Value Investor INSIGHT

The Leading Authority on Value Investing

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Fertile Crescent

Steven Romick has built a great long-term record by expertly navigating rocky markets – making now an opportune time to check in on what he's doing.

His portfolio was up 50% in 1990, but Steven Romick remembers being berated in a client meeting for one particular losing bet. "I knew then I needed to find a model less subject to clients getting upset about what's happening in the portfolio at any given time," he says.

Since starting what is now the FPA Crescent Fund in 1993, Romick has given clients little reason to be upset. Investing across companies' capital structures and often holding plenty of cash, the fund has earned – with much less volatility than the market – an annualized net return of 12.4%, vs. 9.2% for the S&P 500.

After a period of mostly sitting on the sidelines, Romick is finding opportunity in such areas as auto retail, health insurance, energy and (a first) biotech. See page 2

INVESTOR INSIGHT

Steven Romick
First Pacific Advisors

Investment Focus: Seeks firms whose past success informs a brighter future than the market expects, priced so that potential upside is at least three times the downside.

A Reformed "Believer"

Many value investors rely on innate skepticism to stay out of trouble and prosper in tough times. Francois Parenteau learned to be a skeptic, to similar benefit.

INVESTOR INSIGHT

Francois Parenteau
Defiance Capital

Investment Focus: Seeks understandable "boring" companies with strong market positions whose stocks are mispriced due to the market's neglect or cyclical antipathy.

Francois Parenteau was only 25 and admittedly inexperienced when he launched his own independent equity research firm in 1988 out of his bedroom in Quebec. "It would be fair to say that for the first few years my research wasn't world-class," he says. "I'm completely self-taught and I learned the hard way."

He has learned his lessons well. After establishing a name as a researcher, he launched the Defiance Fund hedge fund in the depths of 2002's bear market. Since then his fund has earned an annualized net return of 18.7%, vs. 10.2% for the Russell 2000.

Focusing primarily on smaller, neglected stocks, Parenteau today is finding mispriced opportunities in such diverse areas as apparel retail, glassware, office furniture and medical devices. See page 10

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Investor Insight: Steven Romick

First Pacific Advisors' Steven Romick describes how he likens his research process to a compost pile, why he thinks the mean to which financial stocks will revert has changed, what he's learned from leading scientific researchers and why he sees unrecognized value in Group 1 Automotive, ConocoPhillips, WellPoint and Amgen.

You've run the Crescent Fund from the beginning as kind of a higher-octane balanced fund. Explain the rationale behind that strategy.

Steven Romick: I'd always thought share-price volatility was a bogus measure of risk, but it's a real measure of risk as far as the average investor is concerned. You've probably seen that great Morningstar study about the difference between funds' actual returns and the returns earned by investors in the funds. Because they get scared into and out of stocks when they shouldn't, fund investors earn a lot less than they would if they did nothing and just held their positions. The greater the fund's volatility, the wider the gap between what the fund earns and what investors in it actually earn.

So my goal when I started the Crescent Fund in 1993 was to create a product that offered the best risk-adjusted returns, with lower volatility. I'll sacrifice some upside in bull markets to protect the downside in bear markets. I thought that would provide a valuable service to the average investor who can't handle the level of volatility inherent in equity investing, while it would allow me to spend less time talking to upset investors.

How have you accomplished that?

SR: It's a function of investing across companies' capital structures: buying common stocks, preferred stocks, convertible bonds, subordinated bonds, senior notes or bank debt. It's not a traditional balanced fund that parks the fixed-income portion of the portfolio in Treasuries or mortgage-backed securities. For my fixed-income holdings I'm looking for an equity rate of return, but the analysis doesn't require precise estimates of what earnings will be in any given quarter or year – all we really have to care about is whether we're going to get paid back at maturity. We've found that successfully investing a portion of the portfolio in that way allows us to deliver equity rates of return with a lot less risk than the equity market.

One thing that has changed over time is the equity rate of return hurdle rate. When I started out I was expecting annual equity returns of 10-11% over the next decade. Sad to say, from today out ten years our expected equity return is only in the mid-single digits.

Do you keep the equity and fixed income portions of the portfolio within certain ranges?

SR: I expect generally to have 50-70% of the portfolio in equities and the rest in fixed income, but if we're not finding enough to invest in, we'll let the cash balance grow. As of June 30, we had 56% of the portfolio in long equities, 8% in corporate fixed income and 30% in cash, while also having about 6% in equity shorts.

You've been criticized – primarily when the market is going up, of course – for holding too much cash. How do you respond to that?

SR: We don't look at it as trying to time the market. Our cash level is a function of whether we are or are not finding opportunities that meet our risk-reward characteristics – it's not a conscious top-down decision.

Couldn't you just buy more of what does meet your risk-reward criteria?

SR: In the mutual fund, in keeping with trying to deliver high returns with lower volatility, we usually hold 30-35 stocks. A full position is typically no more than 5% of the portfolio, which keeps a cap on how much we can put into individual names.

Steven Romick

Right-Hand Man

Having earned an education degree from Northwestern and prepping to start law school at USC, Steven Romick figured he had nothing to lose when a friend of his father's, noted Los Angeles money manager Jeff Nathan, offered him a job in order to learn about investing. "He said he was tired of un-learning MBAs," says Romick, "and it wasn't as if I had a burning desire to be a lawyer."

Romick sat at a desk in Nathan's office and followed his every move for the first two years. He spent time at the Teledyne annual meeting with Leon Cooperman and Henry Singleton. He found himself having tea at the Ritz-Carlton in Laguna Niguel with John Templeton. "I couldn't have asked for a better education," he says.

After five years working for Nathan, Romick in 1990 started his own money management firm, which he folded into First Pacific Advisors in 1996. It says a lot when he takes a break from a recent interview to speak with First Pacific CEO Robert Rodriguez – a noted bear with a brilliant long-term record – and comes back saying: "Sorry, but with the market the way it is there's just so much to look at right now."

One big reason we like to hold cash is that my inherent nature is to feel something better to buy is always going to come along and I want to have the cash available to buy it. People assume they can always sell something to buy something better, but I don't like potentially selling into a lousy market when the liquidity isn't there.

I'd add that right now we're starting to find things to do after a year and a half in which we've done very little. We're going to have a lot more to invest in and I'm happy to have the cash on hand to do that.

Has shorting been a core strategy from the beginning?

SR: Yes. I believe shorting over time should positively impact absolute returns, but it also helps accomplish the goal of earning equity returns with less risk than the stock market by dampening the volatility of the overall portfolio.

We also will do some paired trades, such as one we're winding down now among publicly traded business development companies in which we're short what we think are the weakest players in the market and long the strongest. We may also look to hedge specific risks. An example of that is our short position in Russian oil company Lukoil, which is 20% owned by one of our favorite longs, ConocoPhillips. The rest of Conoco's business is attractive enough that I'd rather hedge out the regulatory exposure in Mr. Putin's Russia.

On what valuation metrics do you focus on the equity side?

SR: We ask what our expected rate of return would be if we owned the whole business, which is essentially taking pre-tax free cash flow and dividing it by the current enterprise value. For pre-tax free cash flow we look at normal earnings before interest, taxes, depreciation and amortization, less maintenance capital spending. In the denominator, we adjust enterprise value by adding contingent liabilities and subtracting any kinds of hidden assets we find. If after all adjustments we can see a mid-teens rate of return, we're very interested.

I'll say it in a way that implies more precision and rigidity than we use, but we also want to see potential upside vs. downside of at least 3:1. If at normalized earnings levels in two years or so we see an upside that is three times the downside we could imagine in the next year or so, we're usually comfortable going forward.

How do your more macro views, which have been quite negative, impact your stock-by-stock assessments?

SR: In our calculations we're making judgments on normalized operating profit, which is where our macro views may come in. A lot of very smart people own American Express, for example, but it hasn't gotten cheap enough for us because we've felt that higher than expected charge-offs would cause them to earn at less than normal rates for another couple of years. It's a great company and we can imagine owning it again someday, but the risk/reward over our time horizon hasn't yet worked.

ON AMERICAN EXPRESS:

It hasn't gotten cheap enough – higher charge-offs will cause it to earn less than "normal" for another couple of years.

Has your negative general view on the prospects for financial services stocks changed at all?

SR: We believe in reversion to the mean, so it can make a lot of sense to invest in a distressed sector when you find good businesses whose public shares trade inexpensively relative to their earnings in a more normal environment. But that strategy lately has helped lead many excellent investors to put capital to work too early in financials. Our basic feeling is that margins and returns on capital generated by financial institutions in the decade through 2006 were unrealistically high. "Normal" profitability and valuation multiples are not going to be what they were during that time, given more regulatory oversight, less leverage (and thus capital to lend), higher funding costs, stricter underwriting standards, less demand and less esoteric and excessively profitable products.

How do you typically generate ideas?

SR: In general, the best thing for us is to find companies that have really stumbled, but where you can look at their past and understand why they are going to earn something much better in the future. That's opposed to looking at a company like Amazon.com, for example, which might be a great business, but where understanding exactly what the model is going to be in the future isn't easy. It's a lot easier to look at the prospects for a rail-car manufacturer, whose business has been the same for decades.

There are pockets of inefficiency in the market where we'll run screens on a regular basis. I don't want to discuss everything we do, but one fertile area for us in the past – which has gotten too well plumbed – has been spin-offs. One of our current fixed income investments is in Sally Beauty Holdings, which was spun off from Alberto-Culver near the end of 2006. The Sally Beauty equity wasn't cheap enough for us, but we very much like the return potential of the debt.

Another area we try to mine is busted IPOs. Buying at the IPO often means you're buying from smart sellers, but we'd much rather buy from dumb sellers – which is more likely to happen after an IPO company disappoints in some way and the people who bought in the initial offering bail.

On the subject of screening, we recently ran a screen for banks and thrifts with 10% tangible equity to assets and trading at less than 1.1x book. Even for such a supposedly out-of-favor sector, the list was ridiculously short.

Like a compost pile, we want to recycle all the work we do. We're always

looking to leverage research on an individual company or industry to look for other related opportunities, whether equity or fixed income, long or short. To give an example, we own the debt and have done a lot of work on the largest British residential real estate brokerage, Countrywide Assured. It makes money on real estate commissions, but also brokers loans, brokers mortgage insurance, performs title searches and does home inspections. As a result, it's more transaction sensitive than home-price sensitive, and transaction volume in the U.K. is at a low going back 35 years. That's a big statement given how the population and housing stock have grown over that time. Could things get worse? Sure, but we think we're being more than compensated for the risk in owning the bonds.

Anyway, one reason to be somewhat optimistic about the prospects for the U.K. housing market is that the supply of homes there relative to actual housing formation hasn't grown nearly as fast as it has in the U.S., primarily because there hasn't been rapid growth in second-home construction in the U.K. It's not that the British don't have second homes, but that they tend to build them in places like Spain.

That got us looking at the real estate market in Spain. With 15% of the U.S. population, Spain has built new homes at 50% of the rate in the U.S. over the past five years. If you look at Spanish banks, we found that many had, on average, tangible equity to assets of less than 5%, poor consumer-deposit franchises, and real estate construction loans that made up a disproportionate share of equity. Non-performing assets to gross loans were running at only about 1%, but we thought those non-performing assets would start growing very fast. This all led us to short a basket of Spanish banks a couple of months ago. They've started to crack, but we think some will go to zero.

Do you have a particular cap-size focus?

SR: We try to be cap-agnostic, but we do want businesses that are easier to understand, and smaller to mid-size companies are generally easier to understand. They have fewer divisions and we can usually get more of our questions answered. Our median market-cap in the fund is around $5 billion.

Do you follow any specific guidelines on diversification?

SR: We don't benchmark at all. I don't care if we own almost no financials and I don't care if we own an excess amount of energy. (Our largest sector today is energy, with a high-teens exposure.) We'll go where we think the value is and let the weightings fall where they may.

ON TURNOVER:

The reality is we can't do the level of due diligence we want on each idea and also turn the portfolio over quickly.

Do you follow any rules on selling?

SR: We set an upside target for each holding, which is not the maximum expectation we have, but the level at which we reasonably expect to be able to sell in the future. When we're right, we'll generally hold until the shares reach that upside. The reality is that we can't do the level of due diligence we want on each idea and also turn the portfolio over quickly by constantly trading out good ideas for better ones. So we typically hold companies an average of five years.

Turning to some specific equity ideas, what's behind your interest in Group 1 Automotive [GPI]?

SR: Group 1 is the fourth-largest automobile retailer in the U.S., with a better-than-average product mix consisting of 65% Asian brands. We own about 7% of the company but we haven't made it as big a holding as we might because of our concerns about the macro sell-through of automobiles in the U.S.

Auto sales are obviously volatile and sensitive to the economy. If you look back in time, new-auto unit sales declined 31% in 1982 from the high in 1978, 23% in 1991 from the high in 1986, and this year are expected to come in around 14.2 million units, which is 18% below the most recent peak of 17.4 million in 2000. Our thesis for Group 1 isn't that new-car sales have hit bottom – we don't think they have – but that the upside for the company over the next five years more than offsets the downside we believe exists.

We think the market is missing just how profitable and well-positioned the parts and service side of the dealer business is. Over the past 35 years the auto retail industry has never lost money in an individual year, largely because parts and service is not nearly as economically sensitive as unit sales. If your car breaks down you have to get it fixed. Group 1 earns about 40% of its gross profit from parts and service and we consider that to be a growth area, for a few key reasons. The electronics in cars are increasingly complex, so the neighborhood mechanic can't afford the specialized service equipment that each make of car requires. At the same time, new cars are being sold with longer warranties, which will make it more likely that customers will get their servicing done at the dealer. Finally, the increasing number of used cars having gone through a multi-point inspection and being sold as certified will make those cars eligible for extended warranties – Toyota's is for up to eight years and 80,000 miles – all of which will also improve the dealers' warranty business.

Does anything in particular distinguish Group 1 as an operator?

SR: The company under Earl Hesterberg, the CEO since 2005, is very well managed. They've made the entire operation more efficient and more focused on driving sales. The efforts haven't really shown up yet in the numbers because of the struggle with declining unit sales, but we expect to see real operating leverage when sales eventually pick up again. Normalized for a reasonably good economy, I believe Group 1

can earn as much as $5 per share. For that to happen, annual sales would have to increase from roughly $6 billion today to $7 billion – roughly half from getting back to normal and half from acquisitions – and EBITDA margins would have to increase from around 3.5% to 4%.

That earnings estimate makes the shares, recently trading at $19.30, look cheap.

SR: None of the publicly traded auto dealer roll-ups have been public through a true consumer recession, which makes the market understandably concerned about what's going to happen to profits in the current downturn. But as they get through this cycle – we're not smart enough to say when that happens – we do think these companies will not have suffered as much as the market seems to expect. That would justify a higher P/E valuation than in the past, but even at a 13x multiple – in line with the past – Group 1's shares would be worth $65 if they make our $5 per share earnings estimate.

How are you looking at downside?

SR: We stress tested our model to see what would happen if units declined another 20% from current depressed levels. Even if that happened we'd expect Group 1 to still earn $1.00 to $1.50 per share. At a 10x multiple of trough earnings, that's maybe a $10 share price on the downside. If I think the shares can get to at least $65 over the next five years, that's an upside/downside ratio we can live with.

Does the large short position in the shares concern you?

SR: The shorts have been right so far. This sector understandably has been heavily shorted given its economic sensitivity – we're short ourselves other companies in the industry – but we're looking through the cycle and betting on what we think is the best-run player in the sector.

Among all the energy-stock choices out there, what makes ConocoPhillips [COP] stand out for you.

SR: We've chosen to stay away from the pure exploration and production [E&P] companies, which are so dependent on the price of oil and a company's ability to tap new finds. We're peak-oil theorists (with no idea when that's going to happen), but we have believed for several years that getting access to the remaining oil in the ground will get harder and harder. As a result, we've owned and still own several drillers and service companies, including Ensco [ESV], Patterson-UTI [PTEN] and Rowan [RDC].

ConocoPhillips is a somewhat different story. Two years ago the stock was being penalized because the company had paid a big price for Burlington Resources. The company was in several businesses – E&P, refining, chemicals and pipelines – and any way we looked at it we thought the shares were extremely cheap. What's surprised us since we first bought is how relatively poorly the stock has done relative to the price of oil.

While the stock price has increased about 35% in the last two years, that's less than half the increase in the price of crude oil. Given that Conoco has repaid debt and repurchased $17.5 billion worth of shares, the company's enterprise value

INVESTMENT SNAPSHOT

Group 1 Automotive
(NYSE: GPI)

Business: Owns and franchises automobile dealerships and repair centers, selling and servicing the new and used cars and light trucks of 32 different vehicle brands.

Share Information
(@7/30/08):

Price	**19.28**
52-Week Range	14.53 – 40.00
Dividend Yield	3.3%
Market Cap	$447.0 million

Financials (TTM):

Revenue	$6.40 billion
Operating Profit Margin	3.1%
Net Profit Margin	1.0%

Valuation Metrics
(@7/30/08):

	GPI	S&P 500
Trailing P/E	6.6	22.9
Forward P/E Est.	6.3	14.2

Largest Institutional Owners
(@3/31/08):

Company	% Owned
Fidelity Mgmt & Research	12.9%
Anchorage Advisors	9.4%
Dimensional Fund Adv	7.6%
First Pacific Advisors	6.9%
Franklin Resources	4.9%

Short Interest (as of 6/25/08):

Shares Short/Float	26.7%

GPI PRICE HISTORY

THE BOTTOM LINE

Assuming a return to a reasonably good economy and benefitting from expected acquisition growth and expanding EBITDA margins, Steven Romick believes the company can earn a normalized $5 per share. At an historically reasonable 13x earnings multiple, the shares would trade for $65, more than three times the current level.

Sources: Company reports, other publicly available information

over that time is up just 12.5%. What's particularly vexing is how the market seems to deal with the mix of business between E&P, which typically produces more than 50% of operating income, and refining, which delivers around 30%. It's as if Conoco is considered a refiner when the price of oil is increasing – and refining margins decline – and an E&P company when the price of oil declines.

There's no doubt refining profitability has been hurt, but we think the current woes are worse than what should be considered normal going forward. The big integrated oil companies with refining businesses have recognized that it's not a good idea to be pushing up consumer gasoline prices at the same time they're making so much money in E&P. That's actually keeping gasoline prices lower than the $5.50 to $6 per gallon they probably should be.

Another dynamic for which we don't think the market is fully accounting is the company's investments in joint ventures with companies like EnCana to access oil-sands reserves in Canada. Conoco contributes refining assets to the joint ventures in return for a share of the reserves. That takes refining profits down in the short-term, because they are now shared, but the reserves they get in return are just in the early stages of being developed. The result is a penalty to earnings today in order to create future profitability.

How do you correct for all this in valuing Conoco shares, currently at $84.70?

SR: Valuation is difficult, given that it depends on things like the price of oil, refining crack spreads and the company's continued willingness to repurchase shares. To simplify our analysis for the sake of explanation, the lowest 2010 earnings estimate out there for the company is $10.70 per share. At today's less than an 8x multiple of that, we don't think the stock price fully values even that low-end estimate. By the way, the company is expected to earn $13.50 this year, so you're paying only 6.3x current earnings.

What that means to us is that there are a variety of potential free options on the upside for Conoco: a sustained level of high oil prices, the early-stage joint ventures starting to pay off, the extraction of value by spinning off pipeline assets, higher valuations accorded the company's refinery assets that are under-earning relative to normal today, payoffs from the $1 billion they've sunk into alternative-energy and other emerging businesses, intelligent use of free cash flow to shareholders' benefit and, last but not least, the potential that some of their current 40 billion barrels of probable, possible, and contingent reserves become proved – which is more likely if oil prices remain high.

We've valued this in several different ways – on a sum-of-the-parts, on relative and absolute P/Es, on replacement values, etc. – all of which point to the stock being worth $120 to $140 per share.

WellPoint [WLP] has attracted many value investors. Describe your investment case for it.

SR: People know the company: it's a healthcare insurance company operating primarily in fourteen states, in thirteen of which under the Blue Cross and Blue Shield names. In those thirteen states they have #1 market share, which allows them greater economies of scale and purchas-

INVESTMENT SNAPSHOT

ConocoPhillips
(NYSE: COP)

Business: Integrated energy firm operating through six segments: Exploration and Production, Midstream, Refining, Lukoil, Chemicals and Emerging Businesses.

Share Information
(@7/30/08):

Price	**84.68**
52-Week Range	67.85 – 95.96
Dividend Yield	2.3%
Market Cap	$130.61 billion

Financials (TTM):

Revenue	$185.05 billion
Operating Profit Margin	12.7%
Net Profit Margin	6.7%

Valuation Metrics
(@7/30/08):

	COP	S&P 500
Trailing P/E	11.0	22.9
Forward P/E Est.	6.3	14.2

Largest Institutional Owners
(@3/31/08):

Company	% Owned
Axa	5.3%
Barclays Global Inv	4.9%
State Street Corp	3.4%
Vanguard Group	3.1%
Davis Advisors	2.8%

Short Interest (as of 6/25/08):

Shares Short/Float	2.1%

THE BOTTOM LINE

At an 8x multiple of even the lowest-end estimate of 2010 company earnings, the current stock price is not fully valuing the company's ongoing business, says Steven Romick, providing him with a wide variety of "free options on the upside." Several different valuation methods point to a share value of $120-140 per share, he says.

Sources: Company reports, other publicly available information

ing power with healthcare providers. The other big benefit of market leadership is that doctors want to be part of their network to access the large number of customers and vice versa, because customers want to be part of it to access the large number of doctors.

We went through all the state statutory filings and you can see that WellPoint's plans consistently operate with higher margins, while the company overall produces extremely high returns on capital. That shows the type of competitive moat they have around their business.

We also think the company has a competitive advantage in owning its own pharmacy benefits management [PBM] business. They don't have to pay an outsourcer's margins and can either sell the business or grow it through attracting third-party clients as they see fit. In any case, we think the PBM business makes the quality of the overall business that much higher.

This hasn't kept cyclical and regulatory concerns from hitting the stock. How do you assess those?

SR: There's been a big concern about pricing, that strong price increases in recent years are over and WellPoint is facing pricing headwinds as customers look for alternatives, including self-insurance. We don't claim to know exactly how it's going to play out, but we do think that the fact that not-for-profit competitors have declining market shares in WellPoint's states could very well make pricing pressures less of an issue than the market seems to think. Even if the short-term price pressure is real, it's part of a cycle, and to make money in this stock we expect to own it through the cycle.

The elephant in the room for the company, of course, is what the government is going to do concerning a single-payer health insurance system. If you look at what Obama has been saying about healthcare, when he was arguing with other Democrats he was making a much stronger case for the government's role. Now that he's arguing with the Republicans, he's become much more centrist and not talking as much about a single-payer system.

That's not to say there aren't ways private health insurers could get hurt by new regulation, but we ascribe a very low probability to any catastrophic outcome and don't expect anything to happen for years. At the margin, though, the uncertainty about the government's course probably makes it less likely we'll make WellPoint a top-five holding in the fund.

How economically sensitive is the business?

SR: For the most part, people getting laid off don't tend to go without medical insurance and can extend their insurance through COBRA for longer than they're out of a job. A potentially bigger concern is if cash-strapped companies look in greater numbers to self-insure and switch their relationship with WellPoint to entail less-profitable administrative services only. You can see some of that in the numbers, but not to any great degree yet.

Stepping back, we believe that the government's actions today in trying to deal with the housing and credit crises – operating with a blank checkbook – are going to create inflation. We actually see health insurers like WellPoint as beneficiaries of that – they're working on a spread and

INVESTMENT SNAPSHOT

WellPoint
(NYSE: WLP)

Business: Provider of network-based managed healthcare plans to small- and large-employer, individual, Medicaid and senior-citizen markets in the U.S.

Share Information
(@7/30/08):

Price	**52.91**
52-Week Range	43.02 – 90.00
Dividend Yield	0.0%
Market Cap	$27.05 billion

Financials (TTM):

Revenue	$62.00 billion
Operating Profit Margin	8.4%
Net Profit Margin	4.9%

Valuation Metrics
(@7/30/08):

	WLP	S&P 500
Trailing P/E	9.6	22.9
Forward P/E Est.	8.6	14.2

Largest Institutional Owners
(@3/31/08):

Company	% Owned
Dodge & Cox	7.0%
Wellington Mgmt	4.2%
State Street Corp	3.7%
Barclays Global Inv	3.6%
Barrow, Hanley, Mewhinney & Strauss	3.5%

Short Interest (as of 6/25/08):

Shares Short/Float	1.5%

WLP PRICE HISTORY

THE BOTTOM LINE

With an improvement in its medical cost ratio to 84% and barring dramatic changes in its regulatory environment, the company in two to three years can earn at least $8 per share in annual free cash flow, says Steven Romick. At a 12x multiple – less than the 15x average from 2001 to 2007, he says – the shares would trade in the mid-$90s.

Sources: Company reports, other publicly available information

will only take business at an acceptable margin above their costs.

How are you looking at valuation with the shares just under $53?

SR: With a small improvement in the medical cost ratio [the expenses to deliver insured services as a percentage of premium revenues] to around 84%, we can imagine the company in two to three years earning at least $8 per share in free cash flow. At only a 12x multiple, that would result in a share price in the mid-$90s. We're not talking pie-in-the-sky here – WellPoint's average multiple between 2001 and 2007 was around 15x and the shares have been at $90 within the past year.

Shareholders should also benefit from WellPoint buying a lot of stock back at what we think will be cheap prices. They've bought back nearly 20% of the shares outstanding in the past few years and still have a very aggressive buyback program in place.

Amgen [AMGN] stock is up 50% since you bought it last quarter. Describe your analysis of it and whether you still think it's attractive.

SR: This was the first time we've invested in a biotech company. After more than two decades of success in developing new therapies and seeing its stock hit a high of almost $85 in 2005, the company hadn't had much recent clinical success and its stock price fell as low as $40 in the second quarter. We accumulated our position in the low $40s because we thought the market didn't fully understand the company's challenges, which allowed us to create a free option in its development pipeline.

Amgen generated $13.6 billion in revenues in 2007, primarily from three established and successful drug franchises: Epogen for the treatment of anemia, Neupogen for stimulating white blood cells to prevent infection, and Enbrel for the reduction of inflammations. The major concern, apart from typical regulatory risks, appears to be about the sustained profitability of these franchises – due to some health risks linked to the drugs in the past year, competition from new drug protocols, and the threat of replacement drugs once various patents expire for these drugs between 2009 and 2024.

Based on our research, which included speaking with doctors, people who run clinical trials, current and former management and Wall Street analysts, we came to believe that the market was overstating the competitive fears. Given that, we felt we were paying nothing for unrecognized value in the new-drug pipeline, on which Amgen had spent $8.9 billion from 2005 to 2007, not to mention money spent before and since.

Why do you consider the competitive fears overblown?

SR: It was fascinating to learn more about the science behind biotech drugs. Amgen's drugs have high molecular density, which makes them far more complex than traditional drugs derived from smaller, simpler molecules. When Amgen's drugs go off-patent, new competitors won't have access to the original molecular clone and original cell blank, or to details on what is a complex manufacturing process. As a result, a prospective competitor will have to reverse engineer both the molecule and the drug manufacturing process to create

INVESTMENT SNAPSHOT

Amgen
(Nasdaq: AMGN)

Business: Develops, manufactures and markets biotechnology-based pharmaceuticals, including branded blockbusters such as Epogen, Neupogen and Enbrel.

Share Information
(@7/30/08):

Price	**62.30**
52-Week Range	39.16 – 64.00
Dividend Yield	0.0%
Market Cap	$67.83 billion

Financials (TTM):

Revenue	$14.70 billion
Operating Profit Margin	36.4%
Net Profit Margin	21.7%

Valuation Metrics
(@7/30/08):

	AMGN	Nasdaq
Trailing P/E	21.5	27.4
Forward P/E Est.	13.8	20.6

Largest Institutional Owners
(@3/31/08):

Company	% Owned
Barclays Global Inv	5.7%
State Street Corp	3.3%
Dodge & Cox	3.2%
Vanguard Group	3.0%
Franklin Resources	2.9%

Short Interest (as of 7/10/08):

Shares Short/Float	3.8%

AMGN PRICE HISTORY

THE BOTTOM LINE

After a recent price run, the upside/downside equation for the company's shares has become less favorable, says Steven Romick, but he still believes that better-than-expected performance for its blockbuster drugs and some moderate drug-pipeline successes will put the upside share potential he sees in the high-$80s well within reach.

Sources: Company reports, other publicly available information

a "biosimilar." The difficulty with that is that small differences or impurities can dramatically alter outcomes and present serious health risks, so the FDA may require a separate clinical-trial process for these biosimilars, unlike the more streamlined approval process for small-molecule generics. That will make creating the biosimilar much more costly and the manufacturer won't be able to sell its copycat drug as a generic. The distinction is significant because a doctor will have to prescribe the biosimilar by name, unlike for simpler drugs where a pharmacist may use a generic substitute unless otherwise specified.

The net result of all that is that we don't expect the unit sales and pricing of Amgen's three blockbuster drugs to be as negatively impacted upon patent expiry as the average investor seems to believe. That allowed us to pay (at a share price in the low $40s) around 10x our estimate of the company's core earnings, which to our mind meant we were getting the pipeline for free. We didn't and don't feel capable in valuing the pipeline, but it wasn't a big stretch to assume that something good could come out of a $3 billion annual R&D spend. It's way too early to say we're right on that, but, as an example, the big rise in the stock earlier this week came after the announcement of positive trial results for Denosumab (d-mab), Amgen's treatment for reducing bone fractures, potentially benefiting men who undergo bone-weakening hormone therapy for prostate cancer and for women suffering from osteoporosis.

With the stock now at $62.30, how has your valuation equation changed?

SR: The risk/reward is clearly not as attractive as it was. When we were buying, we thought the worst-case scenario for the shares, say from some big regulatory problem, was in the low $30s. To have a potential 3:1 risk reward, we needed to believe there was an upside of around $88 per share. Assuming a reasonable 18x earnings multiple, all they'd have to earn is around $4.90 per share to reach that upside. If we're right about the competitive impact on the existing drugs and if they get anything exciting out of the pipeline, $4.90 is not at all a stretch. Consensus earnings estimates for this year are already around $4.20.

As quickly as the shares have gone up, they obviously can go back down again. Were that to happen, absent any new relevant information, we'd expect to take advantage.

ON PARANOID INVESTING:

When our stocks are going down I'm driving everyone nuts. When they're going up I'm not any more comfortable.

Your website talks about the importance of maintaining "calm, rational judgment in an inherently emotional market." Any closing advice on how to do that?

SR: Here we try to take a page from the Weizmann Institute, a leading scientific research center based in Israel. Weizmann has a world-class reputation, a result of their having the largest patent and royalty stream of any academic institution in the world. If you talk to the scientists there, they believe very strongly that their success comes from being able to do their work without having to worry about how their science will translate to commercial profit – even though in the end it quite often does. By focusing on long-term goals, they eliminate day-to-day distractions and are more likely to work through problems that inevitably arise.

We want to have a similar mindset. We know our investors are going to worry about their portfolios over short time periods, but we explain to them that we won't. We try to look at short-term market gyrations as nothing more than opportunities to smartly enter or exit a position, subject to valuation and fundamentals.

While I hope that keeps us rational, I wouldn't say I'm always calm. My style at heart is out of the pages of Andy Grove's book, *Only the Paranoid Survive*. When our stocks are going down I'm driving everyone nuts to see what we might be missing. When our stocks are going up I'm not any more comfortable. I'm worried whether they're going up for the right reasons and how it might all come crashing down. I say we invest paranoid somewhat tongue-in-cheek, because we couldn't take the sizable positions we do if we were truly paranoid. I just worry about it every step of the way. VII

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Investor Insight: Francois Parenteau

Francois Parenteau of Defiance Capital explains how he overcame one of the worst character traits an investor can have, how government officials help make energy stocks undervalued, how mountain-climbing strategy informs his current market view, and what he thinks the market is missing in Libbey, Knoll, Le Chateau, Rochester Medical and Timminco.

You spent 14 years as an independent research analyst before starting your own fund in 2002. What prompted the switch?

Francois Parenteau: After the Internet bubble burst and some of the abuses of Wall Street research were exposed, the profile of independent researchers was raised, particularly if you had an objective track record and some modicum of success. Even with that raised profile, though, selling investment research was a tough business. I figured running my own fund would be a much better one and the timing was right for me to do it.

When I started in research, I had one of the worst character traits an investor can have – I was a "believer." I was too often seduced by charismatic CEOs and by concept stocks, where the product or service made a lot of sense but there turned out to be cost, competitive or other reasons it would never succeed. I learned the hard way to be a skeptic about management's – and my own – ability to forecast with precision well into the future.

Only two years ago Howard Schultz of Starbucks was talking about increasing growth and taking the company from 12,000 to 40,000 locations. Wall Street looked on with rapt attention and the stock rose into the upper $30s. You could argue that he deserved the benefit of the doubt, but I wrote at the time that making that kind of prediction was overly optimistic at best and foolhardy at worst. Now the stock is at $15 and nobody's talking about 40,000 locations anymore. I'm always wary of those grand long-term forecasts – even people on the inside don't really have a clue at a certain point.

What types of businesses typically attract your attention?

FP: I like to stick with fairly basic, understandable, boring businesses and avoid sexy, change-the-world stories. My top holdings include a clothing retailer, a company that makes drinking glasses and a maker of urology catheters. I'm a typical value investor with a constitutional aversion to paying a high price for anything, which means I generally look for companies trading at less than 1x sales, no more than real book value (excluding goodwill and intangibles), less than 6x enterprise value to EBITDA and less than 10x earnings. Buying at those valuations is our risk management – if I make a mistake, my downside is usually limited.

We also put a lot of emphasis on brand franchises and market positions. One of our best investments this year has been Superior Essex, the world's largest producer of magnet wire, which is used in everything from giant electric generators to electric toothbrushes. Concerns about the economy hit the stock hard starting in last year's fourth quarter and by January, at less than $20 per share, the stock traded at only book value and 8x earnings – this for a global leader in an attractive industry. We weren't at all surprised when LS Corp., a big Korean wire and cable company, made a tender offer at $45 per share to buy the entire company.

Superior is an example of something that once I stumbled onto it, it was relatively easy to figure out. The balance sheet had some cash, plant and equipment, inventory and debt. In five minutes I could basically figure out what I was buying. I could look at something like AIG for six years and never figure out what its balance sheet and profitability might look like over the next 6-12 months.

How do you generate ideas?

FP: We will do screens on valuation criteria to identify places to look, but most ideas just come from watching what's

Francois Parenteau

Coming Into Focus

There was little in Francois Parenteau's early experience that pointed him toward a career as a hedge fund manager. An avid outdoorsman, he studied photography in college and was working as a freelance sports photographer when his growing interest in stocks led him in 1988 to start his own independent research firm. "I enjoyed research and the markets, but beyond that I had no real idea what I was doing at the beginning," he says.

He slowly built a following for his no-holds-barred research, some of which he shared widely in writing regularly for Bloomberg. In late 2002, his firm was first by a large margin in a *BusinessWeek* ranking of independent researchers, based on the performance of three years' worth of recommendations. Having just started Defiance Capital, the free publicity set Parenteau on his way as a money manager.

Why the name Defiance? "I've always considered myself somewhat of a dark horse in the industry, without the academic or work experience most people think is required to compete. "Defiance" is meant to mean we're going to do what we consider to be right, not just what everyone expects."

happening to companies and industries I know from being in the business for the past 20 years. I don't talk much to other fund managers, but I do have a network of investigative reporters I've gotten to know who call me from time to time to discuss long or short ideas they've come across, which can be helpful.

We don't typically follow themes, although we have like many others built our energy position based on the belief that the supply and demand characteristics for energy companies – particularly service companies – are far more positive than current valuation multiples would indicate. For a contract driller like Rowan [RDC], for example, I still don't think it matters much to its business going forward whether oil is at $90 per barrel or $140. The company's earnings grew 50% in 2007, but the stock is flat over the past year. The market appears to be more afraid of cyclicality – Rowan shares trade for only 8x estimated 2008 earnings – than I believe is warranted.

One issue with energy is that government officials keep going out of their way to reassure people that everything will be fine with energy prices, energy supply and global warming, but in most cases they have no policies or particular insight to support that reassurance. This misplaced notion that everything will get back to normal, I believe, is making many energy stocks undervalued.

Do you have other overall market or economic views that are impacting your strategy today?

FP: Serious mountain climbers have something they call the turnaround time, which is a pre-established time of day at which you turn around to go back down, regardless of where you are on the mountain. You could be 20 feet from the summit but would turn around because it's the safe thing to do. I think we hit somewhat of a turnaround time in the market in June. The accepted wisdom – which we never believed – had been that the economy was going to pick up in the second half of this year. As it started to become clear to the market that wasn't going to happen, we started to pull back on some of our more economically sensitive ideas. It wasn't that our thesis on the individual stocks really changed, but that we didn't want to be overly exposed as the market punished those companies with cyclically vulnerable earnings.

As an example, we just sold a recently acquired position in Harley Davidson [HOG]. I still believe a long-term investor will be vindicated at the current share price [of around $38], but when you read about things like kitchen-appliance sales falling 9.5% in June, the potential is fairly high that things are going to get quite a bit worse for sales of discretionary items like Harleys before they get better. I can always reassess as the outlook continues to change and I don't expect to have to pay a lot more to get back in.

ON TIME HORIZON:

We typically buy looking out 18-24 months. This hasn't been a good buy-and-hold market, so we're trading a bit more.

This hasn't been a very good buy-and-hold market, so we are trading a bit more actively. We typically buy looking out 18 to 24 months. We will hold much longer than that, but it should be clear over that time frame if our thesis was right or not.

Once you've identified a potential idea, where do you focus your research?

FP: It really depends on the idea. In some cases we go into incredible depth to research the industry, the competitive set, management and every aspect of the income statement and balance sheet to put the pieces of the puzzle together. In other cases I can figure out the idea in 30 minutes and don't need to do a lot of additional research. In the second quarter of 2006 we decided to short Boeing [BA] because the stock was priced for a perfect rollout of their new 787 Dreamliner plane. Our simple thesis was that based on Boeing's own history and the history of industrial projects of this complexity, there was no way the 787 would actually launch on time. On top of that, they were assembling the plane in a much different way, with new materials and a greater number of sub-suppliers from around the world. This time it was going to be delivered on time? We shorted the shares at an average price of around $80.

You were wrong on that for a while, as the price went to $105. Did you stick with it?

FP: We shorted more on the way up, again, with no more real insight than that the share price was going to get hit if the 787 project ran into any problems, which we thought were inevitable. When it did run into problems, the short started to pay off. [Boeing shares recently traded around $64.]

Is shorting important to your strategy?

FP: We run a long/short portfolio because we think it's the smartest way to run money, primarily because shorting is an insurance policy against having a big down period. As of June 30, our net exposure was around 55% – 73% long and 18% short. We're normally more net long, but we have a higher cash balance than usual today, which has been a good thing.

There are always companies out there whose shares we believe are going to go down. Boeing was at one extreme, but we also conduct weeks and weeks of research into companies we think are far less reputable and far more vulnerable.

What's a current example?

FP: One of our highest-conviction shorts today is Timminco [TIM.TO], which trades on the Toronto exchange and has a current market cap of around C$2.5 billion. This is a metal smelting company which in 2007 was the best performing stock on the TSX, going from 30 cents to C$22. That caught our attention. The company out of the blue claimed it had developed a new process to convert met-

allurgical-grade silicone into an upgraded form that it could sell to solar-cell makers. How convenient.

There are several things about this story that make us skeptical. The CEO is a guy named Heinz Schimmelbusch, who was the CEO of the German conglomerate Metallgesellschaft when it almost went bankrupt after losing a huge amount of money on speculative bets on oil futures. Management issued themselves cheap stock two days before they made their first announcement about this new silicone-purification process. The process they're using, as far as I can tell, is nothing new and has been tried unsuccessfully many times by competing companies. They claim the cost to purify the silicone will be $10 per kilogram, while Elkem, one of the leading metallurgical companies in the world, after hundreds of millions of dollars in capital spending says it can produce a comparable result for $30 per kilogram. Last but not least, when we visited Timminco's facilities to see what was going on, they denied us access for proprietary reasons.

So it's red flag after red flag, plus the company is still losing money and management has already sold more than C$350 million worth of stock at price levels much below the current price of C$24. If the company's potential is so spectacular, why do that? Needless to say, I don't expect this to end well.

What emphasis do you put on management in your research process?

FP: What's most important is that we're investing with a management team that is honest and acting in our best interest. We have a strong preference for situations in which insiders are buying shares along with us – not in token amounts, but in a substantial way relative to their pay and current share ownership.

Several years ago I made an investment in Cannondale, the bike company. I'm a cyclist, so I knew and liked the product. I went to visit the company around the time they had decided they needed to diversify by manufacturing all-terrain vehicles (ATVs). The CEO then was a pilot, as am I, so I find myself with him flying the company's plane to visit the new ATV plant. I test-ride the ATVs and fall in love with the product. I was so impressed by everything that I wasn't as careful as I should have been in analyzing whether getting into the ATV business was even a good idea. It wasn't. Not long thereafter the company ended up being taken private, the CEO got kicked out and the equity ended up being worthless. I tell that story because it's always important to remember the risk that your judgment can be compromised when you get too close to management.

ON SELLING:

If the company's valuation matches its growth prospects, we should be selling and buying things that are bargains.

Do you follow any particular guidelines on selling?

FP: We'll speak later about Rochester Medical, whose shares we've owned off and on in recent years. The last time we sold it was in early 2007, when the stock had clearly gone from being unloved and neglected to a momentum play. It went from trading 5,000 shares per day to 1 million per day, and even made one of those *Investor's Business Daily* "hot" lists where the higher and faster a stock has risen the better it ranks on the list. We always look to sell into that kind of momentum. In fact, at that point we even went short even though we loved the company.

In general, we're not in the business of holding securities that are fully priced. If in our judgment the company's valuation is appropriate for its growth prospects, we should be selling and buying things that are bargains.

We also don't automatically sell if a stock is down a certain percentage, assuming the market knows something we don't and getting out to be prudent. Superior Essex went 40% against us before the buyout offer came in. My threshold for pain is high as long as I believe I'm still right. Historically, we've made a lot more money on the long side when what we thought we were buying cheap went down another 30% before finally going up – we always buy more if our thesis hasn't changed.

That's probably a good lead-in to discuss your holding in Libbey [LBY], the glassware maker.

FP: We started buying Libbey earlier this year at an average cost of $12 and the stock went below $7 earlier this month, so we have suffered. There are several things pressuring the stock, but the two biggest are the fact that people are eating out less in restaurants, lowering demand from that sector, while energy costs for making glass have gone up significantly, which has hurt gross margins. Making glass requires melting sand, which is quite energy intensive – the company spent $60 million last year on natural gas and that may go up as much as 50% this year.

What we like here longer term is the company's competitive position. It was founded in 1818 and is now the second-largest maker of drinking glasses in the world, behind a privately owned French company called Arc International. Roughly three-quarters of Libbey's sales are in the U.S., where its food-service market share is around 55%, but it also exports to more than 90 countries. Half of the business is selling to the food-service trade and half is selling at retail.

Say you have a small restaurant that uses 40 wine glasses. After 200 uses, three things on average will have happened to those wine glasses: they will be chipped, broken or stolen. It doesn't happen all at once, so after a month or two you may have to replace 10 of the glasses. Not surprisingly, you're going to want to buy exactly the same glass. As a result of that nice competitive moat, 90% of Libbey's food-service revenue comes from repeat business.

Is the business overall threatened by Chinese or other lower-cost competition?

FP: Libbey is actually a low-cost producer itself. Two years ago it bought out Vitrocrisa, the largest glass tableware manufacturer in Latin America, which has large production facilities very near the U.S. border in Mexico. Not only are the average hourly labor rates in Mexico maybe 15% of the rates Libbey pays in the U.S., but because of NAFTA, glasses come into the U.S. duty-free, vs. a 20% duty on glasses coming from elsewhere. The company also has a new low-cost facility in China, which started producing last year.

Does Libbey's market position translate into pricing power?

FP: In the food-service business, the company has successfully passed on cost increases in 30 of the past 32 years, with the only two exceptions being during the start of both Gulf wars, when people were more likely to be watching CNN than going to restaurants. Raising prices to the retail trade, where they deal with big retailers like Wal-Mart and Target, has been much tougher. That's why you're seeing gross margins decline when costs of good sold have been increasing as they have.

The company's stock chart wouldn't appear to be a testament to efficient markets, going from $25 in early 2005, to $6 in mid-2006, to $25 again in mid-2007, to just below $9 today. Have actual business prospects changed that dramatically?

FP: There's clearly cyclicality to the business, but not as much as that volatility would imply. People eat out less when the economy is tough, so fewer glasses get broken. That won't last forever. The volatility in natural-gas prices has been an issue, but absent much larger increases, that shouldn't be an insurmountable long-term problem. One more technical factor contributing to the share-price volatility is the fact that Libbey in May 2007 was added to the Russell 2000 and S&P 600 indexes, which increased demand for the stock. As the share price fell it was taken out of those indexes earlier this year, which added to the price pressure on the way down.

In fact, the biggest long-term change in the company's prospects over that time, the acquisition in 2006 in Mexico, was a positive one that has had a dramatic impact on labor-cost competitiveness.

How are you looking at valuation?

FP: The company earned 90 cents per share last year, excluding a non-recurring, non-cash tax allowance. The unanswered question this year is how successful they will be in passing on price increases. They just announced an 8% price increase. If they get 6%, that would translate into $50 million in incremental revenue, which would allow them to cover most of their increased costs. To be conservative, let's say some combination of unit sales declines and cost increases make them earn only 75 cents per share this year.

On top of that, management is optimistic that they will be able to reduce the interest cost on $500 million of high-cost debt by three percentage points, which would save $15 million per year. After tax, that would add another 70 cents per share in earnings. So you've got $1.45 or so per share of earnings power even in a business downturn, which at the current

INVESTMENT SNAPSHOT

Libbey
(NYSE: LBY)

Business: Designs, manufactures and markets glass tableware products to food-service and retail customers in North America, Latin America, Asia and Europe.

Share Information
(@7/30/08):

Price	**8.97**
52-Week Range	6.44 – 22.95
Dividend Yield	1.0%
Market Cap	$131.0 million

Financials (TTM):

Revenue	$824.3 million
Operating Profit Margin	7.9%
Net Profit Margin	(-0.5%)

Valuation Metrics
(@7/30/08):

	LBY	S&P 500
Trailing P/E	n/a	22.9
Forward P/E Est.	12.8	14.2

Largest Institutional Owners
(@3/31/08):

Company	% Owned
Zesiger Capital	15.8%
Skylands Capital	5.9%
Dimensional Fund Adv	5.5%
Barclays Global Inv	5.4%
Credit Suisse	5.1%

Short Interest (as of 6/25/08):

Shares Short/Float	14.2%

LBY PRICE HISTORY

THE BOTTOM LINE

The company's #2 position in the global market for drinking glasses positions it well to weather concerns over end-market demand and input-cost inflation, says Francois Parenteau. The current 6x multiple on the company's $1.45 per share in earnings power makes the shares "a steal for a company with this type of competitive moat," he says.

Sources: Company reports, other publicly available information

share price results in an earnings multiple of around 6x.

The company's goal is to reach $1 billion in sales, with average EBITDA margins of 15-18%. If they can hit that sales goal, which is reasonable, and earn at the midpoint of their margin goal, that would translate into $165 million in EBITDA. Today's enterprise value of around $650 million is less than 4x that EBITDA level. In my view, these multiples are a steal for a company with this type of market position and competitive moat.

What do you see as the biggest risks?

FP: If natural-gas prices go through the roof, that would be a problem. It would also be a problem if trouble in the credit markets doesn't allow the company to refinance its debt to save interest costs. I'm not an expert on that, but management here usually doesn't commit to something they can't deliver.

What attracted you to office-furniture maker Knoll [KNL]?

FP: I've followed the company for some time. As a customer, I know the products and the quality of the customer service. The basic business is in designing and manufacturing high-end branded office furniture, while they also have a specialty division that sells what they call "high-image" side chairs, sofas and tables for both the office and home.

Since going public (after an earlier LBO) at $15 per share in December 2004, Knoll's revenues have increased from around $700 million per year to more than $1 billion, its operating profit has doubled and its earnings per share has more than doubled. But in April of this year, when I started buying, the share price got as low as $11. This is a company that has industry-leading margins and went through the last downturn, between 2001 and 2003, without a single unprofitable month. Insiders were buying earlier this year at $15 per share on down. At my average cost of $11.35, I could buy in at only 7.7x trailing earnings. That's the kind of opportunity that gets my attention.

Are there any concerns here beyond potentially weak demand as business spending slows?

FP: That's primarily it, which is not to say those concerns aren't real, but it's exactly when temporary cyclical problems scare other investors away from easily understandable, high-quality companies like this one that I look to take advantage.

Looking at the longer-term prospects, the company is not vulnerable to cheap Asian competition because it doesn't compete in the lower end of the market. It is continuing to diversify its product mix by selling more home furnishings. Knoll currently gets 10% of revenues outside the U.S., but they are expanding rapidly as international demand for more upscale branded office furniture grows in places like the Middle East, Asia and Russia.

Better second-quarter earnings than the market expected caused the stock to pop a bit to a recent $15.75. What upside do you see from here?

FP: The stock is still cheap, trading at 9.4x the revised consensus earnings-per-share forecast for this year of $1.68. I

INVESTMENT SNAPSHOT

Knoll
(NYSE: KNL)

Business: Designer and manufacturer of branded office furniture products and coverings, sold primarily in North America through direct and dealer sales channels.

Share Information
(@7/30/08):

Price	**15.75**
52-Week Range	10.85 – 20.64
Dividend Yield	3.2%
Market Cap	$740.7 million

Financials (TTM):

Revenue	$1.10 billion
Operating Profit Margin	13.2%
Net Profit Margin	7.0%

Valuation Metrics
(@7/30/08):

	KNL	S&P 500
Trailing P/E	9.8	22.9
Forward P/E Est.	9.6	14.2

Largest Institutional Owners
(@3/31/08):

Company	% Owned
Columbia Wanger Asset Mgmt	13.4%
Ascend Capital	4.3%
Jennison Assoc	4.1%
Robeco Inv Mgmt	3.7%
Neuberger Berman	3.4%

Short Interest (as of 6/25/08):

Shares Short/Float	8.8%

THE BOTTOM LINE

Near-term cyclical challenges are obscuring the company's bright longer-term prospects from product-line diversification and geographic expansion, says Francois Parenteau. At an earnings multiple halfway between the current 9.4x and the average 20x at which the company bought back shares last year, the shares would trade around $25, he says.

Sources: Company reports, other publicly available information

wouldn't at all use it as a benchmark, but the multiple at the IPO in 2004 was 23x. The company last year bought back stock at an average price of $29, which is 20x last year's earnings. I don't know what the right multiple ends up being for Knoll, but I'm quite confident it's more than 9.4x.

After being bought and sold more than once in the past ten years, is the balance sheet in decent shape?

FP: They have net debt of around $350 million against a current market cap of $740 million. Cash flow is strong, though, and the company even bought back 1.6 million shares in the first half of this year. I don't consider the level of leverage a problem.

Turning to the beaten-down retail sector, describe your interest in Le Chateau [CTU/A:CN].

FP: One of our largest holdings a couple years ago was La Senza, a Canadian retailer of low-priced lingerie whose shares were extremely cheap. For whatever reason, retailer stocks have never been in fashion in Canada – mining stocks and bank stocks, yes, but there tends to be little interest in retailers. But we thought there was a lot of value in La Senza, particularly to an acquirer looking to expand into lingerie or into Canada. That's exactly what happened in the fall of 2006, when Limited bought the company at a big premium. Even if investors failed to see the value in a company like this, a competitor did.

Our thesis is largely the same for Le Chateau. It's also Canadian-based, with just over 200 stores selling apparel, shoes and accessories to a young adult audience. It's value-priced but tries to be fashion-forward as well. The closest analog in the U.S. is probably Bebe Stores, although Le Chateau sells to males as well as females.

The company is well-run and is growing nicely even as some higher-profile competitors like H&M have entered the market. Revenue in the latest fiscal year grew almost 11%, to C$336 million, while EPS in the same period grew more than 30%, to C$1.35. EBITDA margins have been increasing and last year came in above 21%. Even in an environment in which most retailers are reporting dismal numbers, the company says its second-quarter same-stores sales are running at 2% above last year's.

With all that good news, Le Chateau's shares currently trade, net of cash, at less than 7x trailing P/E and only 4x enterprise value to EBITDA. That makes no sense and as we saw with La Senza, we expect a buyer to recognize that and try to take advantage of it. The most likely candidates would be Bebe or another U.S. retailer looking for a high-quality franchise to expand into Canada.

Is the growth potential here still high?

FP: The company's goal is to grow to 245 to 260 stores and have C$500 million in annual revenues within the next five years. On the margin side, they've proven to be very smart in managing inventories and working capital and in allocating capital to the best uses. For example, they shut down an underperforming junior-girls division and have replaced that with a higher-margin shoe business.

INVESTMENT SNAPSHOT

Le Chateau
(Toronto: CTU/A)

Business: Canadian retailer of moderately priced apparel, accessories and footwear targeting men, women and teens predominantly between 20 and 40 years old.

Share Information
(@7/30/08, Exchange Rate: $1 = C$1.02):

Price	**C$12.34**
52-Week Range	C$11.05 – C$16.69
Dividend Yield	0.0%
Market Cap	C$329.0 million

Financials (Fiscal 2008):

Revenue	C$336.1 million
Operating Profit Margin	15.5%
Net Profit Margin	10.0%

Valuation Metrics
(@7/30/08):

	CTU/A	TSX
Trailing P/E	9.1	16.7
Forward P/E Est.	8.2	n/a

Largest Institutional Owners
(@3/31/08):

Company	% Owned
Howson Tattersall Inv	12.7%
Natcan Inv Mgmt	9.9%
Fidelity Mgmt & Research	7.3%
Clarica Funds	2.9%
Clarington Capital	1.7%

Short Interest (as of 6/25/08):

Shares Short/Float	0.0%

THE BOTTOM LINE

Market neglect is the only explanation for the meager valuation accorded this growing and profitable Canada-based retailer, says Francois Parenteau. The current 7x earnings and 4x EV/EBITDA multiples (net of cash) are only 25% and 35%, respectively, what Limited Brands paid for comparable Canadian retailer La Senza eighteen months ago.

Sources: Company reports, Defiance Capital, other publicly available information

Other than neglect, do you see any other reasons for the stock's cheapness?

FP: Just that retail is one of the most hated segments of the market right now. In many cases that's justified, but we think it's being way overdone here.

How cheap do you consider the shares, now trading at C$12.35?

FP: I mentioned that Le Chateau trades, net of cash, at 7x EPS and 4x EV/EBITDA. In comparison, Limited bought La Senza at 28x earnings and 11x EV/EBITDA. Lululemon [LULU], a highly successful retailer of athletic apparel, has comparable sales and profitability to Le Chateau, but trades at more than 20x EBITDA on an enterprise value basis and 23x estimated earnings.

Le Chateau's current dividend yield, including a special 25-cent-per-share special dividend already announced, is over 7%. We also like that top management has been buying shares: the president just bought C$1 million worth of stock at C$13.50.

Explain the thesis behind small-cap Rochester Medical [ROCM].

FP: Rochester makes catheters, which are devices inserted into the urethra to allow urine to flow directly into a bag or the toilet as necessary. The company has been around for twenty years but has historically had a hard time generating growth. Hospitals in North America buy their supplies through group purchasing organizations [GPOs] and unless a supplier is under contract with those GPOs, hospitals can't buy from it. Rochester always claimed that it was being excluded from contracts with the GPOs because of undue pressure put on the GPOs by C.R. Bard, the dominant player in the market. Rochester sued on antitrust grounds and at the end of 2006 Bard agreed to settle, paying Rochester $50 million. Now Rochester has signed with the two largest GPOs in the country and has built out an active sales force to knock on hospital doors.

The market appears to have priced in that bit of good news. What else is working in the company's favor?

FP: You're right, the stock doesn't appear particularly cheap, but we think the company's business is about to fundamentally change. Starting in October, Medicare will stop compensating hospitals for the treatment of certain reasonably preventable conditions contracted on the premises, including urinary-tract infections. That's great news for Rochester because it has independent research showing that its specially treated Foley catheters (the type primarily used in hospitals) are the only catheters on the market that have been shown to reduce infections. The competing C.R. Bard product, what it calls its "silver-coated" catheter, doesn't even come close. We're not so naive as to think that the best product always wins in the market for healthcare products, but if hospitals are not overly concerned about the health of their patients, they will be highly sensitive to the well being of their wallets. Given that, Rochester is bound to gain market share and our industry checks indicate that's already starting to happen.

Another reimbursement trend that should very much work to Rochester's

INVESTMENT SNAPSHOT

Rochester Medical
(Nasdaq: ROCM)

Business: Develops, manufactures and markets urinary continence and drainage products for extended- and acute-care markets, primarily in the U.S. and Europe.

Share Information
(@7/30/08):

Price	**11.56**
52-Week Range	9.03 – 19.96
Dividend Yield	0.0%
Market Cap	$136.7 million

Financials (TTM):

Revenue	$34.2 million
Operating Profit Margin	3.7%
Net Profit Margin	4.8%

Valuation Metrics
(@7/30/08):

	ROCM	Nasdaq
Trailing P/E	86.9	27.4
Forward P/E Est.	96.3	20.6

Largest Institutional Owners
(@3/31/08):

Company	% Owned
Portolan Capital	4.4%
Dimensional Fund Adv	2.5%
Vanguard Group	1.6%
Bridgeway Capital	1.3%
Calpers	0.5%

Short Interest (as of 7/10/08):

Shares Short/Float	5.8%

THE BOTTOM LINE

Changing Medicare regulations concerning payment coverage of urinary-tract infections and reimbursement for intermittent catheters used in the home should fundamentally improve the company's business, says Francois Parenteau. Within the next three to five years he believes the company's earnings – and share price – could triple.

Sources: Company reports, other publicly available information

favor: If you're disabled and at home, you often need what are called intermittent catheters, which allow you to insert the catheters yourself to pass urine. Until recently, U.S. Medicare would only pay for four intermittent catheters per month. That really made no sense, given that you're likely to need to use one every time you go to the bathroom. The regulation has now changed so that 200 catheters per month will be reimbursed. That will significantly expand the market to the benefit of all players, including Rochester.

How do you see all this impacting Rochester's sales and profits?

FP: It's still rather early to guess and I've already mentioned my skepticism about long-term forecasts. That said, catheters today are a roughly $1 billion industry and Rochester currently has maybe 3% of it. It's not a big stretch to imagine that in the next few years that share could triple. Given that the company's gross margins are 55-60%, we'd expect to see at least a comparable increase in the bottom line. The big unknown is how quickly sales start to grow.

At around $11.55, what upside do you see for the shares?

FP: Rochester is currently operating at roughly breakeven, even with the incremental investments it's making to ramp up sales. Taking out $35 million in net cash, the company's current enterprise value is about $100 million, or 3x trailing sales, which we think is quite cheap for a company with such strong growth prospects.

We've looked at comparable valuations – on the open market and in takeover situations – and believe the company can in a reasonable amount of time be worth two-and-a-half to three times what it's worth today. Again, the timing is unclear, but we can be patient.

One final general question: Is the lousy market getting you down at all?

FP: This market comes with a lot of stress, but it's also very exciting. I'm seeing opportunities, particularly in high-quality companies trading at single-digit P/Es and 4-5x EV/EBITDA, that I haven't ever seen. A company like Whirlpool, which is a world leader in appliances, was recently trading at 7.5x earnings and 5x EV/EBITDA. Three years ago it went for at least double those multiples.

You obviously have to get your analysis right to be a great investor, but success also comes down to patience. We think of ourselves a bit like a lion lying in wait. There are plenty of gazelle running around, but we can't run after them all, so we wait for one to get within 125 feet before we go. Not 150 feet or 200 feet, but no more than 125. Sometimes the market offers up those great kills and we try our best to be ready and to take advantage when they come along. VII

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Tethered Ambition

Anyone bottom-fishing in the banking sector over the past year has almost certainly had dismal results. One potential strategy for taking the plunge today: Think small.

With the S&P Bank Index down 50% over the past year, it's not surprising that opinions – divergent as they may be – are flying fast and furious about whether the worst is over for financial stocks. As helpful as such a public discussion might be for investors, the problem with such arguments is that all financial firms are placed in the same boat, as if Citigroup's prospects mirror Bancorp Rhode Island's.

Jason Stock and Will Waller of hedge-fund firm M3 Funds provide a more nuanced perspective on financials. Their investment universe consists primarily of Bancorp Rhode Island-type companies, the 1,200 or so publicly traded U.S. banks and thrifts with market capitalizations of less than $500 million. They are by no means unabashed banking bulls – their portfolio is currently more short than long – but the challenges facing the sector are exactly what can create specific opportunities. "The banking sector has such a poor overall outlook that it creates opportunity for banks that don't have all the issues we're concerned about," says Stock.

After scouring the uniform data banks and thrifts must file with regulators, Stock and Waller study regional demographic and economic trends for the banks in focus – "A bank is a levered play on the economy in which it operates," says Waller – and then visit each market to gauge the health of the local economy. Such research has confirmed bad prospects for such overbuilt markets as Phoenix, Las Vegas and southwest Florida, while also identifying pockets of strength in border communities near Canada and regions with high education- or government-related employment.

The banks heading M3's buy list today (*see table, below*) generally chose to sit on the sidelines and hoard or raise capital in recent years while competitors grew through geographic expansion, launching risky new products or lowering credit standards. These once-considered "stodgy" banks typically sport high capital ratios, low loan-to-deposit ratios, high levels of low-cost deposits and low levels of non-performing assets. "As competitors struggle to preserve or raise capital," says Stock, "these banks should take profitable market share and be able to buy back shares at discounts to tangible book value."

First of Long Island [FLIC] is a typical example. Its overall cost of deposits is only 1.59%. Its loan-to-deposit ratio is just 59% and it has excess capital to use for continued share buybacks and to make properly priced loans as competitors falter. While the stock trades at 138% of tangible book value, Stock and Waller believe book value is understated due to the fact that the company owns much of the real estate for its branches, carried on its books at a significant discount to its true value.

Similarly conservatively managed is **Meridian Interstate Bancorp** [EBSB], the holding company for East Boston Savings Bank, a $1 billion (assets) thrift in suburban Boston. The added twist for Meridian, says Stock, is that the company still has a mutual holding company structure, which essentially means that a majority of its existing shares are still owned by the holding company itself, not the public. With a second-step conversion to become entirely publicly held, an aggressive share buyback program and a generally improving competitive position, the bank's shares should trade at or above tangible book value over the next three to five years, he says, which would result in a share price more than double today's level.

For those less faint of heart, Waller and Stock consider the shares of Los Angeles-based **First Regional Bancorp** [FRGB] to be drastically oversold. At a recent $4.33, the shares trade at 32% of the firm's $13.50 tangible book value per share, as the market appears to fear that real estate loan losses will require a dilutive capital raise. Waller and Stock disagree and think that while First Regional's book value may decline up to $3 more per share before the cycle ends, its low-cost deposit base should help support a share price at or above tangible book as the cycle stabilizes. Even with the book-value hit, that would result in a share price of no less than $10. VII

Small Banks: Weathering the Storm

Community banks and thrifts with low loan-to-deposit ratios, high levels of low-cost deposits and strong capital positions will better weather the credit crisis and will be competitively advantaged as the cycle turns, say M3 Funds' Jason Stock and Will Waller. Below are five of their current favorites.

Company	Ticker	Price@ 7/29/08	Tangible Equity/Assets	Loans/Deposits	Non-Performing Assets/Assets	Price/Tangible Book Value
First Regional Bancorp	FRGB	4.33	6.44%	117%	1.33%	32%
Meridian Interstate Bancorp	EBSB	9.70	19.31%	72%	0.39%	54%
BCSB Bancorp	BCSB	10.14	8.00%	79%	0.28%	66%
Bancorp Rhode Island	BARI	28.99	6.84%	102%	0.47%	131%
First of Long Island	FLIC	19.21	8.90%	59%	0.03%	138%

Notes: (1) Ratios as of 6/30/08 for FRGB, BCSB and BARI, as of 3/31/08 for EBSB and FLIC; 2) EBSB P/TB ratio is an estimate assuming full conversion from mutual holding company structure.
Sources: M3 Funds, LLC; publicly available information

Chasing the Big Score

It's human nature to metaphorically swing for the fences when making investment decisions. But like many aspects of human nature, this trait is one that smart investors should try to keep firmly in check.

In *Roughing It*, his description of six years living and traveling in the 19th-century American West, Mark Twain described feeling "as if an electric battery had been applied to me" when he and a partner thought they'd struck a huge lode of silver in Nevada in 1862. Though the claim was denied within days, Twain referred often to such euphoria in his later writings and appears to have sought to reclaim it in chasing unsuccessful get-rich-quick schemes over the rest of his life.

Neuroscientists have found that the "high" Twain felt at the prospect of sudden wealth has a biological origin. As Jason Zweig describes in his new book, *Your Money and Your Brain*, the expectation of making money causes dopamine to be released and to "fire up" the emotional circuitry located in the lower front region of the brain. This response is similar to what happens when one anticipates basic pleasures like food, drink and sex.

The big downside for investors of this natural response is that the fired-up parts of the brain that anticipate a reward – namely, a rapidly increasing stock price – are much more sensitive to the size of the potential gain than the probability of it actually occurring. "The magnitude of a long-shot reward is going to drive your behavior far more than the probabilities, which are likely miniscule," says Stanford neuroeconomist Brian Knutson.

This phenomenon goes a long way toward explaining the collective irrationality that can grip investors during inflating market bubbles. Alan Greenspan described it well in testimony before Congress in 1999:

"What lottery managers have known for centuries is that you could get somebody to pay, for a one-in-a-million shot, more than the value of that chance. In other words, people pay more for a claim on a very big payoff. That's where the profits from lotteries have always come from. That means that when you are dealing with certain stocks – the possibilities of which are it's either going to be valued at zero or some huge number – you can get a premium in stock prices, which is exactly the price-evaluation process that goes on in a lottery. The more volatile the potential outlook, [the higher the potential] lottery premium in the stock."

This lottery premium doesn't just reveal itself during market bubbles. After analyzing 1.3 million stock returns over a 36-year sample period, researchers Thomas Downs and Quan Wen in a 2001 study published in the *Journal of Portfolio Management* concluded: "The lottery premium, (which) we define as the sacrifice in average return that investors pay for a chance to earn a huge, although remote, return, is persistent and significant. It is greater in up markets than in down markets, and it is higher in the recent past than in the remote past."

While smart investors would be well-served to avoid the pervasive temptation to pay lottery premiums, that's not to say that aspiring to hit the occasional home-run is not a worthwhile goal. Ralph Wanger, the retired highly-successful manager of what is now the Columbia Acorn Fund, described it this way in a 2007 *Money* interview: "Investing, especially in small companies, is a home-run-hitter's game. The point is, 99% of what you do in life I classify as laundry – it's stuff that has to be done, but you don't do it better than anybody else, and it's not worth much. Once in a while, though, you do something that changes your life dramatically. You decide to get married, you have a baby – or, if you're an investor, you buy a stock that goes up twenty-fold." If that sound reckless and flip, Wanger's style was anything but, based on rigorous research to identify long-term trends and disciplined analysis to identify attractively priced companies positioned to benefit from those trends.

"If I knew how to get rich quick, would I be sitting on a mountain-top all day?"

How can investors counteract the negative ramifications of being wired to chase the big score? Never make snap investment decisions, instead putting all potential investment ideas through a similar process checklist. Be wary of "story" stocks and of situations that are reminiscent of previous big investment successes, both of which can lead to costly analytical shortcuts. Focus on being what James Montier of Societe Generale calls an "empirical skeptic" – rather than accepting that earnings can grow 30% annually for ten years or a given level of return on capital can persist, look at the distribution of outcomes from a large historical sample to see how reasonable such estimates are. Finally, as Steven Romick describes in his interview in this issue, spend as much time defining what the downside can be as the upside, and look to make highly asymmetrical bets.

"The game of professional investment is intolerably boring and over-exacting to anyone who is entirely exempt from the gambling instinct; whilst he who has it must pay to this propensity the appropriate toll," wrote John Maynard Keynes. Keeping that toll as low as possible is a prerequisite to sound investing. VII

Value Investing's Dark Days?

Few investment strategies have been bathed in glory over the past year, but value investors have had it particularly rough. Using data compiled by Nomura Securities, *Barron's* ran a chart earlier this month showing that the Russell 1000's cheapest and lowest-momentum stocks had a cumulative 12-month decline of nearly 70% through mid-June. One-year returns for flagship funds managed by value-investing luminaries Bill Miller, Rich Pzena, Wally Weitz and Bill Nygren are down, respectively, 34%, 31%, 27%, and 23% – all more than twice the 10% decline in the Russell 3000 index.

While value investors intuitively know that bouts of underperformance can come along with a contrarian style of investing, it's always comforting when the facts support such intuition. In a study of nearly 600 U.S. fund managers and 150 non-U.S. managers, the research arm of giant value-oriented money manager Brandes Investment Partners found that those funds with the best 10-year performance frequently stubbed their toes, return-wise. In their worst year, the best U.S. managers lagged the market by an average of 20 percentage points, while the leading non-U.S. managers underperformed by 13 percentage points. Against the competition, even over three-year periods 20-30% of the best managers showed up in the bottom performance decile at some point in the 10 years studied.

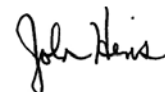
If history is any guide, there is plenty of light at the end of the current value-investing tunnel. Equity strategist James Montier recently looked at those two-year periods in the U.S. since 1960 in which value stocks (defined as those sporting the highest ratios of cash flow to share price) had significantly underperformed against "glamour" stocks (those with the lowest cash flow relative to share price). Interestingly, the poor relative performance of value stocks in 2007 and so far in 2008 is running at roughly twice the level experienced in the last two-year value drought, the Internet bubble years of 1998 and 1999. More importantly, value has historically rebounded strongly after what Montier calls these glamour "surges." In the intervening period from one glamour surge to the next – on average a period of seven years – value outperformed glamour by a remarkable 17 percentage points per year on average. Hear, hear!

Life's Magic

There's no obvious investment angle, but author J.K. Rowling's commencement address at Harvard last month speaks eloquently on life lessons drawn from failure, imagination, compassion and friendship. A brief excerpt on failure:

> "Why do I talk about the benefits of failure? Simply because failure meant a stripping away of the inessential. I stopped pretending to myself that I was anything other than what I was, and began to direct all my energy into finishing the only work that mattered to me. Had I really succeeded at anything else, I might never have found the determination to succeed in the one arena I believed I truly belonged. I was set free, because my greatest fear had already been realized, and I was still alive, and I still had a daughter whom I adored, and I had an old typewriter and a big idea. Rock bottom became the solid foundation on which I rebuilt my life."

To read the full speech, click here. VII



John Heins
Co-Editor-in-Chief

Whitney Tilson
Co-Editor-in-Chief

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