

# ValueInvestor

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The Leading Authority on Value Investing

## INSIGHT

## Defining “Normal”

*Identifying troubled companies is easy. The hard part is making the call whether problems are chronic or temporary. That’s where Rich Pzena shines.*

In the darkest days for value investors, early 2000, Rich Pzena nearly sold the money-management firm he’d started four years earlier. As tech stocks went to the moon, his relative performance was abysmal and investors were walking. “I can’t tell you how many times I heard ‘You just don’t get it,’” he says.

Pzena held firm, with stellar results. Pzena Investment Management now manages \$11 billion in institutional, individual and mutual fund assets. Through February 18, his mutual fund, the John Hancock Classic Value Fund, is up 20.4% annually over the past five years, making it the #1 domestic large-cap fund tracked by Morningstar. [See page 2](#)



**Richard Pzena**

Pzena Investment Management, LLC

**Investment Focus:** Seeks companies earning below what their history and industry would indicate as “normal.” Buys if strategy to address problems is sound and downside limited.

## Shooting the Gaps

*Markets are slow to recognize when the fundamental character of a company or industry changes. That spells investment opportunity for Zeke Ashton.*



**Zeke Ashton**

Centaur Capital Partners, L.P.

**Investment Focus:** Looks for companies undergoing fundamental change, without the full recognition of the market. Holds well beyond “turnaround” phase if the quality of the business warrants.

With fewer constraints due to investment charter, asset size or quarterly rankings, hedge funds attract many of the best and brightest. To the traditional press, these investors operate under the radar, often lacking the public track record required to warrant attention.

To *Value Investor Insight*, hedge-fund managers are an excellent source of fresh and provocative investing wisdom. Take Zeke Ashton, founder of Centaur Capital Partners, L.P. Perhaps better known for his excellent writings for The Motley Fool website, where we first got to know him, Zeke has been managing outside money since 1999. He has quietly trounced market returns by meticulously analyzing companies and industries that are undergoing fundamental change. [See page 10](#)

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# Investor Insight: Richard Pzena

In an in-depth interview, Rich Pzena describes his investment process, how he distinguishes between lethal and non-lethal company problems, why he sees value others are missing in Freddie Mac, Whirlpool and Hewlett-Packard, and much more.

Start us off by describing your investing strategy and process.

**RP:** The philosophy is old-fashioned value: Try to find good businesses when they go on sale. That's it.

How do we define what's value? We're looking to buy basically when we can satisfy five criteria: First, the price is low relative to the company's "normal" earnings. Normal is what should this business earn given a variety of factors -- its history, the industry structure in which it competes, competitor margins, its individual company strengths and weaknesses, its management and its business plan. While the screening process we go through is scientific, obviously [our estimate of normal earnings] is not a scientific number.

Second, we look for current earnings that are below normal. Typically, in the companies we're buying the margins have fallen below their historic norms. That's important to us -- we avoid companies that are doing better than usual, which makes us really skeptical.

Does it matter why performance is below historic norms?

**RP:** Of course, but the primary question is whether you can convince yourself that the situation is temporary and can reverse itself. Take Boeing, which was our largest holding last year. The prior time we bought Boeing was because the company had screwed up. The market was healthy, but they didn't execute. By the way, in general, we appreciate it when management screws up, because that gives us an opportunity to buy. More recently though, it wasn't a company screw-up [that lead to Boeing's performance short-fall] -- it's that people just stopped buying airplanes. Whatever the reason, I don't care. I'll invest if I believe the situation is not permanent.

So we seek out businesses that are at

a low valuation and under-earning. That way you have two ways to win: One is improved valuation and the other is an earnings rebound -- and growth rates can be enormous as you're coming off a depressed level to a more normal level.

The third thing we're looking for is whether management's plan to restore their business back to historic norms is a sensible plan, and whether they can execute it. That is pure judgment. All you're doing is gathering information on industry conditions and then you're listening to what they say. Does it make sense? What does the track record say?

**Including an analysis of whether the competitive environment has simply changed?**

**RP:** Correct. If that's the case and management's plan doesn't make sense, then we don't buy.

Of course, we don't know if the plan is going to work, so we have to consider the case where the plan fails. Our fourth and fifth criteria point to that. The fourth is to ask whether the business is a good business. To us, the definition of a good business is if you can specifically identify reasons why it should be able to earn a return in excess of its [cost of] capital. It could be anything: a competitive cost position, a franchise brand, an installed base of business, unique technology -- some reason to believe that even if the current management fails to restore earnings, somebody else would want to try. Say, an acquirer of the assets. Or the board replacing management with other management. Or even the same management trying another plan, because it's worth trying and you can specifically understand why it's worth trying.

The fifth point is that we need downside protection. We don't want to lose a lot of money if we're wrong. That protection generally comes in one of two



**Richard Pzena**

## From Oil Patch to Wall Street

Only 21 and armed with a Wharton MBA in 1980, Rich Pzena did as many of the best and brightest did then, seeking his fortune in the booming energy industry. "Energy was about 32% of the S&P 500, and I still have the 1980 Amoco oil price forecast projecting \$200 a barrel by the year 2000," he recalls. He left Amoco in 1986 to become an oil-industry analyst for Sanford C. Bernstein, and was hooked on the world of investing. He started his own firm in 1995. The perspective gained from riding out the energy boom and bust serves him well to this day as an investor. "One of those great lessons in life," he says.

forms: in the company's physical assets, or in the established revenue franchise of the business. For example, if you were going to look at Whirlpool, the physical assets of the company are probably not worth a lot. What is worth a lot is the Whirlpool brand. So we'd say if this management team screwed up, somebody else would want to buy the valuable piece of property of the Whirlpool brand. So even if we were wrong on our earnings expectations, we probably wouldn't get killed.

Our metrics typically are that we can envision losses of no more than 25% in any of the companies we own. And we expect upside significantly above that, giving us a more favorable risk/reward outcome.

**When are the stocks cheap enough for you to buy?**

**RP:** Ideally, we want to buy stocks at 5x what we've determined to be their normal earnings. In a good environment, we can find plenty of businesses to buy at 5x to 8x normal earnings power. As you know, today's market is different. We're finding that you have to pay about 8.5x for the hairiest stocks you can imagine, and for the boring, relatively safe ones, you're paying around 9x. We're usually deciding it makes more sense to pay the 9x. Overall, I'd say our portfolio today is probably at about a 25% to 40% discount to our estimates of current value.

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## ON SELLING:

**If you let your emotions dictate when to sell, you risk falling in love with companies that have been doing well and you ride them too long.**

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**How do you screen for potential buys?**

**RP:** We have relatively sophisticated computer model that ranks our value universe of the 1,000 largest domestic companies. It ranks all 1,000 companies from cheapest to most expensive, on the basis of current price to the "normalized" earnings we extrapolate from history five years into the future.

From this computer screen, we do an initial review on the cheapest quintile of these stocks, looking more closely at the company financials and the industry dynamics. After this initial research, we reject about 75% of these companies. The other 25% we do detailed analysis on, including visiting the company and meeting management. Of those, we normally reject another 50% after this detailed analysis. So, in the end, we buy roughly 10% to 15% of the cheapest 200 stocks in our universe. Overall, we generally own between 30 and 40 stocks, with half of our portfolio assets concentrated in the top ten holdings.

**Tell us about the last step in your research process.**

**RP:** We invite in a Wall Street analyst who is a bear, and they come in and make a pitch why we shouldn't buy this stock. We want to see if the reason they don't like it is if they see a real structural flaw in the business that we didn't pick up on, or if it's just that they don't know what's happening. Most of the time they're negative just because of "no earnings visibility," which is Wall Street language for "I don't really have a clue what's going to happen next."

**Do you bring the bears back when you're down 25%?**

**RP:** Sure. We're going to make another decision when we're down 25%. Did we just completely blow it? Are we right, but the market is just insane? Or is it just somewhere in between?

I'll give you an example. A couple years ago we bought a 2% portfolio position in Computer Associates, at around \$15. Within six weeks, the stock was at \$8. We had an analyst in, saying the company was going to file for bankruptcy. They had debt coming due, and the analyst figured nobody was going to refinance it. It was a weak credit environment then. I said, "How do you figure? Can I just show you some arithmetic? This company generates \$1.3 billion in free cash flow. And they aren't going to be able to refinance?" We actually quintupled up in CA, taking what was down to a 1% position up to 5%. They did refinance, and it was over-subscribed 5-to-1. The terms weren't that attractive, in my opinion, but the stock promptly doubled on the news of the refinancing. CA turned out to be our biggest win in 2003.

I believe the biggest way you add value as a value investor is how you behave on those down-25% situations. Sometimes you should buy more, sometimes you should get out, and sometimes you should stay put.

**What do you typically do?**

**RP:** I've never actually looked, but we probably hold tight 40% of the time, and split 50/50 between buying more and get-

ting out. Making the right decisions at these moments adds more value, in my opinion, than the initial [buy] decision.

**Tell us, in general, how you decide to sell?**

**RP:** When a stock reaches the midpoint of the ranking we talked about, from cheapest to most expensive, we sell automatically. The good outcome is you buy, the stock price goes up and gets more and more expensive relative to its normal earnings, so it falls in our ranking. As a stock price goes up and becomes less cheap, we'll want to hold less and trim it back as it's going up, and we're out when it reaches the midpoint.

**How did you arrive at that discipline?**

**RP:** You know what? I arrived at that because otherwise I would have no idea how to sell. It struck me that if you let your emotions dictate when to sell, you risk falling in love with companies that have been doing well and you ride them too long, and then something goes wrong. I guess I have the classic value mentality. It's instinctual for me to want to sell as things go up and I start getting nervous. For me, having something systematic that says "this is cheap" or "this is fairly valued" is really, really important.

**Let's look at some of your favorite stocks today. Freddie Mac is one of the more controversial stocks out there, given all the accounting and regulatory issues.**

**RP:** I think the people who are anti-Freddie are hung up on the accounting, as if the accounting was relevant, which it's not. The accounting for these companies is going to be screwy, and whatever they come up with for their future accounting is going to be equally screwy, and shouldn't be looked at.

**Huh? Are you saying the numbers don't matter?!**

**RP:** The real issue is how much money does Freddie make, which you can really see by looking at what the equity in their marked-to-market portfolio increases by. It goes up 20% to 25% a year, year after year after year. You can see exactly how much money they are making on their

capital employed, and it's a lot. Why? Because they have a government-granted franchise that allows them to issue cheap callable debt to institutions like Japanese central banks. Why do Japanese central banks buy Freddie Mac debt? There's no explicit government guarantee, but somehow they've convinced themselves that it's okay.

So what can go wrong? I'm willing to live with the risk that Freddie just screws up on the investment side. Beyond that, the government could change Freddie's capital requirements to reduce its risk – forcing Freddie to exit from the business of owning mortgages. We'll assume they would liquidate in an orderly fashion, and you can calculate liquidation value – what is the present value of the cash flow stream from winding down this business over the life of existing mortgages, say 10 years. We put about a \$40 per share liquidation value on that.

Then add to that the value of their credit business, which is probably not going anywhere. We put the value of that at \$20 per share. So add these two pieces together and you get a liquidation value of about \$60 per share. For a stock trading around \$62, that's not much downside in the worst case. But I put a 75% or higher probability that nothing happens – that we operate the mortgage market in the way it's always been operated. So in the good case you're buying this business growing 20% to 25% a year, and that can produce normal earnings as we look at it of about \$9 a share. The upside is that it trades above \$100 – I still believe that – and the downside is that it trades somewhere in the \$50s.

**What about the potential of general stress in the housing markets – increasing defaults, lower volume?**

RP: Typically, weakness in the housing market will happen because interest rates are higher. With higher interest rates, banks, which are Freddie's biggest competitors in buying mortgages, will stop buying them. Their cost of borrowing from depositors will go up too much to bid as aggressively on mortgages. With less competition, Freddie should be able

to widen the spreads – which are as low as they've ever been right now – on business they put on. You're right, though, that they may not have a lot of growth in the portfolio.

Credit risk is mitigated by a few things. One is the huge geographic diversity of the portfolio. The second is that their business is limited to the least-volatile housing sector, the low end. They don't buy mortgages above the \$300,000 limit. And third, they require mortgage insurance for anybody that has less than 20% of equity in their house. Yes, it

could get worse than it is now – today is about as good as it ever gets. But we're measuring the peak to trough of credit losses in basis points, not in percentage points.

**So is the market lumping Freddie with Fannie Mae, even though they don't look to be in exactly the same situation?**

RP: They're about the same valuation. We own both, but I think Freddie is a better risk/reward today just because they're two years further into going through their problems than Fannie is – the actual

## INVESTMENT SNAPSHOT

### Freddie Mac (NYSE: FRE)

**Business:** Purchases residential mortgages and mortgage-related securities, financed primarily by issuing mortgage pass-through securities and debt instruments in the capital markets.

### Share Information

(@2/18/05):

<b>Price</b>	<b>61.73</b>
52-Week Range	56.45 – 74.20
Dividend Yield	1.9%
Market Cap	\$42.51 billion

### Short Interest:

(@1/10/05)

Shares Short/Float	1.4%
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### Financials (TTM):

Revenue	\$47.84 billion
Operating Profit Margin	34.2%
Net Profit Margin	21.1%

### Valuation Metrics:

(Current Price vs. TTM)

	<b>FRE</b>	<b>S&amp;P 500</b>
P/E	9.2	23.1
P/CF	9.2	13.9

### Largest Institutional Owners:

<b>Company</b>	<b>% Owned</b> (@ 9/30/04)
Capital Research and Mgmt	7.9%
Barclays Bank Plc	5.2%
Morgan Stanley	4.8%
Citigroup	3.8%
Goldman Sachs	3.8%

### FRE PRICE HISTORY



### THE BOTTOM LINE

In a worst-case scenario – accounting restatements, regulatory changes, sharp residential real estate downturn – Rich Pzena calculates the asset value and ongoing business of Freddie Mac is worth \$60 per share. The upside if what he considers the higher-probability status quo persists: Continued outsized profits and a stock price at more than 50% above today's \$62 per share.

Sources: Company reports, other publicly available information



implementation of changing the senior management team, changing accounting practices, bringing in a whole new accounting team. They aren't going to be totally preoccupied with getting their financials right for the next two years. Also Fannie has historically been more aggressive in taking interest rate risk than Freddie has.

**Speaking more generally, you seem to find opportunities often when there are accounting issues. How do you distinguish between the lethal and non-lethal?**

**RP:** I guess I'd say the most important differentiator in these cases is common sense. Sit back and ask what appears to be happening vs. what should be happening. Take Enron. The whole business strategy, that it was going to make tons and tons of money from buying electricity from company A and selling it to company B without taking any risks, never struck me as a strategy that would work. You either make a lot of money because you take a lot of risk, or you make a little money taking no risk. But making a lot of money by taking no risk didn't strike me as logical.

At Computer Associates, the accounting was clearly unusual – let me use that word – because of the way generally-accepted accounting principles are applied to multi-year software license agreements. But here, it was clear the software buyer didn't care about the accounting. They just care how much they have to pay to license the software. Here the cash flow was king, and you could see that cash flow clearly, running at \$1.3 billion a year.

I'll tell you one I blew also: We made a small investment in WorldCom. We bought around \$2 and sold for basically nothing. We missed what was clearly common sense that we should have seen, which was that their volumes were falling sharply and they didn't have any margin erosion. In a business that is highly fixed-cost, like telecom, that just shouldn't happen – you should have margin erosion. We listened to them saying they were cutting SG&A dramatically and we just missed the whole idea.

**Have you looked at Nortel, which has its own accounting problems?**

**RP:** Not in depth. In that case, the structural issue is that even if the accounting is right, what is the sustainable earnings power? It sounds like it should be great – between Nortel and Lucent you've had major technological innovations in electronics – but they don't make any money, these companies. Very amazing. Look at their operating-margin history, which is not great. I'd have to believe they could do better than their history to be considered cheap.

**Whirlpool is interesting. I can see the investment thesis: trades at a low multiple of earnings, great brand, temporary factors depressing earnings. But what are the odds that five years from now this business looks like the furniture or textile industries, given what overseas competitors did there?**

**RP:** Zero. Look at the textile business: It's labor intensive, with low transportation costs, exactly what is conducive to being done in China. Today, there's no place in the world where you can build a

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## ON WHIRLPOOL'S U.S.

### MARKET POSITION:

**Today, there's no place in the world where you can build a washing machine and have it compete with one that is assembled here.**

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washing machine and ship it to the United States and have it compete with one that is assembled here. Don't forget, Whirlpool doesn't make anything here in the U.S. Components, motors, everything are globally sourced – they're made in China already. Whirlpool is the leader in global sourcing, light years ahead of Maytag, for sure, and light years ahead of the Koreans, like LG, which we think is operating at a loss. There are no Chinese players.

To me, the biggest risk for Whirlpool is that some Korean company decides that it's okay to lose money for a long period of time, and then builds their plant in the U.S. They'll have no choice but to eventually build in the U.S. or Mexico. Or Samsung or LG may choose to buy the Maytag brand – Maytag already has a joint venture with Samsung. Maytag still has a great brand, and they get premium prices relative to Whirlpool. But Maytag is in trouble. Why? Because they didn't globally source. They make the stuff in Newton, Iowa with a big unionized workforce.

**So the market is lumping the two, Maytag and Whirlpool, together?**

**RP:** Yes. Whirlpool has spent the whole last decade restructuring its global manufacturing footprint. It has the dominant share of the U.S. market, at around 40%, and also has a big share in Latin America. Its margin expansion over the past decade has been due, first, to its advantaged global sourcing, and second, to its superior product innovation in recent years. The innovation part scares me a bit – it's hard to assess whether that's just luck.

**But over all that time the stock hasn't moved. It was at today's price, around \$62 a share, in 1994. Is it a value trap?**

**RP:** The stock is flat, but the earnings are so much higher. They've paid down about \$1 billion of debt from the peak. The P/E was as high as 30, but now it's under 10.

**So the thesis is: solid company, market leader, strong brand, trading at an attractive multiple...**

**RP:** With an advantaged cost position vs. their competitors. The big short-term catalyst will be price increases [that Whirlpool introduced last month]. One of our analysts passed around at our morning meeting the copy of the January 2nd Sears' circular and the January 9th Sears' circular. Every single appliance was \$50 more. It's funny, they took the exact same SKU, changed it from black-and-white to color, changed the angle to make it look more upscale – but it was the same unit, just \$50 more.

## INVESTMENT SNAPSHOT

**Whirlpool Corp.**

(NYSE: WHR)

**Business:** Worldwide manufacturer of home appliances, including washing machines, refrigerators and dishwashers. Products marketed under several brand names, including Whirlpool and KitchenAid.

**Share Information**

(@2/18/05):

<b>Price</b>	<b>62.89</b>
52-Week Range	54.53 – 73.89
Dividend Yield	2.7%
Market Cap	\$4.18 billion

**Short Interest:**

(@1/10/05)

Shares Short/Float	6.3%
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**Financials (TTM):**

Revenue	\$13.22 billion
Operating Profit Margin	5.7%
Net Profit Margin	3.1%

**Valuation Metrics:**

(Current Price vs. TTM)

	<b>WHR</b>	<b>S&amp;P 500</b>
P/E	10.7	23.1
P/CF	4.8	13.9

**Largest Institutional Owners:**

<b>Company</b>	<b>% Owned</b> (@ 9/30/04)
Putnam Inv Mgmt	7.8%
Axa	6.5%
Pzena Inv Mgmt	6.2%
American Century Inv Mgmt	5.0%
LSV Asset Mgmt	3.7%

**WHR PRICE HISTORY****THE BOTTOM LINE**

Whirlpool's advantaged cost structure positions it well to defend market share from aggressive competitors and take share from weak ones. Rich Pzena believes the company should net \$9 per share within 2 to 3 years. With little change in multiple, he sees WHR shares hitting \$100, more than 50% over today's price of \$63.

Sources: Company reports, other publicly available information

**American consumers are not used to such price increases in this low-inflation environment. Do you think they will stick?**

**RP:** We think so, even though retailers have pushed back. Home Depot said they wouldn't accept price increases, but Whirlpool has already pulled out of there. They thought Home Depot was running the business wrong by putting washing machines on the floor without sales support. The whole way you make money is by trading people up. Whirlpool stands firm on stuff like that. They say, "If you want to buy from us, this is the price."

**Where do you think the stock can go?**

**RP:** We believe earnings are going to expand from around \$6 a share to something like \$9 in the next two to three years, generating lots of free cash flow, and assuming modest growth. With a 10-12x multiple, the upside over today's price is quite high.

**Big news recently at another one of your current favorites, Hewlett-Packard. Does Carly Fiorina's departure change your investment thesis?**

**RP:** No. The investment thesis is built

around the businesses and the valuation. Her departure doesn't appear to signal a strategic shift in the company.

I always found Carly Fiorina to be very professional, very knowledgeable, very focused. To me, she came across very favorably. Of course I wasn't one of the shareholders who's very angry because she wasted my money buying Compaq.

From a business strategy perspective, whoever takes over will bring a fresh pair of eyes to franchises that should be able to produce more earnings. It's hard for me to assess whether her strategy was flawed or if it was just an incredibly hard task that takes a long time. But I'm always a proponent of a new set of eyes looking at things, so I don't think bringing in a new CEO can be bad.

You know, this is just the normal course of events for the kinds of things we own. We try to buy franchises where there's a plan to restore earnings. If the earnings don't get restored, somebody tries another plan, whether an acquirer, the same management team, or a new management team.

**Give us a general overview of your thinking on Hewlett-Packard.**

**RP:** It's a very simple story: They have a spectacular business in their printer business, a world-class franchise, like a razor/razor blade-type franchise.

**Indeed it's a great business, but with Dell and others encroaching, can H-P maintain its printer market share and margin?**

**RP:** Yes. Dell doesn't have an edge here. They source from somebody else [Lexmark], and that somebody else is making all the money, because why would they let Dell make all the money? There's no sense to cut Dell in, and they're not.

**But aren't H-P's margins so big here that Dell could make their 6-7% after-tax margins and Lexmark could make good margins and they'd still underprice Hewlett-Packard?**

**RP:** I don't see how, unless Lexmark has a business strategy of lowering the margin

structure of the industry, which I don't think makes sense. It would kill Lexmark's valuation, and it has a premium valuation. H-P has lost not a drop of share to Dell, and you can even be skeptical about the share Dell has. A lot of the printers Dell is just giving away. We're a big Dell customer – maybe I shouldn't say that being a big H-P shareholder – and a couple of printers just showed up from them, unordered. Our computer guys just gave them away and let people take them home.

The problem with Dell is people don't want to reorder the cartridge by mail. They just don't. They don't plan. You go to CompUSA and you can't get a Dell cartridge. It's interesting, the margin structure of the cartridge business is that the retailer doesn't make any money. The retailer views this as the loss leader. You talk to the retailer, and ask them where companies comparison shop when they make their decisions, and they say things like ink cartridges and paper. What do they not check the prices on? Pencils. Where do retailers make all of our money? On things like pencils. So the advantage Dell brings – to take the distribution margin down like they do in computers – is non-existent in the cartridge business.

**What's the upside for H-P in this already great business?**

RP: Two things are happening right now in the market. On the consumer side, you have digital photography, which causes people to use a lot more ink. Per-capita ink consumption is rising. Second, there is little penetration of color printing in the corporate world, something like 1%. H-P makes a lot more money on color – there's more consumption of ink, and the ink margins are better. I don't believe corporate penetration will get to what it is in the home, where nearly everyone uses color printers, but to go from 1% to 20% color in the corporate market would be huge. Hewlett-Packard thinks it's going to happen. I don't really know. But what I do know is that the current growth rates of corporate color penetration are high.

**How do you value H-P shares?**

RP: We think the printer business alone gets you to about \$16 in valuation. On top of that they have surplus cash after debt of \$5 to \$6 billion, or another \$2 or so a share, which they're going to use to start a big stock repurchase program.

**What about the rest of the company, the other \$55+ billion in annual sales?**

RP: The computer business historically made double-digit operating margins.

Compaq's margins through the '80s and '90s were double digits. I don't expect it will get there again, but they're only roughly breaking even now. We forecast they can at least get a long-term 2% annual operating margin on this business.

In the high-end server business, Dell is expanding there, but in that business there's a limit to what they can do. When you get to the sophisticated level, you need on-site support, a different infrastructure from what Dell has. So there it's

**INVESTMENT SNAPSHOT**

**Hewlett-Packard Corp.**  
(NYSE: HPQ)

**Business:** Global provider of information technology systems and solutions. Primary lines of business include personal computers, printers, high-end servers, IT services and software.

**Share Information**  
(@2/18/05):

<b>Price</b>	<b>21.00</b>
52-Week Range	16.08 – 23.86
Dividend Yield	1.5%
Market Cap	\$61.11 billion

**Short Interest:**  
(@1/10/05)

Shares Short/Float	0.9%
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**Financials (TTM):**

Revenue	\$81.84 billion
Operating Profit Margin	5.0%
Net Profit Margin	4.3%

**Valuation Metrics:**  
(Current Price vs. TTM)

	<b>HPQ</b>	<b>S&amp;P 500</b>
P/E	17.9	23.1
P/CF	10.4	13.9

**Largest Institutional Owners:**

<b>Company</b>	<b>% Owned</b> (@ 9/30/04)
Axa	4.7%
Capital Research and Mgmt	4.6%
Barclays Bank	4.2%
Dodge & Cox	3.8%
State Street Corp	3.2%

**HPQ PRICE HISTORY**



**THE BOTTOM LINE**

H-P's printer business, a world-class franchise that H-P has shown capable of defending and growing, is worth \$16 per share on its own, estimates Rich Pzena. With moderate improvement in the company's computer, server and services businesses, coupled with share buybacks, Pzena thinks H-P should be earning \$2.50 per share in the next few years. At 15x that earnings level, H-P will be worth \$37.50 a share, 80% above today's market price.

Sources: Company reports, other publicly available information

basically IBM and H-P. In the industry-standard server market we're assuming H-P can only earn a couple of percent in margin because they have to compete with Dell. But in the high-end server market and consulting and services businesses they should be able to make double-digit margins.

**Overall, your projections for earnings out a few years?**

RP: We think earnings go to \$2.50 a share, from about \$1.50 people are projecting for '05. I don't think there will be multiple compression if the earnings go up. [Note: H-P is currently trading at about 18x trailing earnings.]

**What about stock options? How have you accounted for those?**

RP: We assign a margin penalty – I think we have a full point of margin penalty in our numbers for H-P – based on an estimate of what you'd have to pay extra in cash comp if you had to pay cash rather than options.

**Does it bother you that H-P hasn't come within a country mile of the projections they made when they bought Compaq?**

RP: No. I didn't believe their projections then and I still don't believe their projections. They are still way more optimistic than I am.

But that's a problem I have with Wall Street. Wall Street's view is that if you don't make your projections, you're a bad person. That's because they don't want to do the hard work of making their own projections to see if the company's projections make sense. My feeling is that you have to have optimistic projections to be in that kind of a CEO role. You have to be out there. Whether you share them with Wall Street is another question ... maybe that's the mistake.

**Would you prefer that management not give projections?**

RP: I don't care one way or the other who does or doesn't give guidance, because in the end I don't know why their projections are worth any more than projections I make.

**Value investing – in which you often own the stock of reviled businesses – can be tough on the psyche, no?**

RP: When I talk about the companies I invest in, you'll be able to rattle off hundreds of bad things about them – but that's why they're cheap! The most common comment I get is "Don't you read the paper?" Because if you read the paper, there's no way you'd buy these stocks.

**I don't know if he originated the phrase, but Bill Miller once said, "If it's in the headlines, it's in the stock price..."**

RP: Absolutely. They're priced where they are for good reason, but I invest when I believe the conditions that are causing them to be priced that way are probably not permanent. By nature, you can't be short-term oriented with this

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## ON TIME HORIZON:

**If you're going to worry about short-term volatility, you're just not going to be able to buy the cheapest stocks. With the cheapest stocks, the outlooks are uncertain.**

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investment philosophy. If you're going to worry about short-term volatility, you're just not going to be able to buy the cheapest stocks. With the cheapest stocks, the outlooks are uncertain.

In my whole career I have yet to find the great business with a wonderful management team, high margins, a dominant market position and all the conditions everybody wants, at a low price. The stocks of such companies don't sell at a low price. If I find one, I'll cheer, but it hasn't happened yet.

**The late '90s must have been a tough time for you, as the market went nuts and your portfolio trailed badly?**

RP: Well, the market was just focused on

something totally different. The only thing that mattered was growth. People were writing books that were throwing out supply and demand curves – trying to make an economic argument that plentitude was associated with value, as opposed to scarcity being associated with value. That led to the whole "network" phenomenon – the bigger the network, the more people attached to it, the more value it had. And they would even say the closer the price came to zero, the more value it had. People were writing books like that! We laugh at it now, but the stock market was buying into it, and companies were contorting their business plans as a result.

We looked at this and said ... look at one of our favorite companies: Kennametal, small company, but the #1 provider of cutting tools, consumable blades for industrial purposes. It's an incredibly high-margin business. A part costs \$5 and the only thing that matters to a purchaser is if yours lasts one hour longer than the next guy's, because then it pays for itself 5,000 times over. So if you have the best brand reputation, you can make a lot of money. In 1999, when the market was totally focused on something else, you could buy Kennametal, the #1 player in this market, for 4x free cash flow. People were saying these types of companies were going to go out of business. And we'd say, "How are they going to go out of business? You still have to cut the same number of things as ever. It's not like the table doesn't have to be made anymore."

**I assume you were hearing from your investors ...**

RP: It was the worst 2 1/2 years of my life. I can't tell you how many times I heard "You just don't get it." I'd say things like, "Let's compare Kennametal to Cisco. I buy Kennametal and every year it makes 25% more money. Yes, I know the market is telling you it doesn't want to put a high multiple on it, but I still have that money at the end of the year. And I'll have more money at the end of the next year. Why wouldn't I want to get that return?" And then I'd say, "Let's compare that to Cisco. Cisco's market cap is \$500 billion. Say



you're happy with a 15% return, so Cisco needs to make \$75 billion for you to be happy. They're making \$1 billion. Not in your wildest dream can they get to \$75 billion -- the size of the industry doesn't support it, nothing supports it." But people would still say, "You just don't get it," and I'd finally say, "You're right, I just don't get it."

**Did you ever doubt yourself, put some Ciscos into your portfolio?**

**RP:** No, I didn't get that far. What you worry about is can this go on for such a long time that you become obsolete -- that was the really big fear. 2000 was the worst. The same thing kept happening early in the year, and by then even the sophisticated institutions were starting to have some of the same reactions as the individuals. You wouldn't believe how much outflow happened in just the last two weeks of the bubble. It was just amazing. Our assets went down by about 1/3 in no time. As a firm, we were losing a little money and we'd gotten an offer to be bought that I was seriously considering. It would have been the stupidest thing I ever did.

**Then it all turned ...**

**RP:** On February 28, 2000 [the Nasdaq peaked on March 10, 2000], we were cumulatively since inception 65-70 percentage points behind the S&P 500 -- which is how institutions measure us. Yet by December 31st of that year, we were cumulatively ahead of the S&P 500. Who would have ever believed that could ever happen?

**And you've done brilliantly since. To wrap things up, Rich, do you have any advice for people interested in value investing, getting better at it, and maybe even getting into the business?**

**RP:** It's funny how things work out. When I was in business school I took a class called Security Analysis, which was the worst class I ever took. It was awful. The professor taught that investing was all about linear regressions on sales forecasts -- no thinking at all. One of my friends went to work for Fidelity as an analyst out of school, and I remember thinking "What an idiot. Why would anyone want to do that?" Of course he's retired now, and has been for 10 years, but that was my impression back then.

I don't think being a value investor is something you can learn. You can learn how to be better at it and the analytical support for it, but you can't sit there and say, "I'm going to make an intellectual decision that I'm going to become a value investor." My personal belief is that you're either born as a bargain-hunter type or you're born as a bright-eyed optimist. You have to be skeptical and pessimistic, and you have to really enjoy the bargain hunting process, and it has to be part of your whole life. I find that the people who are the best at this are the type of people who are absolutely thrilled to find a pair of shoes for \$20 that they could have paid \$150 for at a department store.

**Do you have to be a bit of curmudgeon, a skeptic?**

**RP:** You can still be a nice person. Hey, people would look at me and say "You obviously can't be skeptical, look at what you're buying." (Laughter.) I need to have a historical framework for understanding a business that makes me comfortable buying it. What you're skeptical of is what matters. **vii**

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# Investor Insight: Zeke Ashton

Zeke Ashton and his Centaur Capital Partners' colleague Matthew Richey share their thoughts on why value investors often underestimate business quality, where market perceptions are lagging reality – both long and short – and why they are particularly interested right now in Laboratory Corp. of America and Shimano.

**Finding any bargains in today's market can be difficult. Where are you seeing opportunities?**

**Zeke Ashton:** There's little out there as attractive as in late 2002 and early 2003, when there were so many cheap value stocks with market caps under \$500 million that we literally couldn't get to all of them. The average multiple was less than 5x free cash flow, for generally unleveraged, profitable and, in many cases, high-quality businesses.

What's happened is that value has migrated, not to super small-caps or super large-caps, but to the \$1 billion to \$5 billion [market cap] range. These companies can fall between the cracks. They're good-quality businesses, growing revenue in the 8% to 10% range, which is too slow for the growth guys. They're trading at 13-15x free cash flow, which is too expensive for many of the classic value guys. But these businesses have demonstrated that they're going to grow at reasonable rates, that they are scalable, that they have competitive advantages, and that they can be bought at modest low-teen multiples of free cash flow. That's where our portfolio has migrated.

**Where do you tend to find your best ideas?**

**ZA:** Our process starts with roughly 20 quantitative screens we've developed to sift through the market to identify stocks that are statistically cheap or are showing incremental improvement. Some are classic value screens on asset value, stocks that trade below tangible book value, or Benjamin Graham "specials" trading below net net working capital.

**Probably not too many candidates out there today on that last screen ...**

**ZA:** They've almost completely disappeared. One screen is more permissive and allows trading at 1.5 times net net working capital to make the cut. We would typically have 40 names on that screen at any one time. That's now down to 12, we've looked at all of them and they are all bad. The next time there's fear in the market, which there isn't right now, those screens will start to get more populated.

One of our best screens looks for companies that are earning higher and higher returns on invested capital, but are trading at a reasonable price based on free cash flow. These companies are becoming incrementally better businesses, but the market has not caught up with the fact that they're incrementally better.

Generally, when we see companies showing up on 4 or 5 of the screens, we pull off the single best candidates and start our research. If a company is on multiple screens, it leads us to believe it has multi-faceted appeal – it's a quality business and it's trading at a reasonable price.

We then try to put a range of intrinsic value on the business – basically, what we think the business should be worth based on how much we're paying for the cash flow today, combined with the rate of cash flow growth. So if we're paying 10x free cash flow, we know that our cash-on-cash return will be around 10%, and if cash flow is growing 8% a year, we're getting about an 18% a year return. That's pretty simplistic, so we compare that with a full discounted-cash-flow calculation as a sanity check.

**So it's a fully bottom's-up approach?**

**ZA:** We don't buy anything unless we know that what we're paying for it is a



**Zeke Ashton**

## Education of a Value Investor

It sounds obvious now, says Zeke Ashton, but his investing epiphany while still working as a financial systems consultant in Europe in the late 1990s was anything but obvious to many at the time: "My portfolio was up 50-75% per year, but I realized I was being rewarded for making a lot of wrong choices, simply by being in the right place at the right time." Since returning to the U.S. as an investment analyst for The Motley Fool in 1999 and then starting his own hedge fund in 2002, value comes first. "Lots of things can make a stock attractive," he says, "But I learned to put the price you have to pay at the top of the list."

conservative estimate of what the business can produce. We've found that to earn repeatable, excellent returns over time with reasonable risk requires being able to assign something approximating a fair value to a business, making conservative estimates. Then it's a question of looking at the price. If price is significantly below that fair value, you're likely to have a good outcome by investing in it. If the price is significantly above that fair value, you can make good money by shorting it.

Yahoo was the epiphany for me, turning me from a relative value investor to an absolute value investor. I thought it was a tremendous business, so as a relative value investor [in the late 1990s] I waited for Yahoo to get whacked and

then started buying it. I bought it at 40% off its high, but I quickly learned you don't get paid for buying something for less than somebody paid for it six months ago. It had no margin of safety in the price. I realized I couldn't really tell what kind of cash flows they could generate into the future, or what kind of competition they might attract.

**How important is original research – talking to competitors, management?**

ZA: That's not a very big issue for us. You know the pictures in *The Wall Street Journal*, made out of those tiny dots? That's not incredibly fine resolution, but

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## ON HIS CIRCLE OF COMPETENCE:

**I'm not going to spend any time trying to figure out what General Electric is worth. So many other people have to own it that it's very unlikely it will be mispriced anyway.**

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you can make out the picture pretty well. Our view is that we're probably able to see relatively quickly with the information at hand whether a stock is undervalued. If the vast weight of evidence tells us this is a quality business and the price is reasonable, even if we spend an extra month on it we probably won't gather much new information to change that perception. As Warren Buffett says, you don't need a precise scale to tell if somebody's overweight or not.

We've had bad experiences where we've tried to do scuttlebutt research, such as overweighting anecdotal evidence given to us by someone in the value chain. We've also overweighted a toxic response to the current management team when we shouldn't have. For us, and for most people, it's very hard not to overvalue information that you think you get from some kind of

specialized source. We try to keep that in perspective.

When the investment decision hinges on one or two critical questions, and you can get those questions answered if you make some phone calls, we'll clearly make the calls. But most of our ideas aren't like that.

**How concentrated is your portfolio?**

ZA: We generally own 20 to 30 long ideas and 6 to 10 short ideas, with never more than 25% of assets short at any given time.

We want to have enough good ideas at work that if we're wrong or unlucky on any one or two, that we haven't lost a significant amount of capital. It's not unusual for us to make a good decision that has a bad outcome – this is a probabilistic business. If you're really concentrated and have two bad outcomes out of ten perfectly good decisions, 10% of your portfolio can blow up.

I've heard the argument that if you have your top ten best investments, why would you want to dilute it with your 11th best investment? But if I had to order my top ten ideas by how much I thought they'd go up, I guarantee you that wouldn't end up being the top ten in actual performance. So we're just more comfortable being somewhat more diversified.

**Are there market sectors you tend to favor, or avoid?**

ZA: We're pretty sector agnostic. But there are some sectors we tend to avoid, that are outside of our circle of competence and have specialists who are a lot smarter than we are in that particular area. Oil and gas exploration is an example. Same for big money center banks. There's no way most people are able to have insight into the portfolios those banks invest in. We don't think the transparency is there.

Berkshire Hathaway aside, we think property/casualty insurance is a tough business, because essentially you're writing call options on anything bad that can happen in the world. That makes management quality incredibly important

there, and management quality can be very hard to gauge. We're only comfortable with a few companies in that industry.

I'm also not going to spend any time trying to figure out what a conglomerate like General Electric is worth. Too many moving parts, and there are so many other people who have to own it that it's very unlikely it will be dramatically mispriced anyway.

**Laboratory Corp. of America is one of your top holdings. Tell us what the market is missing?**

ZA: First, let me give you some background. There are only two big independent providers of laboratory services – blood tests, diagnostic tests – in the U.S.: Lab Corp. and Quest, which is #1. It's sort of a duopoly now, with the top two players having the highest margins.

Several years ago, this was a very fragmented industry, with lots of smaller regional and local mom-and-pops scattered around the nation. It was a commodity businesses and mostly unprofitable. But as treatments and diagnostic tests have evolved, you now increasingly have very specialized tests that are patented, using very sophisticated genomics. The industry began to consolidate as capital was necessary to create and acquire the most useful new tests.

Not only are these so-called esoteric tests much higher-priced, they're also increasingly in demand. Say you go to the doctor and it turns out you might have cancer. Well before they define a treatment for you, they're going to do a detailed check of your genetic predispositions, to help define the course of treatment. As treatment cycles have become ever longer and more expensive, it can make perfect sense to have a few \$200-\$300 diagnostic tests in advance to inform the treatment decision.

**Does that make these companies possible beneficiaries of efforts to rein in health care costs?**

ZA: All companies in the U.S. that are profitable providers of medical services and products are going to be under gen-

eral political pressure to reduce prices, given the need to contain health care costs. But the lab testing companies are better positioned than almost any other sector. The value is becoming more and more clear. ImClone's new drug costs something like \$36,000 for a 12-week cycle of treatment. A \$500 test for genetic predispositions that helps to determine whether it's the right treatment or not is not so egregious.

So this industry has changed and now provides very compelling economics. Lab Corp. has improved its margins every year since 1998. From less than 9%, operating margins have grown to almost 20%. Free cash flow margins are about 17%. They've completely de-levered their balance sheet, and they've increased their pricing power and scale as they've become bigger through acquisition and organically.

**Hasn't the market already noticed? The stock has been up steadily, from the low \$20s two years ago to around \$49 today.**

**ZA:** To some extent, but it still is not very expensive. Lab Corp. is going to produce about \$480 million in free cash flow this year, so it's trading at about 14x estimated free cash flow. If they can continue to grow at the rates they're growing, in the low double-digits, we think this is just a wonderful price.

I really believe there are a couple things going on here. First, we've seen often that there's a lag time in how industries are perceived. A lot of people still think of laboratories as commodity, low-margin businesses without real differentiators. But not only is that not true, these businesses are in the process of carving out huge moats for themselves, which is reflected in rising profit margins.

Second is what I was saying earlier about the concept of buying constituency. Lab Corp. is one of those businesses that grows at a reasonable rate, but it's not a top grower. It grows about 5-10% top-line, but the business scales so free cash flow growth is 8-12%. That's not enough growth to get the growth investors interested, but it trades at 14x

free cash flow, which is not cheap enough for the traditional value guys. So it's kind of stuck in this no-man's land where nobody really cares about it.

**How is Quest valued?**

**ZA:** Usually at a premium to Lab Corp., 18x to 20x free cash flow. Quest has been better appreciated than Lab Corp., maybe because it's been profitable longer. But we feel better about Lab Corp. They've been much more aggressive at growing the higher-value esoteric and genomic testing, which we like. Lab

Corp.'s management team has shown they can grow the business profitably, and they've been very strong capital allocators. The acquisitions they make are out of free cash flow. The debt they have on the balance sheet is long-term at very low interest. They also in the past have been intelligent buyers of their own stock on any momentary price weakness.

**Rising margins often attract new competition. How big is that risk here?**

**ZA:** We think some of the smaller regional labs will continue to consoli-

**INVESTMENT SNAPSHOT**

**Laboratory Corporation of America**  
(NYSE: LH)

**Business:** Through national network of clinical laboratories provides more than 4,400 different lab tests used for routine check-ups, patient diagnosis, and monitoring and treatment of disease.

**Share Information**

(@2/18/05):

<b>Price</b>	<b>49.30</b>
52-Week Range	36.70 – 50.67
Dividend Yield	0.0%
Market Cap	\$6.82 billion

**Short Interest:**

(@1/10/05)

Shares Short/Float	2.4%
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**Financials (TTM):**

Revenue	\$3.08 billion
Operating Profit Margin	19.4%
Net Profit Margin	11.8%

**Valuation Metrics:**

(Current Price vs. TTM)

	<b>LH</b>	<b>S&amp;P 500</b>
P/E	19.6	23.1
P/CF	13.8	13.9

**Largest Institutional Owners:**

<b>Company</b>	<b>% Owned</b> (@ 9/30/04)
Chieftain Capital Mgmt	9.1%
J.W. Seligman & Co	3.4%
T. Rowe Price	3.0%
Select Equity Group	2.8%
Putnam Inv Mgmt	2.7%

**LH PRICE HISTORY**



**THE BOTTOM LINE**

The market hasn't fully recognized the evolution of Lab Corp. – and the clinical testing industry – from a fragmented, low-margin, commodity business to one that is consolidating, with higher value-added testing and better margins. Zeke Ashton believes that even at \$65 per share, 32% over today's price, the stock would be priced to return at least 10% per year.

Sources: Company reports and other publicly available information



date and may ultimately emerge as bigger competitors. But the barriers to entry, as the business has become more sophisticated, are quite high. You need a lot of free cash flow to grow organically and by acquisition, and both Quest and Lab Corp. are way ahead there.

#### What about increased pricing pressure from customers?

**ZA:** The big healthcare purchasing organization is not a particularly new phenomenon.

I think it's a standstill. Lab Corp. has many exclusive relationships with the makers of patented diagnostic tools – if you want to get certain tests, you have to go to Lab Corp. to get them. That results in quite strong pricing power.

#### You define a fair value for all your positions. Explain briefly what that signifies, and what it is for Lab Corp.?

**ZA:** We consider a stock's fair value to be a price discounted to produce an 11% annual return. We don't buy unless it achieves that hurdle, but shoot for much better. We try to buy at a price to get at least a 15% return per year.

Depending on the assumptions for growth, we've put a fair value range from a very conservative \$57, up to \$68. We believe there's still a lot of upside here.

There's one other thing I'd like to mention here. A big part of our Lab Corp. position has been in the LEAP options – deeply in-the-money long-term options. A lot of value investors don't want to play the other asset classes that are available. We always look at the stock first, and if it's compelling we then look at the other asset classes. We found with Lab Corp. that the volatility of the stock was much less than the volatility of the S&P 500. That made the market price of long-term options very cheap. Sometimes, when there's a disconnect between the value of the stock and the value of the business, the option market may reflect prices at an even bigger distortion from fair value. In Lab Corp.'s case, just because it had low volatility, we found that the option market wasn't really assigning much value to the possibility

that Lab Corp. could move up strongly in value. That made the options even more attractively priced than the stock.

#### We're seeing more value investors prospecting in Japan. Tell us about your interest in Shimano Inc.

**Matthew Richey:** People generally know the Shimano brand, primarily as the world's dominant supplier of high-end bicycle components. Almost all the world-class riders, including Lance Armstrong, use their products, which are also on 90% of the bikes sold by the three top brands in the U.S. – Trek,

Giant, and Specialized. Worldwide revenue is about \$1.6 billion, with 80% of that coming from outside Japan.

Given the difficulty in getting as much information as we'd like, we're generally quite cautious about venturing overseas. But U.S. markets tend to be so much more picked over than a market like Japan's. With Shimano, you've got a global brand name people are familiar with, but a lot of investors we spoke with didn't even know it was a public company. The more we looked into the company, the more we believed it was a great business at a deceptively good price.

### INVESTMENT SNAPSHOT

#### Shimano Inc.

(TSE: 7309)

**Business:** Manufacturer of cycling, fishing and snowboarding products, including bicycle gears and fishing rods and reels. More than 80% of revenues outside home Japanese market.

#### Share Information

(@2/18/05, Exchange Rate: \$1 = 105.8 yen)

<b>Price</b>	<b>¥3,220 (\$30.43)</b>
52-Week Range	¥2,210 – ¥3,330
Dividend Yield	0.6%
Market Cap	¥351.7 billion (\$3.3 billion)

#### Financials

(Revenue, est. 2004, Margins, first 9 mo., 2004)

Revenue	¥170 billion (\$1.6 billion)
Operating Profit Margin	17.1%
Net Profit Margin	11.1%

#### Valuation Metrics:

(Current Price vs. TTM)

	<u>Shimano</u>	<u>TOPIX</u>
P/E	18.5	23.8

#### Foreign Stock Ownership:

Share % owned by non-Japanese ~20%

#### SHIMANO PRICE HISTORY



#### THE BOTTOM LINE

Shimano's cash hoard, which it has been using aggressively to buy back shares, still equals nearly 20% of its current market value. Assuming revenue growth at only the level of GDP growth and continued shareholder-friendly use of cash, Zeke Ashton estimates that the shares will be worth at least ¥4,250 within the next three years, a 32% premium to today's price. Further upside catalyst could be growth in China.

Sources: Company reports, Centaur Capital Partners, other publicly available information

**Why a “deceptively good” price?**

**MR:** Basically, on the surface Shimano doesn't look particularly cheap because it trades in the 20x earnings range. But the company is sitting on a massive pile of cash – now around \$600 million – which they've been aggressively using over the past two years to buy back shares. If you back out that cash from the total market cap, then the true operating business is being valued at less than \$3 billion. If you compare that with estimated trailing annual free cash flow of around \$200 million, you arrive at a more relevant free cash flow multiple of around 15x. That's still quite good these days for a dominant global franchise business with double-digit profit margins and returns on invested capital that are approaching 20%.

**Shareholder-friendly moves like stock buybacks are not the norm at Japanese companies. Was there a catalyst of some kind here?**

**MR:** Not that we can see. Management at Shimano just got religion in the past two years and started using excess cash to buy back shares – a total of nearly 19% of the shares outstanding. And we don't see any reason to expect they'll stop, given that the stock price is still clearly reasonable and they still have tons of cash.

There's also a positive operating story to tell. Over-spending on SG&A starting in the mid-90s had hurt Shimano's margin trend for years. But they've combined revenue growth coming out of the 2001 recession with tightened-up SG&A spending, so margins are consistently moving back up.

They've also opened two factories in China in recent years, providing at least two obvious benefits. First, China is a much lower-cost labor supply market than Japan is, so Shimano should be able to lower its cost of production for export. China is also just a massive market for bicycles. Shimano has spent a lot of research and development money on outfitting just the kind of comfort-type bicycles that people use in China to get around.

In other words, as Zeke described earlier, Shimano is another “incrementally better business, but the market has not fully caught up with the fact that it's incrementally better?”

**MR:** Exactly.

**What's the upside potential for the stock, recently trading around ¥3,200?**

**MR:** Even if we assume, very conservatively, that they grow with the economy – around 3% annually – we think the shares are priced to return at least 10% per year over a fairly long period.

**Are you hedging your currency exposure here?**

**MR:** Our bias is to believe the dollar will probably weaken, so no, we're happy to get a small amount of diversification from holding a yen-based investment. But that wasn't at all a primary driver behind the decision.

**Switching gears, so to speak, how did you come to embrace shorts as a core component of your portfolio?**

**ZA:** The latest bear market taught me two excellent lessons. First, that it's not bad to be less than fully invested. In the absence of a really compelling idea, you should always have cash rather than go into mediocre investments just to be invested. I also learned that selling short overvalued stocks or otherwise hedging your portfolio is not a bad thing. In fact, it can be an excellent way to protect your capital.

If we wanted to be dedicated short sellers, we could come up 25 or 30 great short ideas right now. What we typically do is try to pick the six to ten best that combine what we think are the most overvalued companies with a reasonable catalyst, i.e. we're expecting investors will come to appreciate a certain piece of information, or we think the next quarter's financials will reveal that the business is really not as good as people are thinking it is.

**Are there common themes to your current short ideas?**

**ZA:** Yes, one is having a \$500 million

market cap and no revenues. Many of these companies are some version of scams, really. This year is funny that way – there must be a record number of companies like this, and that's even excluding biotech companies for which there might be a legitimate reason to have a big market cap with no revenues.

We are currently short a couple biotech, as well as a software company and an alternative-energy company. The best short candidates are almost always

**ON COMMON SHORT-SALE THEMES:**

**One is having a \$500 million market cap with no revenues. Many of these companies are some version of scams, really.**

cash burning. We have a motto, “buy cash flow, short cash burn.” If a business is burning cash, they're destroying value quarter after quarter. Two things generally happen. They have to recapitalize on unfavorable terms, which is good for us as short sellers. Or, they can't get financing, which, of course, is nirvana for us as short sellers because the stocks then usually go to zero. In the permissive financing environment we've been in, we figure most companies will find financing on some terms, but usually at 15-20% discount to the current stock price, which will cause an immediate market reaction.

We'll continue to look at the airlines for short ideas – we think the industry as a whole is still in a lot of turmoil, and even the good players are going to have a tough time creating any real shareholder value over the next three years. It also would not surprise me to find an over-leveraged home builder to short in 2005. With home ownership the highest it's ever been, we're very skeptical about the rising trend in real estate prices. Higher interest rates will definitely hurt the riskiest players in the housing sector.

For a value investor, you've done well in some fairly fast-growing tech stocks, such as Quality Systems, Inc. (QSII). You first bought at \$13, and kept buying on the way up. How do you distinguish between the keepers and the flame-outs?  
**ZA:** Historically, value investors can be guilty of ignoring the quality of a business, especially in terms of generating cash. When we originally bought Quality Systems in 2002, it wasn't classically cheap, trading at 18-19x cash flow. They had growing returns on invested capital, generated consistent free cash flow, and were trading at a reasonable multiple to free cash flow given what we felt they had going for them. The market cap at the time was under \$150 million.

What's so attractive about Quality Systems' business?

**MR:** Basically, Quality Systems is the leader in electronic medical records for medical practices of between 5 and 100 physicians. Over the past five years or so, medical practices have begun moving away from paper-based patient charts – all those color-coded files you generally see. So with Quality Systems' software, when a doctor sits down with a patient, instead of scribbling on a pad, he or she uses a laptop or PDA to enter patient information. It's not only far more accurate, which saves lives, but it also saves money and facilitates billing and working with insurance companies.

Their software is the best in class, which is what gives software companies a key competitive advantage. If you're in a 20-physician practice and you've got a lot of other things to worry about, you're generally happy to go with the market leader. Then the switching costs are very high, because these people are not motivated to get trained on another platform.

**ZA:** Management is also critical in a business like this. Do they have a track record of generating cash? How are they reinvesting it? Are they credible? We feel Quality Systems' management is conservative in terms of managing their capital intelligently. They're expanding

margins and growing free cash flow by at least 15% per year. Another element we like: Stock option grants are very small, particularly for a tech company.

**MR:** Another thing management does that we very much respect: They don't issue public guidance. They don't set investors up to be disappointed. They ask investors to just look at the history of the business and judge growth potential on that. That goes to the credibility of the management team.

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### ON SELLING TOO SOON:

**We specialize in getting the low-risk profits. It's okay if other people make money on the higher-risk profits.**

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**ZA:** In fact, we think the most courageous managements don't put out revenue and earnings guidance, particularly for software companies. I'll tell you why: Every software company that puts out guidance will find itself at the back end of their quarter having to close deals to make their guidance. Every IT manager who buys a lot of software knows this, and so has been trained to hold out on price until the last days of the quarter in order to get a better deal. Deals get cut in the last 20 days of the quarter – lots of revenue, but the profit might not be there.

In Quality Systems' case you have a management team that says "We're going to sell our product for what we think it's worth and what we put into it, and we're going to support it really well. We're not going to put out guidance that gives pricing leverage to our customers." That just makes a lot of sense to us.

[Editors' note: When we first spoke with Zeke and Matt about Quality Systems, the stock was trading around \$63. One week later it reached \$76. We called them back to get their latest thinking on its valuation.]

Clearly Quality Systems is an excellent company. At 32x cash flow, is the margin of safety gone?

**ZA:** We have trimmed our position size on QSII down to about a half-position, so we recognize the higher valuation, but still believe the stock has room to grow from here. The electronic medical records market is estimated to be only 20% penetrated, so there's a lot of potential growth left.

One thing we've learned is that we've been far too quick at times to sell the truly high-quality business. The mediocre ones you buy for 50 cents on the dollar, and when they get to 90 cents you'd better start thinking about selling. Sometimes you should let your truly great businesses run a bit.

**MR:** We sold a shoe company this past year that had worked out real well for us, in the low/middle end of our fair value range. We decided, "Hey, it's a shoe company – there's no permanent competitive advantage whatsoever." But businesses that have very strong moats that can be protected for a long time, in industries that are growing strongly, we want to make sure we give the businesses a chance to develop. With those, we sell at the high end of fair value. Our fair value range right now on Quality Systems is from the high \$60s up to \$80 per share.

**ZA:** We never want to own overvalued stocks. We have a friend who, though he means well, keeps sending us e-mails about all the stocks we sold too soon. But you know what we've realized? It's okay to give up the risky profit. We kick ourselves when we turn out to be too conservative by selling at the midpoint of our fair value range. But we can live with that. We specialize in getting the low-risk profits. It's okay with us if other people make money on the high-risk profits.<sup>VII</sup>

*VII Co-Editor-in-Chief Whitney Tilson invested in Centaur Capital Partners at its inception and holds a small equity stake.*

# Perpetual Growth Machine

While Costco shares aren't cheap, value investor Nicholas Sleep shares some fascinating insights about the company and makes an excellent case for its long-term prospects.

Value investors have long been intrigued by Costco Wholesale Corp. It has a fabulous long-term record of steady growth, it's old-school in its management and compensation practices, Berkshire Hathaway's Charlie Munger is on the board – plus, any bargain hunter loves to shop there. Not so many value investors own the stock, however, in part because it has extremely low margins – less than 2% after tax – and the stock rarely looks cheap, trading today at 24x trailing earnings per share.

So we didn't expect anything particularly new when we sat down to read the discussion of Costco in the annual letter of Nicholas Sleep of London's Marathon Asset Management. But Sleep's fresh insights, arguments and analysis – “Mungeresque” in tone and content – persuaded us that Costco's intrinsic value is probably quite a bit higher than we'd thought. We followed up with him to learn more on why he believes, even if it's not a 50-cent dollar, Costco is an outstanding long-term investment.

## Customer really is king

Retailers love to boast that the “customer is king,” but none live it like Costco. It starts with how the company negotiates with suppliers. As Sleep notes:

“Costco's key to negotiating terms is that the number of items in a store (SKUs) is fixed at around 4,000, with those suppliers that provide the best value proposition to the consumer winning space on the shop floor. Contrast this to normal industry practice, where the supermarket assumes the role of landlord, auctions space to the highest bidder and pockets the rents (“slotting fees” in industry parlance). Many supermarkets make their money from buying from the supplier. Costco makes money from selling to the consumer.”

Costco fixes its retail prices at a maximum of only 14% over the compa-

ny's cost – with no exceptions. This pricing discipline – even Wal-Mart's mark-ups are around 20% – engenders outstanding customer loyalty. As the company has raised its annual membership fee over time, to \$45, membership renewal rates have barely budged from an enviable 86%.

The real power of Costco's strategy – and the source of its competitive advantage, according to Sleep – is how the benefits of growth are reinvested in the relationship with the consumer. As Costco opens new stores, supplier and other scale cost savings are passed back to customers through even more compet-

## INVESTMENT SNAPSHOT

### Costco Wholesale Corp. (Nasdaq: COST)

**Business:** Membership warehouse retailer offering members low prices on limited selection of branded and private-label products across multiple product categories. Primary operations in U.S. and Canada.

### Share Information (@2/18/05):

<b>Price</b>	<b>45.80</b>
52-Week Range	35.05 - 50.46
Dividend Yield	0.9%
Market Cap	\$21.64 billion

### Short Interest: (@1/10/05)

Shares Short/Float	2.47%
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### Financials (TTM):

Revenue	\$49.16 billion
Operating Profit Margin	2.91%
Net Profit Margin	1.86%

### Valuation Metrics: (Current Price vs. TTM)

	<b>COST</b>	<b>S&amp;P 500</b>
P/E	23.9	23.1
P/CF	15.8	13.9

### Largest Institutional Owners:

<b>Company</b>	<b>% Owned (@ 9/30/04)</b>
Davis Selected Advisers	7.9%
Barclays Bank Plc	3.6%
State Street Corp	2.7%
Capital Guardian Trust	2.3%
Vanguard Group	2.2%

## COST PRICE HISTORY



## THE BOTTOM LINE

Costco's “perpetual machine” of growth is capable of keeping company revenue and cash flow growing 13% annually, says Nicholas Sleep of London's Marathon Asset Management. If the market price reflected even a 10% growth expectation, he says, COST would trade at \$62, a 35% premium to the current market price.

Sources: Company reports, other publicly available information



itive prices. Customers then respond to the better prices, driving incremental revenue at both new and old stores. As Sleep writes:

“In the office we have a white board on which we’ve listed the very few investment models that work and that we can understand. Costco is the best example we can find of one of them: scale efficiencies shared with customers. We often ask companies what they

that’s just Wall Street’s obsession with short-term outcomes. The firm could earn Wal-Mart margins by taking pricing up a little and the stock would then trade at 11x earnings, but would it be a better business as a result? We think not, because it might allow the competition to catch up.”

Contributing to margin pressure in recent years has also been a rise in SG&A costs as a percentage of rev-

with Price Club in 1993, Costco thought 31 stores were too many for the market, but today there are 36. Likewise, in Seattle and Alaska, the penetration of membership cards is an astonishing 65% of households, but in most markets it is below 10%.”

All told, Sleep estimates that Costco can conservatively increase revenue and free cash flow by 13% per year into the foreseeable future – 4% from the increasing asset turns of newer stores as they mature, 4% from same-store growth at already-mature stores, and 5% from new stores.

“This is an early life-cycle company whose competitive moat gets deeper as the company gets bigger and the consumer is consistently cut-in on the benefits of the company’s growth,” Sleep says, terming this cycle a “perpetual machine” of growth.

The market, which currently prices Costco shares at around \$46, is not so generous in its growth expectation. Sleep calculates that if Costco shares were priced to reflect just 10% annual growth, the stock would trade at \$62 today. Even at that price he wouldn’t sell, he says, given his expectation for even faster growth.

What could go wrong? Wal-Mart, with Sam’s Club, could mount a sustained direct attack to undercut Costco’s prices. Sleep considers that unlikely, as Costco has shown itself more than capable of competing head-to-head with the discounting giant. The departure of CEO James Sinegal, 68, the architect of Costco’s unique and disciplined culture, could also be a blow. Sleep points out that Sinegal shows no sign of slowing down, and that Costco’s experienced board can be counted on to appoint a worthy successor.

We’ll leave to Marathon’s Nicholas Sleep the final word on Costco: “The consensus has it that Costco is a low-margin retailer with an expensive stock and a cost problem. That is certainly one description. But in our judgment it is a cost-disciplined, intellectually honest, high-product-integrity, perpetual motion machine trading at a discount to value.” <sup>vii</sup>

#### PRIVILEGES OF MEMBERSHIP



Costco’s membership-only model helps foster a unique relationship with its customers. People shop there because it’s Costco, not because it stocks Pepsi or Pampers. As Costco has raised its basic annual membership fee over time, to \$45 currently, membership renewal rates have barely budged from an enviable 86%.

would do with windfall profits, and almost no one replies ‘give it back to customers’. How would that go down with Wall Street? That is why competing with Costco is so hard to do. The firm is not interested in today’s static assessment of performance. It is managing the business to raise the probability of long-term success.”

By sharing the cost savings of growth, Costco earns revenues per square foot – around \$830 – that are the envy of the industry. Wal-Mart’s Sam’s Club checks in at around \$500 per square foot, while BJ’s Wholesale Club is about \$400. Even more importantly, Sleep estimates that mature Costco stores – open at least five years – generate revenue of over \$1,000 per square foot.

#### Margin trouble?

Costco’s pricing discipline, by definition, keeps margins low – at 1.9%, they are roughly half those of Wal-Mart (3.6%) and Target (4.1%). Sleep argues that Wall Street’s focus on margins is short sighted:

“True, the company has low margins, but that’s the point. The firm is deferring profits today in order to extend the life of the franchise. Of course Wall Street would love profits today, but

enues, fueled in large part by spending on a new warehousing and distribution system and rising employee wages and benefits. A sign of trouble? No, explains Sleep: “We clearly differentiate between ‘good’ and ‘bad’ SG&A spending,” he says. “In both of these cases, Costco is investing in areas critical to its growth.” With the new warehousing system in place, efficiency gains will start showing up in the financials this year. And the slightly higher wage base helps Costco retain its employees twice as long as competitors do, which Sleep sees as positively impacting customer service and contributing to its very high customer retention.

#### Still an early life-cycle company

Even with annual sales of nearly \$50 billion, Sleep makes a compelling case for Costco as a growth company, through geographic expansion, increased market penetration, and the virtuous cycle of growth in maturing-store asset turns as scale efficiencies result in even lower prices.

“One-third of the store base remains in California, and almost half on the West Coast. Management always confesses to underestimating saturation. In Los Angeles, for example, after merging

# Insurance Against a Market Storm

*There are plenty of ways to hedge against a possible stock market meltdown.*

*But few out there beat the risk/reward ratio of buying put options on the Nasdaq-100 Trust.*

After a strong run, even many bulls worry the market has risen too far, too fast. Consequently, prudent investors might want to think about hedging in some way against the possibility of a market correction. These hedges can be quite profitable and, even if they're not, can be viewed as cheap insurance. After all, were you upset that you paid for homeowner's insurance last year, even though your house didn't burn down?

There are many strategies to profit from a downturn, of course. Many smart money managers we know are buying long-dated put options on the tech-heavy Nasdaq-100 Trust, a publicly-traded unit investment trust consisting of the largest non-financial securities listed on the Nasdaq exchange. The options are liquid, trading actively on the Chicago Board Options Exchange.

Option prices are primarily a function of the market price of the underlying security and its perceived volatility. A put option, bearing the right to sell the security at a pre-set price, generally becomes more valuable as the price of the security falls. If you have the right to sell in the future at \$40, that right is worth more if the stock is at \$30 than if it's at \$35. At the same time, the more volatile the stock – all other things equal – the more valuable the put option. If prices are gyrating wildly, puts tend to rise in value.

## Unsustainably low volatility

The first factor making QQQQ puts so attractive, explains Franz Heinsen of Heinsen Capital LLC, is that their prices are remarkably cheap, due largely to what he considers unsustainably low expected volatility in the Nasdaq-100. The CBOE volatility index for the tech sector, which tracks the expected future volatility of the Nasdaq-100, traded recently below 18 – down as much as 80% over the past four years. “Complacency, or the appearance of it, has taken hold, and puts are priced as if only peaceful, calm waters lie ahead,” says Heinsen. “This, at a time when the treacherous conditions the stock market will have to

## PROFITING FROM MARKET MISFORTUNE

**The Strategy:** Low expected volatility is keeping premiums down on long-dated Nasdaq-100 Trust put options. At the same time the Nasdaq-100 Trust is richly-valued by any metric. The result is a unique opportunity to make a low-cost, high-upside hedge against falling stock prices.

The Nasdaq-100 Trust (QQQQ) closed February 18 at \$37.35. On the same day, January 2007 puts with an at-the-money strike price of \$37 were selling at around \$2.85 each. Here's what the puts would be worth at expiration at various prices in the QQQQ:

QQQQ Price @ Expiration	%Change	Put Value	Cost of Put	Net Gain	%Gain
\$22.41	-40.0%	\$14.59	\$2.85	\$11.74	412%
\$26.15	-30.0%	\$10.85	\$2.85	\$8.00	281%
\$29.88	-20.0%	\$7.12	\$2.85	\$4.27	150%
\$34.15	-8.6%	\$2.85	\$2.85	\$0.00	0%
\$37.00 +	-0.9%	\$0.00	\$2.85	(\$2.85)	-100%

With puts, you can't lose more than your investment and, if you're right, you can make many times your investment. The best put prices today, according to Franz Heinsen, are in contracts with strike prices at least \$2 to \$3 in either direction from the current QQQQ price of \$37.35.

contend with in the next few years include rising interest rates, mounting debt, the eventual ending of the country's home-equity cash-out party, and a weakening dollar.”

As a result of this low expected volatility, option premiums – the amount by which an option's price exceeds the implied value of the option, resulting from differences between the current security price and the option's strike price – are very low. For example, QQQQ puts that expire in January 2007, with an at-the-money \$37 strike price, trade for about \$2.85. This means that if the QQQQ falls only 9% at some point in the next two years the investment breaks even – and returns from further declines increase rapidly (see table).

The second argument for buying QQQQ puts, argues Heinsen, is that tech shares by historical and relative measures are too expensive. Reuters data shows the Nasdaq-100 trades at 50x trailing earnings, more than twice the S&P 500 and Dow multiples. This discrepancy is unjustified by growth prospects, which are modest, says Heinsen. He notes that the true P/E for tech stocks is even higher since stock options are not being expensed and money-losing companies are

excluded. With these adjustments, Heinsen estimates the Nasdaq-100 currently trades for an absurd 55-60x trailing earnings.

So, if a basket of tech stocks is so overvalued, why not pick the priciest company and buy puts on its shares? Here, Heinsen argues caution: “The risk rises sharply when you're dependent on being right about a specific company. With a diversified basket, you only have to be right overall.”

## Time can work against you

Put options have a key downside: Time can work against you. If volatility stays low and the Nasdaq-100 stays high for another two years, you can lose all your investment, even if you bought the longest-dated puts. But puts allow you to tie up far less capital, and losses are limited to the original investment. If you believe two years is ample time for the laws of valuation gravity to catch up with tech shares overall, the risk/reward ratio for buying QQQQ puts is hard to beat. “I look at it as cheap insurance,” says Heinsen. “It's like buying hurricane insurance in Miami, but at Toronto prices.” <sup>VI</sup> Investment funds managed by Co-Editor Whitney Tilson owned QQQQ puts at presstime.

# Investing on Instinct

*Should following one's "gut" play a central role in making investment decisions?  
Probably not ... if you really think about it.*

One of the more interesting and thought-provoking books published in recent years was Malcolm Gladwell's *The Tipping Point*. Through vivid anecdotes, Gladwell described the underpinning of "social epidemics," from the decline in New York City crime to the explosive sales growth of Airwalk sneakers. It's the rare book that casts a fresh look on, well, just about everything.

Gladwell's latest book, *Blink*, is equally fascinating and, though not written specifically for investors, has many insights for the investment process. Subtitled "The Power of Thinking Without Thinking," *Blink* explores the psychology and science of decision-making, focusing largely on first impressions and instinct. The conclusion: Under the right circumstances, "decisions made very quickly can be every bit as good as decisions made cautiously and deliberately."

No argument there. We've all learned to listen to our instincts in making decisions, whether in making a hire, picking a mate or picking a stock. First impressions matter, at the very least as a filtering mechanism. "Great decision makers aren't those who process the most information or spend the most time deliberating,"



"But I CAN be spontaneous...just give me a couple of days."

writes Gladwell, "but those who have perfected the art of "thin-slicing" – filtering the very few factors that matter from an overwhelming number of variables."

## The Warren Harding Error

Most instructive to investors, however, are the book's descriptions of where first impressions err. Take, for example, "The Warren Harding Error." Voters took immediately to the dashing handsome Harding, who "radiated common sense and dignity and all that was presidential." This emotional connection blinded them to the fact that his policies were hollow and his record in public office undistinguished. Harding eventually served two years before dying of a stroke, and most historians list him as one of the worst presidents in American history.

Behavioral finance experts cite just such emotional connections, particularly when they override alternative information and input, as a pervasive investor mistake. While Fidelity's Peter Lynch famously made a small fortune by investing in Dunkin' Donuts stock after falling in love with its coffee, investors who make investment decisions on what they like are generally disappointed – witness Krispy Kreme, for example.

Another classic investor error is "anchoring" too quickly on select data or information that turns out to be flawed. This is the mistake Coca-Cola made with its disastrous launch of New Coke. The primary driver of this decision was the fact that Coke consistently lost to Pepsi in head-to-head blind taste tests. The tests were simple: subjects were asked to take a sip of each soft drink and report their preference.

But the tests had a fatal flaw. Taking a sip in a taste test is a very different experience from sitting and drinking an entire can. Consumers tend to like a sweeter product, which Pepsi is, initially, but for many, the sweetness becomes overpower-

ing and less appealing as more of the product is consumed. So Coca-Cola nearly destroyed the world's greatest brand by relying too heavily on initial data that proved to be incorrect.

Combating the ill effects of such anchoring requires discipline on the part of investors. Rich Pzena, whose interview is featured in this issue, uses one interesting technique before buying any stock: He invites the Wall Street analyst who is most bearish on the stock to come into his offices and make the bearish case – a direct challenge to Pzena's most firmly-held convictions.

A final lesson from *Blink*: Intuition tends to break down under duress. In 1999, four New York City police officers fired 41 shots at Amadou Diallo, killing him as he reached for his wallet. Diallo posed no threat, but the first impressions formed by both Diallo and the officers led to the fatal series of events over a matter of seconds. The police officers were under a great deal of stress – it was dark and they were in a high-crime neighborhood and likely expecting trouble – which undoubtedly contributed to the failure of their intuition.

## Adrenaline risk

It's a stretch, of course, to equate the Diallo shooting with anything experienced by investors, but the key point is that adrenaline is not a friend to good decision-making. A dramatic move in the market or a given stock price can trigger a visceral "I've got to do something" reaction in even the most experienced investor. Numerous studies have shown time and again, however, that such visceral reactions are usually costly. In such cases, careful analysis, reflection and patience are often virtues.

"How good people's decisions are," concludes Gladwell, "is a function of training, rules and rehearsal." Not very sexy, but a very sound recipe for investment success. **VII**



# Welcome to Value Investor Insight

*"The game is to keep learning ... if you don't keep learning, other people will pass you by."*

The best investors are acutely curious, always seeking to expand their knowledge. Charlie Munger once said:

"If Warren Buffett had never learned anything new after graduating from Columbia Business School, Berkshire Hathaway would be a pale shadow if its present self. Warren would have gotten rich – what he learned from Ben Graham at Columbia was enough to make anybody rich. But he wouldn't have the kind of enterprise Berkshire is if he hadn't kept learning. I don't know anyone who [learned to be a great investor] with great rapidity. The game is to keep learning ... if you don't keep learning, other people will pass you by."

*Value Investor Insight* is aimed at investors who embrace what Munger is saying – who want immediate, actionable investment ideas, but also want to learn to be better analysts, build their circle of competence by reading about interesting companies and industries, develop their understanding of behavioral finance and, in general, become better, more successful investors.

There's no lack of information out there for investors. Sell-side research from less-than-independent brokerage firms. Effusive

TV anchors treating minute-to-minute market moves as sport. Magazines touting the "Best 10 Stocks to Buy Now!" Newsletters claiming proprietary "systems" that will "Triple Your Money in Six Months!"

Our belief in launching *Value Investor Insight* is that savvy investors want and deserve more. They deserve a publication that ignores the hype and delivers clear and concise information that helps them make better investment decisions. They deserve a publication that explores the process of great investing, by providing direct access to the best investment thinking from the most successful investors.

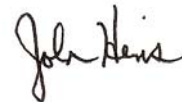
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As co-Editors-in-Chief, we bring complementary skills to this endeavor. Whitney is an experienced and successful investment manager, who has written an investing column for The Motley Fool website for over five years. John has been both a business journalist, at *Forbes*, as well as a senior media executive at Bertelsmann and AOL.

We welcome you to our first issue. We hope this is just the beginning of a long and successful relationship.



John Heins  
Co-Editor-in-Chief



Whitney Tilson  
Co-Editor-in-Chief

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