capital-expenditure cycles – we haven't considered them to be high growth for some time, which has saved the portfolio a lot of money.

That said, we wouldn't be surprised if our technology weighting doubled over the next year. There's evidence that the reinvestment cycle in technology is shaping up to be quite healthy, driven by strong consumer electronics and server sales, a Windows 7 upgrade and excellent memory demand. Strong potential sales growth in cash-rich, well-managed companies that are trading at single-digit earnings multiples should provide us with plenty of opportunity.

It's too early to talk about newer names we're considering, but two that we've owned and still like are Infosys Technologies [INFY], the Indian outsourcing company, and Wincor Nixdorf

[WIN:GR], a German firm which sells ATMs and point-of-sale hardware and software.

Why does your portfolio tend not to correlate closely with global benchmarks?

BH: We go where the most undervalued stocks are, regardless of market cap or industry. So we're very likely to hold smaller stocks than would be found in most indices, and to overweight versus the index stocks in sectors sporting lots of bargains.

We've purposely avoided basing our bonuses on performance against benchmarks. We're always running into managers who say they're unable to look at certain stocks because they don't fall within a prescribed benchmark. They tell us, "I can't take the risk. If I buy it and it goes down, I'll have to write all sorts of memos explaining it, and I'll get less bonus because my portfolio went down more than the benchmark."

What are your bonuses based on?

BH: Basically the more money we manage, the bigger the bonus pool and people's individual bonuses. Our ability to attract and grow assets is obviously a function of our performance, but we try not to corrupt our process for the wrong reasons. A company with 200 funds can't reasonably do it the way we do, which we believe gives us an advantage.

How concentrated are your portfolios?

BH: Our global fund usually owns around 75 positions. We could own less than that and have theoretically "proper" diversification, but greater concentration doesn't provide enough downside for me in a volatile market.

The positions tend to be equally weighted. We know there are potential errors in the portfolio, which we'd obviously avoid if we could predict what they were. Since we can't, we assume the future errors are randomly distributed, which is a primary reason we equally weight the positions.

We also try to be well-diversified across industries and countries. It's not a hard-and-fast rule, but we usually try to own a minimum of 15 different sectors and 15 different countries.

You seem to pay quite a bit of attention to the beta of your portfolio and your individual stocks. Why?

BH: We believe the best values are often in companies with the lowest betas. That's helpful to us, because our objective is to outperform with lower than market risk. If you look at our returns against

ON CURRENCY HEDGING:

Over time, the worst impact of currency movements will be 30-40 basis points. It costs more than that to hedge.

global market returns, our beta has consistently been below 0.8. Our screens tend to favor less-volatile stocks, by giving preference to more stable cash flows.

A legitimate case can be made that low-beta stocks are consistently undervalued by the market. Portfolio managers tend to favor high-beta stocks as a way to beat the market. If a portfolio beta is 2.0, the portfolio should double the market returns, right? Of course it can go the other way as well, but with their bonuses dependent on beating the market, many managers are willing to take that risk.

Do you hedge currency exposure?

BH: No. In any one or two quarters currency movements in a portfolio can have a big effect, however over 10 to 20 years, the worst impact will be maybe 30-40 basis points. It costs more than that to hedge, so we don't do it.

Describe your selling discipline.

BH: Our valuation methodology tells us what we should pay for a stock assuming

it's priced to give us 2% alpha over the market. When it's no longer priced to give us any of that alpha, we consider it fairly valued and it's time to sell it and buy an undervalued stock. That often means our sell prices are conservative, which is OK with us.

Valuation is a dynamic process, so we very often own stocks for several years. One example is Autoliv [ALV], a Swedish company that is one of the biggest global suppliers of car airbags and other safety systems. After a great run, the stock got hammered in 2008 as the car market turned sharply down. But while its volumes were off more than 25%, Autoliv compensated with aggressive cost cutting. In addition, some competitors were forced out of the business, which indicated that Autoliv was likely to generate more cash coming out of the crisis than we had expected going in. So while the stock price went from \$60 in late 2007 to \$12 in March 2009, our sell price on the stock never went below \$40. We were originally too early in buying more, but it's now come back very nicely and we still own it. [Note: Autoliv shares closed recently at \$57.50.]

Give an example of something you've sold recently and why.

BH: A good example of what we've been selling is Cargotec [CGCBV:FH], a Finnish cargo-handling company. It's terrifically well-managed and cash flows held up pretty well through the worst of the crisis as it worked off a very healthy order book. However, as we're seeing in many companies like this, the company is having a hard time filling the order book back up again. With demand suspect, we sold out as the stock rebounded earlier this year.

Describe your investment thesis for German reinsurer Hannover Re [HNR1:GR].

BH: We had historically steered clear of property/casualty insurers because of the unpredictability of their expenses and the opacity of their reserve accounting.

Starting a few years ago we saw reinsurance companies showing up all over our screens, so in the summer of 2008 we decided to take a deeper look at the industry and try to figure how to make money there. We noted that after September 11th, the market seemed to have become more rational, with fewer players willing to lose money on underwriting and then trying to make up for it by taking riskier bets on the asset side of the balance sheet. That made it a better business in general, and while it's difficult to get totally comfortable with reserve accounting, we also identified a few companies – namely Hannover Re, Munich Re and Chubb – that appeared to have consistently taken a conservative approach and done a good job of reserving against unexpected claims.

Because we were new to the sector, we didn't take a rifle-shot approach, instead taking half positions in those three companies, all of which were trading at 7-8x earnings. If we were still comfortable with their ability to weather difficult times, we would increase to full positions if the value was still there. That ended up happening in early 2009.

How well did Hannover Re come through the crisis?

BH: As we had hoped, the company actually performed quite well. Management is very conservative about the investment portfolio, which meant they didn't get involved in the subprime and other types of paper that hurt so many other insurers. The balance sheet

has always been solid, so they didn't have to raise capital. They have also proven nimble on the underwriting side, moving fairly well from market to market worldwide depending on where they can cherry pick the best business.

This isn't a sexy growth story, but it is indicative of the types of opportunities we find interesting. This is a very solid company in a decent industry that is currently priced well below where we think it should be.

With the shares trading at just over €37, how are you looking at valuation?

Bin Xiao: We estimate maintenance free cash flow at almost €500 million, so the free-cash-flow yield on the €4.4 billion market cap is over 11%. In our DCF model, we assume premium revenue grows at 2% per year, the investment portfolio generates a 3.5% annual return and that the combined ratios for the property/casualty and life/health lines are 100% and 103.5%, respectively. All of those assumptions are conservative against what they've done in the past, but we still come out with a sell price of €63.

What are the biggest risks?

BH: The stock got hit a bit in May because Hannover Re has some exposure to European government debt "of concern." But debt holdings in Greece, Spain and Portugal make up only 5-6% of the company's portfolio, so we think it's unlikely they'll end up losing much money on that.

The other big risk is the fact they have a giant bond portfolio. If interest rates shoot up, our yield assumptions could well turn out to be too high. Management is well aware of this and we believe is managing the duration of the portfolio accordingly.

What interests you about French engineering and construction firm Technip [TEC:FP].

Sumanta Biswas: Technip is one of three major players – the U.K.'s Wellstream and

INVESTMENT SNAPSHOT

Hannover Re
(XETRA: HNR1:GR)

Business: Germany-based global reinsurer, serving a broad base of life, health, accident, damage, property and high-risk specialty reinsurance markets.

Share Information

(@7/29/10, Exchange Rate: \$1 = €0.77):

Price	€37.24
52-Week Range	€26.75 – €38.00
Dividend Yield	5.7%
Market Cap	€4.43 billion

Financials (Full-year 2009)

Net Premium Earned	€9.31 billion
EBIT Margin	12.2%
Net Profit Margin	7.9%

Valuation Metrics

(Current Price vs. TTM):

	HNR1	S&P 500
P/E	6.6	17.5

HNR1 PRICE HISTORY



THE BOTTOM LINE

The company's conservative approach to underwriting, reserving and investing may not make for a sexy story, says Bernard Horn, but it does make for a solid investment opportunity. Assuming 2% annual premium growth, a 3.5% annual investment return and combined ratios above historical levels, he believes the shares are worth €63.

Sources: Company reports, other publicly available information

Luxembourg-based Tenaris being the other two – that operate in the high end of the market for designing, engineering, supplying and building energy infrastructure around the world. They build pretty much across the value chain, from piping to entire drilling platforms to refineries. They serve both offshore and onshore markets, and are very well diversified geographically.

BH: One long-term trend we see in the oil and gas business is for state-owned companies – which now own 75% of all the world’s reserves – continuing to invest in capturing more of the value attached to their owned reserves. The Middle East has experienced massive spending on refinery capacity and liquid-natural-gas infrastructure. In Brazil, big financial out-

lays have focused on offshore and deep-water exploration. If we can’t invest in the Saudi Aramco-type businesses, we can invest in pick-and-shovel players like Technip that serve them.

How cyclical is this business?

SB: The business is clearly subject to the capital spending cycles of major oil companies, but Technip’s cash flows have been quite resilient as the oil-price environment has changed dramatically. That’s partly because the production and refining sides of the business often move in opposite directions. It has also been a function of considerable improvement in the company’s project-management skills. When energy prices were at their highest and drilling activity worldwide

was extremely high, Technip’s costs of construction grew very rapidly and, because of some poorly executed contracts, they weren’t able to pass on the rising costs. We believe they now have a much better handle on that, and margins have risen appreciably over the past year as a result.

The big national oil companies are getting back in the market with projects they halted earlier due to prohibitively high costs. On the refinery side of the business the trend is for high-cost refineries to be replaced by low-cost refineries coming online in Asia and the Middle East. That’s positive for companies like Technip, which recently announced a \$1 billion share of a new Saudi Arabian refinery project.

Technip touts its expertise in deepwater drilling projects. Does the crisis in the Gulf put a cloud over that?

BH: The Gulf spill did appear to impact the share price, but in that same period Brazil’s Petrobras announced significant new projects to develop deepwater oil reserves and Technip is expected to be a major supplier of the flexible pipe to be used. The Gulf crisis will probably prompt more sophisticated technology in production infrastructure, which actually plays into the strengths of high-end players like Technip.

How cheap do you consider the shares, trading recently at €51.90?

BX: The stock has run up about 10% in the past two weeks, but still trades at a cash-flow yield of about 8%. That’s assuming maintenance cash flow of close to \$450 million over the next few years, which is only about 65% of what they earned in recent years. Our current estimate also gives the company no credit for the Petrobras projects or for the fact that EBIT margins have risen from 5% to 10% so far this year. Our sell price today is only €57, but as the year continues and we get more confidence in the predictability of future cash flows, there’s a strong chance that will be revised upward.

INVESTMENT SNAPSHOT

Technip
(Paris: TEC:FP)

Business: Design, engineering and construction of industrial facilities used primarily in the worldwide exploration, production, transport and refining of oil and gas.

Share Information
(@7/29/10, Exchange Rate: \$1 = €0.77):

Price	€51.87
52-Week Range	€39.96 – €64.85
Dividend Yield	2.7%
Market Cap	€5.55 billion

Financials (Full-year 2009)

Revenue	€6.46 billion
Operating Margin	6.6%
Net Profit Margin	2.6%

Valuation Metrics
(Current Price vs. TTM):

	TEC	S&P 500
P/E	35.6	17.5

TEC PRICE HISTORY

THE BOTTOM LINE

Having gotten its operating house in order, the company is well-positioned to capitalize on heavy spending by national oil companies on energy infrastructure, says Sumanta Biswas. Assuming maintenance cash flow of only 65% of what Technip has earned in recent years, he arrives at a fair value for the stock of at least €57.

Sources: Company reports, other publicly available information

Talk about a smaller, off-the-beaten-path idea, Greencore Group [GNC:ID].

SB: Greencore is a specialty food company based in Dublin, Ireland that produces and distributes a wide range of ready-made sandwiches, salads, snacks and desserts to grocery and convenience stores. The bulk of their sales are in the U.K. and Ireland, where the ready-made food concept is well established, but they have also been successfully expanding in the U.S. after buying a Massachusetts-based company called Home Made Brand Foods in 2008.

We have owned Greencore shares for several years and have been impressed with how management continues to improve the company. They have divested a decent but volatile commodity malt

business to focus on convenience foods. After some early growing pains, the U.S. business is showing a lot of promise and accounted for €100 million of the €850 million in convenience-food revenues in 2009. They have also maintained excellent relationships and shelf space with their retailer base, and have top market shares for most of their niche products. Finally, they're cost-conscious, which shows up in increasing margins over time.

There are also a couple of external-to-the-company reasons we're optimistic. The value proposition seems in tune with the times. Creating a meal from Greencore's selection of products is cheaper than eating out and is almost as convenient. We also see opportunity for the company to improve profitability in the U.K. – the financial crisis led some

key competitors to close factories and scale back distribution.

What upside do you see in the shares, now trading at around €1.35?

BX: The yield from our €30 million estimate of maintenance free cash flow at today's price is around 11%. If we assume the company has no revenue growth over the next five years and generates a 6.5% EBIT margin, our DCF model produces a sell price of €2 per share. We hardly think that's aggressive, given that the shares traded at €4.50 two and half years ago.

BH: One added margin of safety: Not included in our estimate is the value of real estate the company still owns from from an earlier sugar-processing operation. If that's worth just 25% of what we valued it at the peak of the market, it would add €1 per share in value.

You mentioned finding opportunity in small U.S. banks. Describe the value you see in Independent Bank Corp. [INDB]

BH: As I mentioned earlier, this is one of the small banks that we believe the market has mispriced by treating it similarly to the big players in the industry.

The story is quite simple. Independent is a no-frills commercial and retail bank with \$4.2 billion in assets operating in southeastern Massachusetts. We first got involved with it after it acquired for stock one of our portfolio holdings, Benjamin Franklin Bancorp, in April 2009.

While Independent's charge-offs as a percentage of total loans were still extremely low last year, 0.38%, they did have several charges impacting earnings that we expect to be temporary. Reserves for loan losses were \$17 million, versus an annual level of \$2 to \$4 million prior to the crisis. Costs related to foreclosed properties – so-called Real Estate Owned [REO] – went from \$1.7 million in 2008 to \$13 million in 2009. FDIC premiums went from almost nothing to \$7 million. The company was also one of the first banks to pay back its TARP money, at a

INVESTMENT SNAPSHOT

Greencore Group
(Ireland: GNC:ID)

Business: Manufacture and distribution of prepared foods and related products sold to commercial vendors as well as through convenience and grocery stores.

Share Information

(@7/29/10, Exchange Rate: \$1 = €0.77):

Price	€1.34
52-Week Range	€1.04 – €1.69
Dividend Yield	5.7%
Market Cap	€272.8 million

Financials (Full-year 2009)

Revenue	€1.10 billion
Operating Margin	6.4%
Net Profit Margin	1.5%

Valuation Metrics

(Current Price vs. TTM):

	GNC	S&P 500
P/E	8.2	17.5

GNC PRICE HISTORY



THE BOTTOM LINE

Structural changes in its home European markets and solid growth prospects for its line of ready-made food products in the U.S. bode well for the company's stock, says Sumanta Biswas. Even assuming no revenue growth over the next five years, his DCF model arrives at a fair share value of €2, 50% above today's price.

Sources: Company reports, other publicly available information

INVESTMENT SNAPSHOT

Independent Bank Corp.
(Nasdaq: INDB)

Business: Holding company for Rockland Trust, a commercial and consumer bank operating primarily in southeastern Massachusetts with \$4.5 billion in assets.

Share Information
(@7/29/10):

Price	24.43
52-Week Range	19.53 – 28.23
Dividend Yield	3.1%
Market Cap	\$512.1 million

Financials (TTM):

Revenue	\$178.0 million
Operating Profit Margin	28.3%
Net Profit Margin	18.6%

Valuation Metrics
(@7/29/10):

	INDB	Nasdaq
Trailing P/E	13.6	12.2
Forward P/E Est.	12.6	15.7

Largest Institutional Owners
(@3/31/10):

Company	% Owned
BlackRock	7.6%
MFC Global Inv	4.1%
Vanguard Group	4.0%
Columbia Mgmt Adv	3.8%
Delaware Inv	3.3%

Short Interest (as of 7/15/10):

Shares Short/Float	11.0%
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INDB PRICE HISTORY



THE BOTTOM LINE

Bernard Horn believes the market is still penalizing the companies' shares for a variety of what will turn out to be temporarily high hits to earnings. Assuming more moderate but still historically high levels of loan loss reserves, FDIC premiums and costs related to foreclosures, he estimates the price at which he would sell the shares at \$31.

Sources: Company reports, other publicly available information

net cost of \$5.7 million in 2009. Even with all those unusual expenses, it still earned \$17 million in profits.

How do you “normalize” all that?

BH: If we assume reserves for loan losses at \$10 million per year, \$5.6 million in annual FDIC premiums, around \$2 million in REO expenses, and no TARP-related costs (because they paid it all back), we arrive at a price to sell the shares of around \$31. If we didn't build in such a large margin of safety to the loan-loss number and used a level more consistent with the bank's history, our sell

price would be closer to \$35. [Note: INDB shares closed recently at \$24.43.]

The earnings multiples on these types of banks still look high, because most of them have been continuing to build reserves and some – although not Independent – have reported elevated loan charge-offs. But with even a conservative pass at normalizing earnings, there are a lot of great values out there.

Has the turmoil of the past few years led to any changes in how you operate?

BH: We haven't changed anything fundamental, however we are working to incor-

porate more non-traditional research into our process. We have maybe focused too narrowly on just the companies we were interested in, not paying enough attention to what was going on elsewhere in a given industry. For instance, we never liked mortgage banking and subprime lending, so we didn't spend a lot of time with companies that were active in those areas and therefore we didn't fully appreciate how crazy it was getting.

One of our biggest mistakes in recent times was holding an Irish bank that ended up being seized by the Irish government. In retrospect, we listened too much to the company and didn't fully hear concerns being raised about it in the industry. We've always tried to tap diverse sources to better understand our companies and their industries, but we can do even more of that.

We're also more actively writing calls on some of our positions, primarily to protect our downside as a stock gets close to our sell price. At the same time, we're observing the implied volatilities. If they're low, that might indicate the market isn't pricing in enough risk. If the implied volatility on a company is high, it might indicate a potential risk that requires more research.

You've written that you expect markets and business cycles to be “more normally volatile” going forward. How is that changing your behavior?

BH: We do believe the volatility we've seen in recent months will be more the norm. In any given month there will be bouts of good news and bad news and that's going to drive stock prices more sharply up and down. In that environment, the premium will be on being disciplined in selling and de-risking in up periods, and then holding cash for when the market corrects on the downside. We're also trying to pull the trigger more quickly when something appears to be going wrong. We were fortunate to get out of the Spanish banks before the worst headlines hit, for example, because of our heightened sensitivity to risk. Being nimble will be more important than ever. **VII**

Investor Insight: Eric Cinnamond

Intrepid Capital's Eric Cinnamond explains the “easiest and most dangerous thing to get wrong” in valuing a company, why he's steering clear of cyclicals, why he avoids face-to-face management meetings, where he finds his best insight on the macro environment, and why he sees upside in Tidewater, Aaron's, Core-Mark and Weis Markets.

The word “boring” comes to mind in reviewing your typical portfolio company. Is that a fair characterization?

Eric Cinnamond: We have historically tended to favor companies that are more mature in their life cycles, with fairly stable end markets, strong market positions and a track record through many operating cycles. We do that because we only want to own businesses for which we can value normalized free cash flow with a high degree of confidence. The ultimate goal of that is to limit mistakes, so it's an investment process that revolves around not screwing up.

We don't like making assumptions about highly uncertain outcomes, such as how a new product will work or an industry transition will play out. If you look at most value traps – say newspapers or various industrials over time – they look extremely cheap *if* some significant problem goes away or isn't as bad as expected. I try not to deal in those big “ifs.” Therefore many of the companies we own are quite boring, but they generate cash flows we believe we can value.

So even as a small-cap manager, is growth typically not a key variable for you?

EC: Growth is important, but it's a volatile variable in any valuation model and probably the easiest and most dangerous to get wrong. I don't want to have to make aggressive growth assumptions for the valuation to work out. If I find a stock trading at a good discount assuming 3-5% annual growth, then if the company is able to do really well with a certain product or service, that can be gravy.

A good recent example of that for us is Maidenform [MFB], the market leader in bras selling through high-volume retailers like Wal-Mart and Target. We bought into it because they were deleveraging

their balance sheet and we didn't think the market was giving them credit for that. That turned out to be true, but at the same time their “shapewear” business – slimming, Spandex-type undergarments – started to take off, providing a nice growth kicker that wasn't in our valuation model. It's not that we're averse to growth, we just don't want to feel like we're paying for it. As the stock went up sharply through the first and second quarters, we've sold most of our position.

One primary reason banks didn't make sense to me prior to the credit crisis was that much of the financial industry was just growing too fast. Why should such a mature industry grow at double-digit rates? Small-cap banks were selling at 2-3x book value and growing their loans at 20-30% per year, which to me was a fairly clear sign that credit was too easy and there was trouble ahead.

Did your opinion on banks reverse as the crisis unfolded?

EC: We did buy one last year, Washington Federal [WFSL], which was trading at a discount to tangible book value, had aggressively written off bad loans and wasn't levered, with tangible equity to assets of 11%. The only reason it sold at a big discount was the mass liquidation of all stocks like it at the time. The stock came back very fast, so it's only a tiny position for us today.

What typically creates opportunities for you to buy?

EC: It can be a mass sell-off like we had in 2008 and early 2009. More often, though, it's just a function of being in the performance derby, where people don't like to own things that have had and may continue to have a difficult quarter or two. Federated Investors [FII], the



Eric Cinnamond

Bucking the Trend

Having seen the Evergreen Small Cap Equity Income Fund that he co-managed grow from \$6 million in assets to \$350 million during his two-year tenure, Eric Cinnamond was primed to start a small-cap strategy from scratch at Florida's Intrepid Capital when he joined the firm in 1998. “After my Evergreen experience,” he says, “I thought, how hard can this be?”

He quickly found out. The waning years of the Internet boom were less than kind to Cinnamond's strict value strategy. Unwilling to buy technology stocks whose valuations “made no sense at all,” his portfolio actually lost money in 1999, a year in which the Russell 2000 was up more than 20%. “Had I stayed at Evergreen, I probably would have been fired,” he says.

His new bosses' “willingness to allow their managers to underperform” is critical to his success, Cinnamond says: “Fear of lagging the market in the short-term encourages trend-following and consensus investing, hardly a recipe for market-beating performance. To win the game over time, you have to protect capital when valuations get speculative, which is impossible if you're afraid to look stupid every now and then.”

money-management firm, is a good example. It's one of the market leaders in money-market funds, a business that's hurting today because short-term interest rates are so low that Federated is having to waive fees on many of its accounts.

We estimate normalized free cash flow at around \$2.10 per share, but they'll only make maybe \$1.50 this year because of the subsidies. All we need for this to work out is for the short end of the yield curve to go up 50 basis points and earnings will increase substantially. No one knows when that's going to happen – which is why the stock trades at an 11% normalized free cash flow yield – but I'm fairly certain it will. I should add that I've been known to be early on these types of macro calls – sometimes by years – but we don't need to always get the timing right to do well. Federated has an excellent balance sheet to make it through the cycle.

Another example: The reason I was able to buy an excellent company like ICU Medical [ICUI] earlier this year was that it reported a bad first quarter and people were expecting another one. The company is a market leader in intravenous connectors and systems that help protect against needle sticks and it has been growing very nicely, particularly overseas. The only reason for the bad quarter was that ICU was making investments in a new plant to serve Europe and in building out its direct sales force. Both of these are key to the business long-term and I love that the founder, who is a doctor, says he's not running his business quarter to quarter, even though so many investors want to see that.

I was able to get in around \$32 when my DCF model – using normalized operating margins of 18%, normalized free cash flow of \$2.40 per share, annual cash flow growth of 5%, and a discount rate of 12% – gave me an intrinsic value of around \$40. The start-up costs hurting earnings were going to go away in 2011, so I expected that to be a catalyst toward intrinsic value. At a time when people were buying two-year Treasuries with 0.5% yields, waiting a year on something like this didn't seem to be a long time.

In fact, the stock bounced back quickly after the second quarter wasn't as bad

as people expected. [Note: ICUI shares currently trade at \$37.25.] We'll have no problem taking gains earlier, but this is the type of company we like to keep on our potential buy list. They'll miss again, the market will react again, and we'll probably get another opportunity to buy.

How do you create your list of potential buys?

EC: Our universe includes companies with market caps of roughly \$50 million to \$4 billion, which is the range of the popular

ON CYCLICALS:

Many cyclicals today have fully priced in a recovery. It may happen or it may not, but that gives me pause.

small-cap benchmarks. We run some screens focusing on cash flow yield and balance sheet ratios, but most of the 300 or so names on our list just come from doing this for 15 years and knowing businesses I'd like to own at the right price.

We pride ourselves on being patient, so some names never come off the list. One we bought last year after following it for at least 10 years was Waters Corp. [WAT], which is the market leader in chromatography measurement devices that are important in pharmaceutical research and development. Its products allow companies to get to market more quickly with new compounds, which is of huge value. It was a high-quality company that had never been cheap enough, until the crisis cut its market cap from \$8 billion in 2008 to \$3 billion in March 2009. [Note: At a recent \$64.80, Waters' market cap is now \$6 billion.] You have to be ready when things like that happen.

Is there ever a thematic element to your idea generation?

EC: I understand the concept, but I'm not good at themes. I've just never been able to time it right. I shorted homebuilders,

for example, in 2003 and 2004 – about the time I gave up, the industry collapsed.

I will find many things to buy in the same industry, which was the case in the spring of 2009 with energy stocks. But in that case it was a function of looking at the individual companies' balance sheets, finding costs, and how low energy prices could go for cash flow to still be positive. It was a bottom-up process that resulted in several ideas.

Doesn't investing in a cyclical business like energy run a bit counter to what you were saying earlier about predictability?

EC: If I'm getting paid to take cyclical risk, I will, with the condition that the balance sheet has to be strong. We value energy companies based on normalized cash flows and asset replacement costs – for exploration and development companies that's how much it costs to replace reserves through drilling, while for service companies it's how much it costs to replace their equipment. Last year there were a number of natural gas companies in particular selling at large discounts to a conservative replacement valuation, so we bought them. That to us didn't require a strong opinion on energy prices.

Has that opportunity played out?

EC: For the most part. Early last year we had as much as 23% of the portfolio in energy. That's now down to about 6%, consisting primarily of Tidewater [TDW], which we'll speak about later, and E&P company Bill Barrett [BBG].

For what it's worth, I think many cyclicals today have fully priced in a recovery. It may happen or it may not, but the fact that it's already priced in gives me pause and has me focused more on my traditional boring companies. With cyclicals right now you're generally not getting paid to take the macro risk.

You're not a fan of face-to-face management meetings as a research tool. Why?

EC: I just don't find them useful for what I'm trying to do. Those meetings tend to be promotional and I'm a sucker for a

charismatic CEO. Early in my career I met with Dave Thomas, the founder and CEO of Wendy's. He was an incredibly nice guy and he told me over lunch all about this pita-sandwich concept they were rolling out. I came back to my portfolio manager and said, "You have to buy Wendy's, this pita thing is going to be big." This was in 1996 or 1997 and the launch was a flop. That's one of the last times I went to meet management.

We do develop an in-depth list of questions for management as part of our research, focused on getting direct answers that help us understand the mechanics and personality of the business. I also find earnings-call transcripts quite useful, particularly the Q&A sections. Reading a lot of them, across an industry and over time, can give you a decent sense of what's really going on.

Describe your valuation process.

EC: Most of our valuations are done by a DCF model, the primary variables for which are the normalized cash flow level, the growth rate of that cash flow, and the discount rate used to bring it all back to the present. One thing we do differently is to not try to guess several years' results, but instead start with the normalized cash flow and do a terminal value immediately. I also mentioned that we typically don't build in more than 3-5% annual growth. Another way we're conservative is to use absolute rather than relative discount rates. The Capital Asset Pricing Model would say to base the discount rate on a risk-free rate plus some risk premium. I don't like that because sometimes when rates are low, like today, that's not an adequate return. We'll typically assign a discount rate of between 10% and 15%, based on a subjective assessment of the business's operating risk. An energy firm like Tidewater would have a higher required rate, while for Oil-Dri [ODC], the market leader in cat litter, the rate would be closer to 10%.

The way we come at it gives me a high degree of confidence in our valuations, and our batting average has been quite good. Before buying, we typically want at

least a 20% discount to what we believe something is worth. You won't see a lot of 200% or 300% types of gains – the companies we're trying to value usually aren't mispriced that badly.

How many positions do you hold?

EC: Our mutual fund usually has 40 to 60 positions. The actual number at any time is usually a function of how pricey the market is: When discounts are larger, the full weights tend to be 2-4%; when

ON POSITION SIZES:

Things that go wrong you often didn't even think of in advance – that keeps me away from mega-positions.

discounts aren't as large, like today, position sizes are more like 1-3%.

I prefer to keep single bets below 4% of the portfolio. When I started in the business I thought I knew everything, but I've learned that the things that go wrong are often those you didn't even think of in advance. I'm confident in my valuations, but knowing you can get blind-sided keeps me away from mega-positions.

How much cash are you holding today?

EC: If we can't find undervalued stocks we'll let cash accumulate, as we believe cash is a better alternative than owning an overvalued security. I'd argue that having the patience and discipline to save your cash for when the fat pitches come along is probably the most valuable trait an investor can have.

Our cash level today is around 18%, which is about average in recent years. Overall, we're finding things to be relatively fairly priced.

Describe your selling discipline.

EC: As something approaches intrinsic value I'll gradually sell because I don't

want a bigger weight of a smaller-discount stock. I don't always make it, but the goal is to be out by the time it hits full value.

Our annual turnover is normally 30-40%, but it's been running higher in the past year. Most of that has been because we've taken advantage of things hitting our valuation targets more quickly than we expected. There are also some less-positive cases, where we've cut back after adjusting our models to incorporate a tougher environment than we planned on. With International Speedway [ISCA], for example, we underestimated the recession's impact on its business, particularly on admissions and concession revenues at NASCAR races. Because the overall market was so good we haven't lost money on it, but after lowering our normalized cash flow estimate and increasing the discount rate because of higher uncertainty, the margin of safety decreased enough that we let the position fall by more than half.

Your small-cap mutual fund is up an annualized 12.5% over the past three years. How did you pull that off?

EC: A lot of things went relatively right. In 2008 I had a few good-sized positions, such as Applied Signal and Family Dollar, that did very well, which makes a big difference in a market down 35%. That year I had 12% of the portfolio in utilities, which everybody hates in a good market, but which held up relatively well and paid decent dividends. I also didn't own to any real degree banks, energy, industrials or cyclicals when the crisis hit. Stock prices in all those areas seemed to extrapolate cyclical growth well into the future – if you truly normalized cash flows, those prices just didn't make any sense.

In October 2008 when everything crashed, we had about 25% in cash, which helped both because the cash didn't fall in value and because we were able to buy things with it that did. We were then pretty fully invested when the market rallied. I'd like to say it was all skill, but we were definitely fortunate that as many things went right as they did.

Let's start on specific ideas with Tidewater, one of your remaining energy plays.

EC: Tidewater operates the world's largest fleet of offshore supply vessels serving the oil and gas industry. Companies lease Tidewater's boats to transport supplies and personnel to offshore rigs and to tow mobile rigs to new destinations. It has roughly 10% of the global market, roughly twice its next-largest competitor.

This is both a cyclical and capital-intensive business, which you might assume we wouldn't like. The company since 2000 has spent over \$2 billion on new boats, with each one going for \$20-30 million. At the same time, capacity utilization rates usually run from 60% to 80% through a cycle, with day rates paid being volatile as well.

Some capital-intensive businesses we like because that makes it unattractive for competitors. The key with respect to capital intensity is whether the business in normal periods can earn high returns. In Tidewater's case, return on equity in the trough is roughly 4% and at the peak is around 20%. We estimate the normalized level at 10-12%, which is pretty good.

With respect to cyclicality, the key for us is whether the business is still profitable at the bottom of the cycle. They'll make in a normal cycle with their current boats around \$2 per share in the trough and \$8 at the peak. They've gotten to that over more than 50 years in the business, and it's not something a new competitor could accomplish without spending a tremendous amount of money. We also believe the ability to make money at the trough – combined with the strong balance sheet they have – positions them well to acquire distressed assets from distressed owners when times are bad. Tidewater has proven quite good at that.

We're guessing recent news on offshore drilling hasn't been kind to the stock.

EC: The Gulf oil spill clearly hurt the stock, but in our view that reaction reflects some misunderstanding. For one thing, more than 90% of Tidewater's rev-

enues come from outside the U.S., so any near-term problems in the Gulf won't have much impact on its business. More broadly, the world just can't live without offshore drilling. There's not enough margin of safety of production versus demand to stop it. If you do, you're going to have a *Mad Max* world.

We've read criticism that Tidewater's fleet is relatively old, requiring costly upgrades. Is that an issue?

EC: I've heard that, but it's wrong. They're the biggest, so they do have a lot of old boats, but it's not a major part of

their business. They actually have the largest new fleet in the world, with 200 boats built since 2000, and that new fleet accounts for at least 80% of EBIT.

With the shares currently at \$40.50, how are you looking at valuation?

EC: We estimate normalized free cash flow at between \$4 and \$5 per share, growing at an annual rate of 4-5%. Using a discount rate of 13% because of the cyclical nature of the business, we think the stock is worth \$52 to \$54 per share.

The shares trade at quite a large discount to book value, which today is

INVESTMENT SNAPSHOT

Tidewater
(NYSE: TDW)

Business: Operator of marine vessel fleet providing towing, supply, transportation and other services to energy companies' offshore exploration and production activities.

Share Information
(@7/29/10):

Price	40.54
52-Week Range	37.99 – 57.08
Dividend Yield	2.5%
Market Cap	\$2.10 billion

Financials (TTM):

Revenue	\$1.17 billion
Operating Profit Margin	19.1%
Net Profit Margin	22.2%

Valuation Metrics

(@7/29/10):

	TDW	S&P 500
Trailing P/E	8.1	17.5
Forward P/E Est.	10.4	13.2

Largest Institutional Owners

(@3/31/10):

Company	% Owned
LSV Asset Mgmt	4.9%
Vanguard Group	4.6%
Shapiro Capital	4.5%
BlackRock Inv Mgmt	4.3%
Royce & Assoc	4.0%

Short Interest (as of 7/15/10):

Shares Short/Float	15.1%
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TDW PRICE HISTORY



THE BOTTOM LINE

Even though operating in a cyclical and capital-intensive business, the company is solidly profitable in trough periods and has an attractive normalized return on equity, says Eric Cinnamond. Assuming annual growth in normal free cash flow of 4-5% and a discount rate of 13%, his DCF model values the shares at up to \$54.

Sources: Company reports, other publicly available information

\$47.50 per share. For a company with a double-digit normalized ROE, we'd expect it to trade at a premium to book. That's particularly interesting given that Tidewater has a history of reporting gains when it sells its boats. On \$700 million of used boats sold since 2000, it has booked about \$200 million in gains. That gives us comfort the book value is conservative.

The short interest on the stock as of July 15 was a fairly high 15%. Do you pay attention to that?

EC: I wasn't aware of that ... which I guess answers your question.

What appeals to you about lease-to-own retailer Aaron's [AAN]?

EC: When our credit analyst first brought Aaron's and its main competitor Rent-A-Center to my attention, my first reaction was, "No, that must be a horrible business." But I try to be open-minded and once I understood the business, I got much more interested. If you think about it, my initial reaction probably indicated it was exactly the type of idea I should pursue further.

Aaron's is basically a rent-to-own business in a variety of product categories, including furniture, consumer electronics, computers and appliances. The target market is the roughly half of American households with \$50,000 and below in annual income. These are people who often don't have the full purchase price to pay up front, or like the flexibility of not having to commit to a purchase right away. In general, too-easy credit is not good for Aaron's, while a tight credit environment, like today's, makes them a more viable alternative.

Is there something vaguely usurious about this type of business?

EC: The ultimate purchase price if something is leased for a while and then bought is clearly higher than it would be if the item was bought up front, but Aaron's only earns about a 6% net margin, so it's not like they're gouging people.

It's a service-intensive business, with lots of customer follow-up, delivery expenses and repair and replacement costs.

But you're right that one thing weighing on the stocks of both Aaron's and Rent-A-Center is concern about whether new financial regulation will impact their business. I don't see it, given that these are not finance companies. People rent the items and pay for them until they don't, when they return the merchandise or the company comes to pick it up. There are no hidden finance charges or high interest rates charged. But the concern is obviously priced into the stocks, which are kind of the Rodney

Dangerfields of the retail business. Aaron's has grown its EBIT at a double-digit annual rate over the past ten years, but it trades at 10x earnings. Rent-A-Center goes for even less.

You own both Aaron's and Rent-A-Center [RCII]. How do you distinguish between the two?

EC: Aaron's has bigger stores, averaging around 9,000 sq. ft., which is twice the size of the typical Rent-A-Center. Aaron's probably has a nicer product lineup, geared toward a somewhat higher-income customer. While Rent-A-Center has

INVESTMENT SNAPSHOT

Aaron's
(NYSE: AAN)

Business: North American specialty retailer of consumer electronics, computers, residential and office furniture, household appliances and related accessories.

Share Information
(@7/29/10):

Price	17.84
52-Week Range	16.24 - 24.32
Dividend Yield	0.3%
Market Cap	\$1.45 billion

Financials (TTM):

Revenue	\$1.80 billion
Operating Profit Margin	10.4%
Net Profit Margin	6.2%

Valuation Metrics

(@7/29/10):

	AAN	S&P 500
Trailing P/E	13.2	17.5
Forward P/E Est.	11.6	13.2

Largest Institutional Owners

(@3/31/10):

Company	% Owned
T. Rowe Price	8.3%
Allianz Global Inv	6.2%
Perkins Inv Mgmt	5.0%
State Street Corp	4.6%
Earnest Partners	4.5%

Short Interest (as of 7/15/10):

Shares Short/Float	13.1%
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AAN PRICE HISTORY



THE BOTTOM LINE

A "Rodney Dangerfield" of the retail business, the company is getting little respect from the market for its solid business model and growth prospects, says Eric Cinnamond. Based on his \$1.70-per-share estimate of normalized free cash flow, growing at 4-5% per year, he believes the shares' intrinsic value is closer to \$25.

Sources: Company reports, other publicly available information

stopped growing, Aaron's is adding stores and taking market share. From a business-model perspective, Aaron's owns around 1,000 stores and franchises 700, while most all of Rent-A-Center's stores are company-owned. Overall, Aaron's is the higher-quality play, while Rent-A-Center trades at a greater discount.

What value do you ascribe to Aaron's shares, now trading at just under \$18?

EC: To normalize earnings, I basically assume the existing store base is mature, without the start-up costs and with the first two or three years of unprofitability in new stores out of the way. Doing that for Aaron's I get around \$1.70 per share in normalized free cash flow. The number of new stores is growing at a mid- to high-single-digit rate, but I don't build that in because it takes cash flow to do that. I use 4-5% growth in annual cash flow, which is the rate at which mature-store comps have grown, plus a bit extra because the company is gaining market share.

With a discount rate of 12.5%, we estimate fair value at \$23 to \$25 per share. This is a better business than most people think, and we're betting that the regulatory risk is overstated, although it is hard to know what the new consumer-protection agency is going to do.

Is the founding-family ownership and management here a plus or minus?

EC: Both generally and in this case I think it's a good thing. A family that's looking to pass on a legacy asset is going to be more careful in how they allocate their capital. It's different dynamic than the CEO who may just be in it to spike the stock and get rich on his options.

Describe your investment case for retail distributor Core-Mark [CORE].

EC: Core-Mark delivers a wide variety of food and packaged goods to around 24,000 convenience stores in the U.S. and Canada. It's a very fragmented market with obvious scale advantages and Core-Mark has the #2 market share in the busi-

ness behind McLane, which is owned by Berkshire Hathaway.

The convenience-store market is an above-average growth area in retail, with sales increasing around 7.5% annually over the past 10 years on a 3% or so increase in annual store count. One driver of that has been a continued shift toward more fresh and prepared foods. You can actually now go into a 7-Eleven and find a decent sandwich and a cup of fruit. That trend benefits distributors like Core-Mark, who have the number and types of trucks in their fleet to accommodate more fresh foods and more frequent deliveries.

Small mom-and-pop distributors are struggling to keep up. If competition comes down to price, as it often does in this business, the mom-and-pop distributor is usually going to lose against a Core-Mark, which has denser routes, better operating leverage and a balance sheet with \$58 million in cash. Continued industry consolidation should only be positive for Core-Mark.

Is this a decent cash flow business?

EC: That's one of things we don't think they've gotten credit for. Free cash flow over the past five years has averaged \$30

INVESTMENT SNAPSHOT

Core-Mark
(Nasdaq: CORE)

Business: Distributor of fresh and packaged goods to over 24,000 North American small-format retailers, the bulk of which are convenience and drug stores.

Share Information
(@7/29/10):

Price	30.36
52-Week Range	25.93 - 34.51
Dividend Yield	0.0%
Market Cap	\$324.9 million

Financials (TTM):

Revenue	\$5.16 billion
Operating Profit Margin	0.6%
Net Profit Margin	0.5%

Valuation Metrics

(@7/29/10):

	CORE	Nasdaq
Trailing P/E	13.3	12.2
Forward P/E Est.	11.7	15.7

Largest Institutional Owners

(@3/31/10):

Company	% Owned
Giovine Capital	7.0%
Dimensional Fund Advisors	6.8%
Wynnefield Capital	6.5%
Apollo Mgmt	4.7%
BlackRock Inst Trust	3.7%

Short Interest (as of 7/15/10):

Shares Short/Float	8.3%
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CORE PRICE HISTORY



THE BOTTOM LINE

Eric Cinnamond believes the market isn't recognizing the company's potential to capitalize on the trend toward fresh and prepared foods in convenience stores and the continued consolidation in its industry. Assuming a 3-4% annual increase in normal free cash flow and a 12% discount rate, he pegs the shares' intrinsic value at \$34.

Sources: Company reports, other publicly available information

million, which is a fair estimate of the normalized level. That's pretty significant for a company with a \$325 million market cap.

They also haven't gotten credit for the strength of the balance sheet. At the end of 2006, Core-Mark had \$93 million in debt. Now they have no debt and \$58 million in cash. That not only gives them plenty of cushion should the economy falter, but it also gives them dry powder to continue to make acquisitions to fill out their distribution footprint. They're already in 50 states, but are looking to increase route density particularly in several northeastern cities.

Why do you think the market remains unenthused?

EC: The company is fairly small, hardly in an exciting business and few people follow it. One issue is that quarterly earnings are volatile, due to changes in commodity prices impacting LIFO reserves and some complexity in how cigarette taxes are booked. People also don't seem to like that 70% of the revenues are from cigarettes at a time when cigarette consumption is declining. But cigarettes account for only 28% of gross profits, so we think that concern is overdone, especially as the non-cigarette parts of the business continue to grow nicely.

What upside do you see in the shares, now trading at \$30.35?

EC: Our average cost is approximately \$26, so the stock has run up a bit, including a 10% uptick in the past two weeks. Assuming a 3-4% annual increase in normalized free cash flow and a 12% discount rate, we arrive at an intrinsic value of \$34. I know that's not a huge discount, but that's pretty representative of what we're finding out there today. This will move up and down and we'll just have to be ready to take advantage, either way.

You've described Weis Markets [WMK] as a "basic boring business." Why is it a good investment?

EC: I like owning businesses in which you have a clear sense of how capital is allocated, and Weis has proven over many years to be a slow, consistent grower that pays a big dividend, maintains an extremely strong balance sheet and is unlikely to make large mistakes.

The company was founded in 1912 and operates about 165 grocery stores, primarily located in smaller-town and rural Pennsylvania. They operate smaller, 50,000 sq. ft. stores, which has proven to be a nice little niche versus the big-box competitors that are already in their areas. They're non-union. The balance sheet is asset rich – they own half their

stores free and clear, while also owning their own dairy, warehouse and distribution facilities.

This isn't a growth story. They did make an acquisition of 11 stores last year, but they'll typically open only two to three stores per year on top of whatever same-store sales they can muster.

Why does something like this ever get cheap, or expensive for that matter?

EC: Operating margins can be more volatile than you'd think, which makes the valuation move. The primary drivers of that are food inflation and energy

INVESTMENT SNAPSHOT

Weis Markets
(NYSE: WMK)

Business: Regional retail grocery chain founded in 1912, operating more than 160 stores – most of which are in Pennsylvania – under the Weis brand name.

Share Information
(@7/29/10):

Price	35.60
52-Week Range	30.51 – 38.32
Dividend Yield	3.3%
Market Cap	\$957.6 million

Financials (TTM):

Revenue	\$2.61 billion
Operating Profit Margin	4.2%
Net Profit Margin	2.6%

Valuation Metrics

(@7/29/10):

	WMK	S&P 500
Trailing P/E	13.9	17.5
Forward P/E Est.	n/a	13.2

Largest Institutional Owners

(@3/31/10):

Company	% Owned
Allianz Global Inv	4.2%
Dimensional Fund Adv	2.0%
Vanguard Group	2.0%
Mesirow Financial	1.7%
Heartland Adv	1.4%

Short Interest (as of 7/15/10):

Shares Short/Float	5.7%
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WMK PRICE HISTORY



THE BOTTOM LINE

Volatility in quarter-to-quarter operating margins – from food inflation and the impact of energy prices on distribution costs – can make the company's share price move more dramatically than its underlying business value, says Eric Cinnamond. While not as cheap as it can be, the stock (net of cash) trades at a free-cash-flow yield above 8%.

Sources: Company reports, other publicly available information

costs, given that Weis owns its own distribution fleet. When both of those costs were high in 2007 and 2008, operating margins fell to around 2.5%. We think the more normal level is around 4%, which is good for a grocery chain.

How cheap do you consider the shares, now at \$35.60?

EC: Our average cost is around \$32, but even at today's price the yield on our \$2.60 estimate of normalized free cash flow per share is over 8%. That's after subtracting \$4 per share in cash from the stock price.

Using a discount rate of 11% and assuming 3% growth, we come to a fair valuation of around \$39. They've been showing positive comps through a difficult environment, which supports our view this is a defensive play – more like a bond than a stock. The dividend yield is 3.3%. It's the type of idea that may put you to sleep, but keeps you in business.

Does anyone on Wall Street follow this?

EC: I don't know for sure, but it's certainly not one you'd expect to generate much interest. The Weis family owns roughly 60% of the stock, they've never needed to raise capital and the trading volume is pretty low. That's not exactly what attracts Wall Street's interest, which is a good thing in my book.

Are any particular macro views informing your overall strategy today?

EC: When I started in the business you just had to focus on fundamentals and valuing companies, without having to have a strong opinion on macroeconomic variables. Now there are some days I come to work and everything seems to move together in one big risk trade. That can make investing difficult.

That said, if you focus on normalized cash flows, as we do, you always have to pay close attention to cycles and where

we are in them. The best insight I get for that just comes from following so many companies and industries and listening critically to what's being said. That gives me a much better feel for what's going on than reading sell-side research or listening to economists.

So what's going on?

EC: I was afraid you'd ask that. It's really just a terribly mixed bag. Most companies are planning for a flat economy and not investing very aggressively. If there's any consistent message, it's how inconsistent the signals are about where the economy's going.

In the end, I fall back on the fact that our process is meant to identify undervalued companies on an absolute basis, using conservative assumptions. If I can find them, I'll buy them. If I can't, I'll hold the cash until I can. That process is meant to work in any macro environment and so far it's held up pretty well. VII

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Battening Down

Few investors navigated the financial crisis more successfully than Fairfax Financial's Prem Watsa. Here he explains why he doesn't believe the crisis is over and how he's positioning his portfolio as a result.

INVESTOR INSIGHT



Prem Watsa

Fairfax Financial Holdings

On opportunity: "The fact that you go through times when you're out of sync or out of favor, that's good, you should expect that and even welcome it."

Editors' Note: Turning 60 next month, Prem Watsa would certainly make the short list of most-accomplished investors of his generation. Driven largely by his investing acumen, Watsa's Toronto-based Fairfax Financial Holdings has increased its book value per share at a compound rate of 26% per year since he founded the company in 1985. He was at his best as the financial crisis hit in 2008, when his cash-heavy portfolio and giant bets on the credit default swaps of many of the crisis' poster children – think Fannie Mae, AIG and Countrywide – resulted in a portfolio gain of 16.4%, more than 5,000 basis points better than the overall market. We spoke recently with Watsa about his storied investment past, as well as how he's preparing his portfolio for the future.

Growing up in India, was a career in investing an early aspiration?

Prem Watsa: In India, if you're good at math and physics you go into engineering, which is why I studied chemical engineering in college. My father was a teacher and a school principal, so grow-

ing up I had almost no exposure to business, let alone investing.

After graduating with my engineering degree, I concluded I had no interest in being an engineer, so I got admitted instead to one of India's best graduate business programs. I was very much settled down and had already met my wife-to-be, so in my mind life was good. But my Dad felt that there wasn't enough opportunity for me in India, so he convinced me to go to London, Ontario in Canada, where my brother was living, to pursue my studies. I came to Canada in 1972 and got my MBA from the Richard Ivey School of Business two years later. My wife and I wanted to live in a bigger city, so we moved to Toronto where I joined an investment firm. We've been here ever since.

What were your most important investing influences early on?

PW: Some of the best early advice I got was to forget all I'd learned in business school about efficient markets and instead read Ben Graham. You either take to it or you don't, and I knew right away that this was how I wanted to do it. (By the way, there's now a Ben Graham Center for Value Investing at Ivey.)

Of course Warren Buffett has been a mentor for all of us, but the mentor I came to know really well was John Templeton, who I knew for 30 years. He was obviously a value investor, but one thing that truly set him apart was his flexibility in seeking out value investments across industries, borders and asset classes. He was also a wonderful, spiritual man. There was so much to learn from him.

Do you consider yourself a traditional value investor in the Ben Graham mold?

PW: I began that way, yes, looking for net-nets, discounts to book value and all

of that. I would say, though, that I have graduated over time to be more focused on very good companies selling at fair prices. I would have been hard-pressed in the early days to buy something like Johnson & Johnson [JNJ], for example, but now almost all of our big equity positions are in these types of high-quality companies that we believe the market is mispricing.

Few investors did a better job than you did in recognizing the credit bubble and benefiting from it when it burst. Have such macro bets always been important to your investing strategy?

PW: Not entirely, no. We are sensitive to bubbles and have done a fairly good job of avoiding them, from the oil and gas boom in Canada in the late 1970s to the Internet bubble of the late 1990s. We saw the same thing happening in 2003, 2004 and 2005 in real estate. Read our annual reports from then and you'll see that we were very skeptical about real estate prices and saw big problems resulting from all the slicing and dicing of asset-backed securities that was going on. It blew our mind that so many insurance companies were reaching for yield and blindly relying on ratings to properly reflect risk. Nobody seemed to question how it was possible that there were only a handful of AAA corporate credits, but literally thousands of structured products that were rated AAA with no track record or responsible management.

What was a new effort this time on our part was to not only avoid the risks we saw, but to figure out how to take advantage of the low credit spreads in the market. In this instance I credit Brian Bradstreet, who I've worked with for nearly 35 years, who came up with the idea of buying a broad portfolio of credit default swaps on what we considered the most vulnerable companies.

I want to emphasize that we were wrong for a long period of time in this case. Our credit-default-swap portfolio and other hedges were quite costly and hurt our performance for three or four years before paying off. One of the reasons there aren't really that many value investors is because it can be very difficult to appear to be wrong for so long. We're used to it, so as long as we felt we'd eventually be right it didn't bother us. But most people can't take such a long-term view.

Describe more fully how your portfolio was positioned when the crisis hit.

PW: We essentially had 75% of the investment portfolio in cash and government bonds, our stock positions were fully hedged, and then we had the large holdings of CDS's. That translated into a total return of 16.4% for all of 2008.

In November of 2008, after equity markets had dropped 50% from their highs, we removed the equity hedges on our portfolio. As the yield on long U.S.

Treasuries fell below 3%, we sold the bulk of them and put a lot of the new money into U.S. state, municipal and other tax-exempt bonds, almost 90% of which carried a Berkshire Hathaway guarantee. By the end of the first quarter of 2009, we had liquidated most of our CDS portfolio.

What environment are you positioned for today?

PW: The two historical periods we believe are relevant are the U.S. in the Great Depression and the Japanese experience over the last twenty years. In Japan, nominal GDP remained flat for 20 years even though total debt as a percentage of GDP went from 50% to 200%. People will say it's different this time and that that can't happen in the U.S. Maybe, but I remember being in Tokyo in 1989 and people were saying the same thing. It won't be that bad because we have high savings rates, or because the Keiretsu cross-shareholdings provide stability. Look how that turned out.

The economic story was similar in the U.S. in the Depression. After falling dramatically, nominal GNP came back up at the end of the 1930s to where it was in 1929, so there was no growth for the entire period. If not for the war, that would have lasted for a longer time.

So we don't believe the financial crisis is over. After 20 years in which most developed countries saw leverage going to record levels, we think there are many, many years of deleveraging to go. Governments have tried to step in to mitigate the pain of that process, but as you see already in Europe, attention is turning to cutting spending and raising taxes. We expect after the mid-term elections to see much the same thing in the U.S. With a \$1.5 trillion deficit and near-0% interest rates, there aren't many bullets left.

Our conclusion is that the economy either stays relatively flat as it de-levers, or the economy slips and the resulting crisis of confidence contributes to a double-dip recession.

With that cheery prognosis, what's an investor to do?

PM: What we've done is position ourselves not to give back the significant gains we've had. We like the stocks we own, such as J&J, Wells Fargo [WFC] and U.S. Bancorp [USB]. But while we're holding on to those, we've increased our equity hedge ratio as of June 30 to 90%. Those hedges are almost exclusively in the form of shorts on the S&P 500 and Russell 2000 indexes.

We've trimmed our corporate bond portfolio significantly and have added some to our municipal bonds, which provide a nice stream of income for us. We tend to focus on bonds that support essential government services, say funding the Los Angeles airport, where we'd expect the U.S. government to step in if there was a problem. Our cash position in the insurance-subsidiary portfolio is now about 15%, and is building up again.

What we're basically doing is batten-down the hatches and just being very careful here. If the stock market takes off and interest spreads come down even fur-

INVESTMENT SNAPSHOT

Fairfax Financial

(Toronto: FFH)

Business: Holding company with primary operating subsidiaries involved in property/casualty insurance and reinsurance in Canada, the U.S. and Asia.

Share Information

(@7/29/10):

Price	\$391.13
52-Week Range	285.17 - 402.86
Dividend Yield	2.5%
Market Cap	\$8.42 billion

Financials (Year-end 2009)

Revenue	\$6.64 billion
Net Profit Margin	12.9%

Valuation Metrics

(Current Price vs. TTM):

	FFH	S&P 500
P/E	7.9	17.5
P/BV	1.0	

FFH PRICE HISTORY



Sources: Company reports, other publicly available information

ther, our performance might lag for a year or two. But in the spirit of building our company over the long term, we're willing to take that risk.

Are you at all concerned about inflation and rising interest rates?

PW: Right now we're more concerned about deflation, which would reduce Treasury rates even further. If we have a repeat of the U.S. in the 1930s or Japan over the past 20 years, long Treasuries could keep going down – or at least stay very low – for some time.

How is a stock like Johnson & Johnson right for the times?

PW: It's a high-quality company with a tremendous track record of creating shareholder value over time. It's financially sound, with a lot of cash on the balance sheet. It's also a global franchise, so will benefit as markets like China, India and Brazil continue to develop. With all that, you're able to buy it today at less than 12x earnings – some days you've been able to get it for as little as 10x earnings. There have only been a handful of times over the past 60 to 70 years when you've been able to buy J&J that cheaply.

We recognize, of course, that nothing's going to stop J&J from going down if the market does. But long-term, this is the type of company we want to own.

Is the story similar for Wells Fargo and U.S. Bancorp?

PW: Yes, but with maybe even more opportunity to take advantage of the competitive upheaval in their industry. Wells bought Wachovia at a fabulous price. A deflationary environment will be rough on banks, and Wells and U.S. Bank have the management, earnings power and corporate cultures to make their way through that and come out even stronger on the other end.

Describe your enthusiasm for Dell [DELL], which hasn't exactly been firing on all cylinders.

PW: It's a strong global franchise, with very little debt and lots of cash. We're also very positive on Michael Dell's renewed leadership of the company. He's still in his 40s and we're confident that a guy who's taken the company from zero to \$55 billion in revenues will figure out how to take it forward. And you're not paying much for that opportunity – if you take out the cash per share from the stock price, you're buying it at a single-digit multiple.

Turning briefly to Fairfax Financial's operating business, describe the rationale for your February purchase of U.S. workers-compensation insurer Zenith National.

PW: We've known and invested in Zenith for a long time. Stanley Zax, who took over the company in the late 1970s, is one of the premier insurance executives in the United States. Zenith's combined ratio during his tenure, even in a long-tailed line like workers comp, is about 95%. He's proven over a long period of time that he doesn't care how much business he writes, just that it's profitable. That's how we run our own businesses.

So what we've done is to combine Zenith's outstanding underwriting with our ability to invest well over the long-term. We think we paid a very fair price in this environment, but the company is going through a cyclical downturn that is showing no immediate signs of turning up. It may take years for the business to improve, but with their staying focused on underwriting and our managing the portfolio, we expect over time for this to be a very good addition for Fairfax shareholders.

You've also been active in expanding Fairfax's presence in emerging markets. Describe how you've gone about that.

PW: We believe our model of combining solid underwriting with investment expertise can work just about everywhere. What we've tended to do in emerging markets is buy into small local companies or partner with an experi-

enced management team to start from scratch. We went into India ten years ago by partnering with ICICI Bank to create ICICI Lombard, which is now the largest property/casualty insurer in the country. (We own 26% of ICICI Lombard, the maximum amount allowed.) It now writes around \$1 billion in annual premiums, but that's just scratching the surface of the long-term opportunity. As an example of insurance penetration levels there, only 1% of all homes in India are insured.

We're now the second-largest insurer in Singapore, but first in underwriting profit. We own companies in Hong Kong, Thailand and Poland. We're in the process of starting a new business in Brazil. In every case we rely on decentralized management of the business, while centralizing the management of the investments. That obviously puts a big premium on identifying and keeping the right management – knock on wood, in the 25 years we've been at it, we haven't lost a division president we wanted to keep.

How prepared is the insurance side of the business for a period of deleveraging?

PW: As of the end of the second quarter, we have cash and marketable securities at the holding company level of approximately \$1.4 billion. We test ourselves against a 50% drop in the stock market and are comfortable that our companies will still have sufficient capital to write business without having to tap that excess capital.

Can you imagine making more "control" investments outside of insurance?

PW: What drives us is to do well for our shareholders over a long period of time – our goal is to compound book value by at least 15% per year. We could certainly see ourselves buying anything that we believe helps us reach that level of return.

Having said that, we know our strengths are in insurance and investments worldwide. We'll stick with that for the most part, but if something comes

up outside of insurance that we really understand and isn't too big, we're very open to pursuing it.

You're almost 60 and have been running Fairfax for 25 years. Do you envision ever wanting to do something else?

PW: I honestly don't. This is what I enjoy and I get a tremendous amount of satisfaction working with the team here. You may not know this, but our name comes from "Fair, Friendly Acquisitions," and I believe our culture truly is fair and friendly. There are always challenges in business, but there's no tension in terms of working with our people. I find it all very exciting.

It wasn't long ago that you were considered badly off your game. Markets were soaring and Fairfax stock was going the other way. Was that tough to deal with?

PW: I've been at this long enough that I can keep things in perspective. My family

is very strong. I have a strong spiritual faith. Ben Graham said it well: He said to succeed in the investment business it helps if you're smart and it helps if you work hard, but what's most critical to success is that when you have conviction, you stick with it.

The fact that you go through times when you're out of sync or out of favor, that's good, you should expect that and even welcome it. That's where opportunity comes from. If we'd given up on our conviction in early 2007, we would have missed a huge opportunity. That we didn't was a game changer for us.

What advice would you give policymakers confronting the environment you fear?

PW: There are no easy answers, but I generally believe that the more we allow the economy to naturally adjust, the faster we come out of it. In the U.S., housing starts have gone from 2.2 million per year to 500,000, which is the type of thing that has to happen for the excess

inventory of homes to ever be digested. When you're working off way too much debt in the system, there are no short-term fixes for that.

I'm not a long-term pessimist. The U.S. and all of us are going to survive and the economy will come back. But I do think we're on dangerous ground here.

Is your goal of 15% annualized increases in book value going to be a stretch?

PW: Fairfax has an equity base of more than \$8 billion. We have \$22 billion in investments. We have \$1.4 billion in excess capital at the holding-company level. We write \$5 billion worth of insurance per year, and we could easily write twice that if the pricing environment were more favorable, as it eventually will be. All of that means we have the resources to bring us through difficult times and to take advantage of opportunities that such times create. Our returns may be lumpy, but we fully expect to meet our long-term goals. VII

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NEW ISSUE due out August 23 – DON'T MISS IT!



Persistence Pays

Collective investor attention spans continue to shrink, but Bulldog Investors' experience with Long Island REIT Gyrodyne is an example in which patience – combined with rattling some cages – can pay off quite handsomely.

When Phil Goldstein and Andrew Dakos of Bulldog Investors first got interested in tiny Gyrodyne Company of America six years ago, the investment case was a simple one. The former defense contractor was sitting on a 314-acre piece of land on Long Island's north shore, adjacent to Stony Brook University, that they believed was worth at least \$100 million. There were other assets and moving parts to the story, but the essence was that if they were right about the value of the 314 acres, the stock was worth two to three times the then-price in the \$30s.

As is often the case, even simple stories can get complicated. The state of New York in November 2005 took through eminent domain 245 of those prime acres, paying Gyrodyne just over \$26 million. If that value held, the acreage was worth about one-third what Bulldog had estimated. At this point, Goldstein and Dakos started living up to their firm's name, agitating for Gyrodyne to more aggressively fight the state's land grab and take other steps to realize shareholder value. An acrimonious battle ensued, including two proxy fights and Gyrodyne filing suit against Bulldog. "It got more than a bit ugly," says Goldstein.

While the ugliness continued, Bulldog maintained its conviction that the Long Island parcel was still worth at least \$100 million, making the case in early 2008 in VII [March 31, 2008] that the pre-tax value of the shares – then \$39 – was still at least \$100. After rising and falling as the real estate bubble inflated and then popped, Gyrodyne shares in June of this year were stuck at around \$40.

Then lightning struck, in the form of a New York claims court ruling on June 30 that the state owed Gyrodyne an additional \$99 million on the land it had taken, plus interest at 9% per annum from November 2005 until the date payment is eventually made. On news of the

ruling the company's stock doubled. It currently trades at \$79.

Bulldog's persistence was less a function of stubbornness than it was analysis, says Dakos. "We make the calculation all the time whether the IRR on a stock from today's price to our estimate of terminal value – given how long we think it's going to take to get there – is sufficient," he says. "In Gyrodyne's case, the value gap was just so big that we never really considered giving up."

Time to move on? Not yet. Adding up the values of the medical office buildings Gyrodyne bought with the earlier pro-

ceeds from the state, the \$99 million award, the more than \$40 million (and counting) interest award, the 68 remaining undeveloped acres on Long Island and an interest in an orange grove in Florida, Dakos says the company today, assuming efficient tax planning, may be worth as much as \$140 per share. The state of New York is likely to appeal the recent award, but Dakos and Goldstein believe the award will hold and that management is now focused on maximizing shareholder value. "It could all take another year or two to play out," says Dakos. "That's OK with us." VII

INVESTMENT SNAPSHOT

Gyrodyne
(Nasdaq: GYRO)

GYRO PRICE HISTORY



Share Information (@7/29/10):

Price **\$79.17**
52-Week Range **\$34.75 - \$82.53**

Valuation Metrics (@7/29/10):

	GYRO	NASDAQ
Trailing P/E	n/a	12.2
Forward P/E Est.	n/a	15.7

ORIGINAL BOTTOM LINE – MARCH 31, 2008

Andrew Dakos believes management should more aggressively pursue several opportunities to unlock the company's existing asset value. Assuming a \$100 million valuation on land taken under eminent domain by the state of New York, he believes the pre-tax value of the assets underlying the shares is around \$100 per share.

NEW BOTTOM LINE

The company's shares doubled after a favorable court ruling on June 30, but Andrew Dakos still doesn't believe it's time to move on. Based on his sum-of-the-parts analysis, assuming efficient tax planning, he thinks the shares are worth as much as \$140.

Sources: Company reports, other publicly available information

No Excuses

One of the best descriptions we've heard of the mandate given to him by his investors was this from Omega Advisors' Lee Cooperman in his interview in the November 30, 2006 issue of *VII*:

"If you're a hedge fund with the audacity to charge between 1% and 2% as a management fee and take 20% of the profits, your clients have the right to expect something more. What I consider "more" is that when the market's overvalued, my clients expect me to figure it out and be hedged and out of harm's way. When the market's undervalued, they want me to be leveraged to the upside. If the U.S. is uninteresting, they expect me to find something around the world that makes sense. That's why we have diversified capability – we have an excellent team that is also looking at fixed income, commodities and currencies. Those are areas, if we do them well, in which we can produce additive returns without necessarily correlated risks."

What's great about that description is that it leaves no excuses for poor performance. One key reason for that is the breadth of Omega's mandate: with all the tools at their disposal, if something hap-

pens they weren't ready for, there's nothing and no one to blame but themselves.

Most money managers, of course, have far narrower mandates, and the tyranny of style boxes and required benchmark adherence can tighten the field of discretion even more. The result is a wide array of built-in excuses for poor performance: I had to be fully invested. I couldn't buy small-caps. I had to have a stake in financials. A great year is chalked up to skill, a bad one to circumstance.

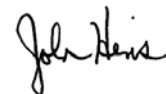
Our point in bringing this up is not to bemoan the state of affairs in money management. In fact, that these constraints exist on most managers' discretion is good news for smart value investors – they add to the reasons stock prices can vary from companies' underlying values. What we do recommend, however, is to step back and assess whether your specific strategy leaves you too many tidy explanations if things go wrong. Your clients – even if you're the only one – deserve better.

The "Death" of Value Investing

In his 2009 letter to investors, Abingdon Capital's Bryan Jacoboski

(*VII*, August 29, 2005) offered this insight about successful investing:

"I had an inkling that 2009 would be a good year when *Institutional Investor* magazine published an article in late 2008 titled "The Death of Value Investing." In my experience, "Death of ..." articles usually mark a turning point, irrespective of the subject. In this instance, I was struck not only by the article's potential as a contrary indicator, but also by the utter preposterousness of its assertion. For value investing to die, either humanity would have to die too, or people would have to become entirely and consistently rational. The very reason price and value diverge in predictable and exploitable ways is because people are emotional beings. That's why the distinguishing attribute among successful investors is temperament rather than brainpower, experience or classroom training. They have the ability to be rational when others are not." **VII**



John Heins
Co-Editor-in-Chief



Whitney Tilson
Co-Editor-in-Chief

Value Investor Insight™ is published monthly at www.valueinvestorinsight.com (the "Site"), by Value Investor Media, Inc. Chairman and Co-Editor-in-Chief, Whitney Tilson; President and Co-Editor-in-Chief, John Heins. Annual subscription price: \$349.

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