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ValueInvestor INSIGHT

The Leading Authority on Value Investing

Safety Over Sorrow

Great debt investors make sure to get their money back. Great equity investors uncover hidden long-term value. Canyon Capital's Mitch Julis excels at both.

When he started Canyon Capital in 1990 with long-time friend Josh Friedman, Mitch Julis planned to create a "mini-version" of his previous employer, investment bank Drexel Burnham Lambert. But Canyon fairly quickly turned solely to investing. "We learned the virtue of focus when building a business," says Julis.

This virtue has paid handsomely for Canyon investors, who have entrusted more than $10 billion with the firm. Investing across debt and equity asset classes, Canyon's flagship fund has returned a net 13.4% compounded annually since 1999, versus 2.2% for the S&P 500.

With a historically high share of assets devoted to equities, Julis is finding plenty of opportunity in "post-stress" situations in airlines, heavy industry and media. See page 2

INVESTOR INSIGHT

Mitch Julis
Canyon Capital Advisors

Investment Focus: Seeks companies under stress – and therefore cheap – with an ability both to meet current obligations and to invest in building long-term value.

Scouring the Underbrush

For nearly 15 years, few have uncovered "promising turnarounds, dullards and assorted investment misfits" as successfully as Carlo Cannell of Cannell Capital.

INVESTOR INSIGHT

J. Carlo Cannell
Cannell Capital LLC

Investment Focus: Seeks small-cap companies with excellent growth potential that is not appropriately valued, primarily because of market neglect.

Giving money back to investors is anathema to most professional money managers, but that's exactly what Carlo Cannell has done – to the tune of $300 million – over the past three years. "The great disadvantage of our investment approach is that it's not very scalable," he says.

But it is very profitable. Owning primarily small-cap companies neglected by the investment community, Cannell's lead fund, Tonga Partners, has earned a net 25.2% compounded annually since 1992, trouncing the annual 10.8% gain of the Russell 2000.

Now managing $900 million, Cannell continues to unearth long and short opportunities for which, he says, there is "imperfect distribution of information." See page 9

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Investor Insight: Mitch Julis

Mitch Julis of Beverly Hills-based Canyon Capital Advisors describes where he's finding opportunity in today's most troubled industries, why value investors should avoid being ideologues and what he thinks the market is missing in ACE Aviation Holdings, Williams Companies, Solectron and Mediacom Communications.

How did your fixed-income experience at Drexel Burnham Lambert in the 1980s inform your investment philosophy?

Mitch Julis: The credit culture of Drexel gave me an important way to frame investment opportunities. The idea is to combine a full understanding of whether a company will be able to pay back its obligations, in sort of a ratings-agency sense, with a focus on whether the company has a business model or competitive advantage that builds long-term value. Drexel was unique in looking at credit quality this way and we think it's a great way to think about any investment in a business.

My partner, Josh Friedman, was working on leveraged-buyout deals at Drexel and I worked primarily with special situations and restructurings, so we both saw how important it was that a company's capital structure be appropriate to the different stages of its lifecycle. Whether a company will have access to capital, what kind and on what terms, is key to understanding the bet you're making and payoffs you'll receive.

Does your credit orientation explain why you focus on distressed opportunities?

MJ: Stressed and distessed situations are those in which a company's ability to meet its obligations is most important. They are also where you're most likely to find unrecognized value. This type of investing is consistent with our basic goal: to earn reasonable returns most of the time, abnormal returns some of the time and negative returns almost none of the time.

We invest in all layers of the capital structure, with about 65% of assets in debt securities, 30% in equities and 5% in convertibles. At every level we're focused on understanding both the staying power and earnings power of the companies we're investing in. Marty Whitman of Third Avenue [*VII*, May 22, 2005] talks about how he looks for safe and cheap companies. Joel Greenblatt [*VII*, November 30, 2005] and others talk about looking for companies that are cheap and good. We look to invest in companies that are safe, cheap and good.

What specifically makes an investment safe, cheap and good in your eyes?

MJ: Safe companies have staying power, the operational and financial flexibility to withstand the ups and downs of their business cycles and what's going on in the capital markets. Here we look at traditional credit statistics like interest coverage and whether the base of assets versus the debt level is comfortable. We also look carefully at the level of free cash flow being generated and the sustainability of that free cash flow given the company's business model and competitive position.

A company's ability to honor its debt obligations is the basic level of staying power. Once you have a view on that, you can move up or down from that layer in the capital structure. Investing in one type of asset gives us insight into the risk/reward tradeoffs for other types.

Good companies have earnings power, earning a good return on capital and with growth that creates value because returns on incremental capital exceed the cost of capital. As for cheap, we focus on a high ratio of earnings before interest and taxes over enterprise value and whether we have enough upside optionality for which we're paying very little.

We also pay a lot of attention to capital structure. How much debt is coming due and when? How does the level of free cash flow support the size and composition of the capital structure, in book and market value terms? Is optionality built into the debt, to the benefit of creditors or to the benefit of the company? If a compa-

Mitch Julis

Learning from "LDOs"

Armed with a joint business and law degree from Harvard in 1981, Mitch Julis could easily have pursued investing upon graduation. Instead, he joined Wachtell, Lipton, Rosen & Katz as a bankruptcy attorney in New York. "For Jewish kids from Rockland County, New York, there were only two professions, medicine or law," he says.

Realizing the lawyer's daily routine wasn't for him, Julis quit Wachtell, Lipton in 1983 and pursued some writing projects, including one for which he interviewed a partner at high-flying investment bank Drexel Burnham Lambert. That led to an introduction to Michael and Lowell Milken and a job offer. "I had no regular job," he says, "so working at Drexel in 1983 seemed like an interesting thing to do."

His specialty? "I was basically doing 'leveraged die-outs'," he says, the wrenching restructurings of overextended firms such as offshore driller Reading & Bates and steel producer Wheeling-Pittsburgh. "Seeing first-hand why companies failed and what it took to come back was an ideal experience for me," he says. "Understanding that is at the core of what we do as value investors."

ny has high-cost debt but can call it at par, there's a lot of value in that option. Unless you understand the options a company has vis-à-vis its investors, you're not really going to understand its flexibility – or lack thereof – to create value.

In your equity bets, where do you tend to find inefficiencies?

MJ: Companies in severe financial stress still tend to be overlooked and underloved, because they have a risk or fundamental profile that many equity investors are not comfortable with. Our credit culture gives us an advantage there.

Distressed opportunities tend to come in cycles. While we expect credit deterioration in the normal cycle of things to create more opportunities in the stressed and distressed areas, you don't see much supply right now. The key for us is to have a clear sense of how asymmetric any given bet is, based on the fundamentals, and move quickly whenever the downside is low enough for an attractive upside.

Inefficiencies also occur in event-driven situations, where the longer-term effects of things like deal activity, management change or changes in the regulatory environment are not accurately discounted by the market.

When the theatrical exhibition industry started to consolidate, for example, we bought into the equity of AMC Entertainment. We thought the cost of borrowing was such that they could leverage their balance sheet to make acquisitions, and that they'd see advantages to doing that as a private company. They eventually did go private at an attractive premium to our purchase price. We still like AMC and own a lot of their publicly traded debt.

Have you had success with spin-offs?

MJ: Yes. Often spin-off opportunities are bond-like in nature, generating a lot of cash, with a great base of assets and excellent incentives in place for the right things to be done with the cash generated. But the numbers generally don't look so great at the beginning, because it's in management's interest to underpromise and overdeliver. Coupled with the fact that the shareholder base is usually in flux at the beginning – many holders of the parent-company stock don't want to or, because of their charters, can't own the spin-off – inefficiencies arise.

We also like what we call "crossover" equities, where a transition between value and growth shareholders causes them to fall out of focus. SanDisk [SNDK] is a good example. This was a broken growth story that became interesting to us as value investors when the stock was in the low $20s in 2004 and last year. So many applications in the world of communications and media require the type of instant access provided by the "flash" memory products that SanDisk makes. When you looked at the strength of their intellectual property, their royalty streams, their free-cash generation and their franchise in the marketplace, we saw this as still being a growth story that was undervalued because growth investors had abandoned it. The stock is now in the mid-$50s.

ON PROCESS:

After Enron and WorldCom, we look at accounting statements in a more forensic way, literally tracking the money and accruals.

You put a lot of emphasis on process in your research and decision-making. Describe the key elements of that process.

MJ: Investing is fundamentally about a good decision-making process and a big part of that is a full and regular articulation of the assumptions and heuristics you're using to come to decisions. We carefully detail – and question – the assumptions and heuristics we're using at every step in our research.

We're also big on reframing questions, issues and analysis. For example, we'll look at a leveraged equity position as if it was an option or at high-yield bonds as a combination of being long a Treasury and short a put. We've redesigned our analytics to look at fundamentals from different points of view. Reframing is an excellent way to bring new perspectives and flexibility to how we think about ideas.

In 2002, the long-term bonds of AOL Time Warner declined sharply and were trading below 70, for an 11% yield to maturity. We could have looked at that and said that investing in the long-term debt, paying 11%, of a company with $30 billion in debt and a troubled business model didn't make much sense. But if you looked carefully at the flexibility they had in working with their banks on covenant and amortization relief and from selling valuable but non-essential assets, you could re-frame the investment as one with great total-return potential over a 12-month period, which required very little improvement necessary in the operating side of the business.

When we missed some opportunities on the short and long side with Enron and WorldCom, we instituted a process that looks at accounting statements in a more forensic way. We now literally track the flows of money and accruals across all financial statements. This helps us see anomalies we might otherwise miss and also gives us a better context for drawing inferences about where money is going to come from and be used in the future. I have a book coming out in the next year or so [*Beyond Graham and Dodd : A Multi-Asset, Multi-Strategy Approach to Value Investing*, with Purdue University's Michael Kirschenheiter], which explains in detail how we do this and, in general, how we've reengineered how we work.

Another important thing about our process: We make sure everyone at Canyon knows they have full permission to tell Josh and me that we're looking at something the wrong way. You need a certain level of confidence and competitiveness to succeed in this business, but arrogance can really hurt you. We think the best way to avoid that is to make sure dissenting opinions are encouraged, taken seriously and acted upon when appropriate.

Do you have any rules when it comes to selling?

MJ: We grew up in an environment at Drexel where the head trader always reminded us that you never went bankrupt by taking a profit. We're not immune to the common mistakes of being overly risk averse on winning positions by not letting them run and taking on excess risk with losing positions by holding on.

We've gotten better at letting our winners run. Part of that comes from really understanding what we're betting on. Say you bought something at $5 that's now at $20. If $15 of that $20 is just the cash the company has accumulated since you bought in, the bet on the future business is still only $5. Absent a change in your thesis, why would you sell in a case like this just because you've already made a bunch of money?

How concentrated is your portfolio?

MJ: We're fairly broadly diversified – our value at risk per position is low and our largest position rarely accounts for more than 3% of total assets under management. That goes back to our core belief about limiting any impact of negative returns.

While we focus on a bottom-up analysis of all our investments, we do make sure we understand the broad exposures we have. Take exposure to energy prices, for example. We look to somewhat balance the big exposure we have to the energy and merchant-power sectors, which benefit from higher energy prices, with bets, say, on airlines, that benefit when energy prices decline.

Let's talk about airlines and one of your bets there, the parent of Air Canada, ACE Aviation Holdings [ACE.B].

MJ: We generally think airlines are interesting now, even though oil prices are high, because they're rationalizing their businesses and fleets. Overseas growth in air travel is strong and looks like it will stay that way, which gives you a lot of downside protection because the asset values of planes are so strong.

We often find mispricing in multi-line businesses like Air Canada's. The company's mainline business is the world's 14th-largest airline, with a 60% domestic market share and only one major competitor, WestJet. They control Jazz, their regional feeder airline that is 23% publicly traded as a Canadian income trust. They control Aeroplan, a loyalty-program business with five million members and 60 partners, of which 24.5% trades separately as an income trust. They own 100% of a global technical services business, primarily focused on aircraft maintenance, which they also will eventually spin off. Finally, they also own about 6% of US Airways.

This is a case where the value of all the disparate assets allows you to buy the mainline business of Air Canada very cheaply. That gives you a nice option on their ability to retool their business model and take advantage of the strong market position they enjoy.

Walk us through the math.

MJ: The Aeroplan stake is worth around C$16 per share and is a solid and growing business. The Jazz position is worth just under C$8 per share and is also well-run and benefits from its long-term contract already in place with Air Canada. The maintenance business has substantial revenue outside of Air Canada, including from third-party carriers like JetBlue, Delta, US Airways and several European airlines. We value that at C$4.70. The five million shares of US Air they own are worth C$1.85.

INVESTMENT SNAPSHOT

ACE Aviation Holdings
(Toronto: ACE.B)

Business: Parent of Air Canada, with additional business units providing maintenance services, regional air transportation and loyalty-awards programs.

Share Information
(@3/30/06, Exchange Rate: $1 = C$1.1609):

Price	**C$33.50 ($28.86)**
52-Week Range	C$30.25 – C$43.00
Dividend Yield	0.0%
Market Cap	C$5.7 billion ($4.9 billion)

Financials (as of 12/31/05):

Revenue	C$9.8 billion ($8.5 billion)
Operating Profit Margin	4.6%
Net Profit Margin	2.6%

Valuation Metrics
(Current Price vs. TTM):

	ACE.B	S&P/TSX
P/E	13.6	21.7

ACE.B PRICE HISTORY

THE BOTTOM LINE

Given the independent values of non-mainline businesses, the flagship Air Canada airline franchise is valued at less than C$4 per share, says Mitch Julis. At the multiples at which comparable North American airlines trade, he believes the parent company's shares are worth at least C$45 – even before expected profitability increases kick in.

Sources: Company reports, Canyon Capital Advisors, other publicly available information

That's over C$30 per share, while ACE shares trade at C$33.50.

MJ: You're getting the mainline business for less than C$4 per share, at a multiple of only 4.4x our estimate of 2006 earnings before interest, depreciation, amortization and rent. North American airlines generally trade at 5x to 6.5x that figure, while emerging-country airlines trade at more than 8x.

So the main Air Canada business is cheap. What are they doing that also makes it valuable?

MJ: Their goal is to retool their fleet and cost structure to better compete with low-cost airlines, while still offering the convenience, frequency and service that discount carriers can't match. I know that's what everybody says they're doing, but they've already made good progress toward that goal. We're very encouraged that they've hired as their chief financial officer Brian Dunne, who had been the CFO at Aer Lingus, which transformed its flagship carrier successfully into a low-cost carrier.

One thing weighing on the stock is the fact that they're spending a lot of money on reconfiguring their fleet of aircraft to make it more economical. It's the right thing to do and will allow them to generate higher returns on capital in the future, but it's expensive today. They have a strong balance sheet and, given the asset value and free cash flow generated in the other businesses, they can easily handle the investment plan. In the end, it will make this a much better business to own.

What's the potential upside?

MJ: We look at it in a couple of ways. Every half-point turn in multiple for the mainline business is worth C$6 per share. So at a more reasonable multiple of 6.5x for the mainline business, the stock would be worth more than C$45 per share – without accounting for any of the increase in operating performance we expect in the next couple of years.

At the same time, while we're not making a bet on energy prices here, every dollar decrease in oil prices adds $20 million to the company's annual EBITDA. If there was no change in multiple and average oil prices fell to $54, the stock would be worth C$50. We don't need that as a reason to buy the stock, but given that we're long energy elsewhere in our portfolio, it's important to take into consideration.

Another multi-line business you like is Williams Companies [WMB].

MJ: Williams is a good example of the post-stressed type of company we often buy into. They avoided bankruptcy after bottoming out in 2002, after some misplaced telecom and energy-trading bets. But because of the taint of that recent past and the complexity of its current business structure, we don't think the market is giving it its due.

The company operates in all sectors of the natural-gas business – exploration and production, midstream processing and pipeline – and also has a growing power-generation business. The fact that they're in four different businesses makes it difficult for mainstream analysts to value the whole company, which limits institutional ownership.

Similar to our analysis of Air Canada,

INVESTMENT SNAPSHOT

Williams Companies
(NYSE: WMB)

Business: Exploration, production, gathering, processing and transportation of natural gas. Separate subsidiary produces and sells wholesale power.

Share Information
(@3/30/06)

Price	**21.43**
52-Week Range	15.62 – 25.72
Dividend Yield	1.4%
Market Cap	$12.74 billion

Financials (TTM):

Revenue	$12.58 billion
Operating Profit Margin	9.8%
Net Profit Margin	2.5%

Valuation Metrics
(Current Price vs. TTM):

	WMB	S&P 500
P/E	39.6	21.4
P/CF	11.7	14.9

Largest Institutional Owners
(@12/31/05):

Company	% Owned
Barclays Global Inv	3.3%
Goldman Sachs	3.0%
State Street Corp	2.8%
Wellington Mgmt	2.7%
Morgan Stanley	2.5%

Short Interest (As of 3/8/06):

Shares Short/Float	1.8%

WMB PRICE HISTORY

THE BOTTOM LINE

Mtich Julis believes a complex business structure and tainted recent past is unduly restraining Wall Street's enthusiasm for the company's significantly improved business prospects. His sum-of-the-parts analysis values the stock at $30 within the next 12 to 18 months, with a likely balance-sheet restructuring providing additional upside.

Sources: Company reports, other publicly available information

we've looked at the fundamentals of each business and figured out almost on an arbitrage basis that you're getting the company's exploration and products assets very cheaply, both in terms of intrinsic operating value as well as current market values.

How is Williams safe, cheap and good?

MJ: The company is safe because net debt of $6.1 billion is less than half the equity market cap, providing an excellent equity cushion below the debt.

As for good, we have seen considerable operational improvement in the E&P business from learning and technology improvements that have increased drilling efficiency and well productivity. We believe this trend will continue. They're also ramping up E&P production in a variety of areas by reinvesting the strong cash flow they're generating. In the pipeline and midstream businesses, we expect increases in EBITDA as investments they've already made start to bear fruit. Finally, near-term earnings will benefit significantly as unprofitable hedges they put in place when natural gas was much cheaper start to expire.

With the stock trading just under $21.50, how cheap is it?

MJ: Given the earnings improvements we expect, the stock trades at an enterprise value of only 5.8x what we think normalized EBITDA will be by 2008. The current 6% free cash flow yield on the equity will grow to 16% by 2008. That's assuming $6.70 [per million BTU] natural-gas prices, which could be conservative given the forward prices currently in the market.

If the operating improvements happen as we expect, our sum-of-the-parts analysis gives us a $30 stock price in the next 12 to 18 months. Beyond that, we also believe there's upside from restructuring their balance sheet to monetize certain of the separate businesses, for example, by spinning them off as master limited partnerships. This could lower their overall cost of capital and unlock even more of the value we think is hidden.

Tell us about Solectron [SLR], hardly a Wall Street darling.

MJ: Solectron is one of our newer positions, and as you say, one of the Street's least-favorite stocks. The company is basically a contract manufacturer for original-equiment manufacturers in electronics and technology industries, which was a tough business as the tech/telecom bubble broke and new Asian competition came online. But we're now seeing renewed growth in traditional markets as well as increased penetration in non-traditional markets like health-care equipment, automotive and aerospace/defense.

We also think things like logistics complexity, hazardous-materials handling and the need for scale are increasing barriers to entry, making the overall industry more attractive. We don't believe these changing dynamics are being recognized by the market.

Why is Solectron well-positioned to take advantage of the changing dynamics?

MJ: They have excellent, long-standing relationships with large customers such as Cisco, Lucent and Nortel, and their revamped sales force has had recent important wins in new areas like defense

INVESTMENT SNAPSHOT

Solectron
(NYSE: SLR)

Business: Value-added contract manufacturing for original-equipment manufacturers operating primarily in the electronic and technology markets.

Share Information
(@3/30/06)

Price	**3.96**
52-Week Range	3.08 – 4.40
Dividend Yield	0.0%
Market Cap	$3.62 billion

Financials (TTM):

Revenue	$9.95 billion
Operating Profit Margin	0.9%
Net Profit Margin	0.0%

Valuation Metrics
(Current Price vs. TTM):

	SLR	S&P 500
P/E	n/a	21.4
P/CF	5.7	14.9

Largest Institutional Owners
(@12/31/05):

Company	% Owned
Axa	13.7%
Fidelity Mgmt & Res	13.2%
Capital Res and Mgmt	6.9%
Vanguard Group	4.2%
Barclays Global Inv	3.7%

Short Interest (As of 3/8/06):

Shares Short/Float	0.7%

THE BOTTOM LINE

Mitch Julis expects aggressive restructuring efforts and ongoing new-business wins to result in significantly improved operating profitability that is not priced in the stock. Hitting even a 4% operating margin – the low end of the company's target range – should result in a share price double the current $4 level, he says.

Sources: Company reports, other publicly available information

and healthcare. They've made significant efforts to improve margins and returns on invested capital – by revamping manufacturing processes, moving more plant capacity to lower-cost countries and taking headcount down by nearly 20,000 employees in the past 2 1/2 years. They target a minimum 20% return on invested capital on new projects, and we think they can do even better than that.

Do they have the financial flexibility to fully turn things around?

MJ: The company has $1.4 billion in cash and only $700 million in debt. They have no meaningful debt maturities until 2011, so there's almost no financing risk. They have plenty of staying power and time to keep improving operating margins on a large – and now growing – revenue base.

The shares now trade near $4 per share. How are you thinking about valuation?

MJ: With a market cap of $3.6 billion and net cash of $700 million, the net enterprise value is only $2.9 billion, versus a sales base of $10 billion. For 2007, the company should earn 24 cents per share, which translates to a P/E of only 13x on a cash-adjusted basis – the lowest in the industry. At these valuation levels, we think Solectron gives us a very nice option on both improving industry and company prospects. The operating leverage is significant if the company delivers on improving performance. With only modest revenue growth, if they hit the 4% operating margin that's at the low end of their target range – up from around 1% currently – they'll earn north of 50 cents per share. Adjusting again for cash, that's a forward P/E of less than 6x.

Our intrinsic value for Solectron is about $8 per share, which should be reflected in the market within 12 to 24 months if they perform as we expect.

Turning from heavier industries, why are you high on Mediacom [MCCC]?

MJ: Mediacom is a medium-sized cable company, located in smaller cities and towns. They've had to deal with intense satellite-TV competition and have seen their subscriber base fall from a peak of 1.6 million subscribers in 2001 to 1.4 million in 2005. They have a lot of debt, so we look at this as a leveraged equity, with an option on the cable business and their position in it. The question is whether that option has value, which we believe it does for both intrinsic and event-driven reasons.

On the intrinsic side, they've invested heavily to upgrade their systems and are now in a position to offer the triple-play option of broadcast, voice and Internet services in most of their markets. We think this will go a long way to stabilizing subscriber losses to satellite TV – which can't really offer the same package of options – and reduce subscriber churn. We estimate Mediacom will generate positive net subscriber adds for the first time in several years this year.

What about the threat of telephone-company competition?

MJ: The established positions Mediacom has in smaller markets makes them less susceptible to the threat of the phone companies. The phone guys will be more than occupied elsewhere.

INVESTMENT SNAPSHOT

Mediacom Communications
(Nasdaq: MCCC)

Business: Eighth-largest U.S. cable television company, offering video, Internet and phone services to 1.4 million subscribers in smaller cities and towns.

Share Information
(@3/30/06)

Price	**5.80**
52-Week Range	4.75 – 7.59
Dividend Yield	0.0%
Market Cap	$657.1 million

Financials (TTM):

Revenue	$1.10 billion
Operating Profit Margin	16.9.%
Net Profit Margin	(-20.2%)

Valuation Metrics
(Current Price vs. TTM):

	MCCC	S&P 500
P/E	n/a	21.4
P/CF	3.9	14.9

Largest Institutional Owners
(@12/31/05):

Company	% Owned
Neuberger Berman	16.0%
Barclays Global Inv	7.2%
Legg Mason	4.4%
TCW Group	2.6%
Duquesne Capital Mgmt	2.1%

Short Interest (As of 3/8/06):

Shares Short/Float	7.1%

MCCC PRICE HISTORY

THE BOTTOM LINE

The full rollout of broadcast, voice and Internet packages should reverse churn and result in profitable net subscriber growth for the first time in years, says Mitch Julis. Valued at per-subscriber levels at which comparable systems have recently been sold, he believes the shares are worth $8.50, a nearly 50% premium to today's price.

Sources: Company reports, other publicly available information

What's the event-driven play?

MJ: Some sort of going-private transaction, similar to what happened with Cox Communications. Mediacom has net debt of $3 billion, but it's long-term in nature and the capital markets are sufficiently open right now that they could be taken private and still have no issue in meeting their obligations out of the current level of cash flow generation. They also have a tremendous amount of net-loss carryforwards – they aren't likely to have to pay taxes for another decade – which would be valuable to both private-equity or strategic buyers. Based on comparable deals that have been done, somebody could easily pay upward of $8 per share to take the company private.

With the stock trading at $5.80, is the upside similar on an intrinsic-value basis?

MJ: Yes. One relevant way to value these companies is on a per-subscriber basis. Charter just sold some cable systems for a total enterprise value of $2,835 per subscriber. On a comparable basis, Mediacom trades at $2,600 per sub, although you could argue that the Mediacom assets are more attractive than those sold by Charter. If Mediacom were valued at $2,835 per sub, that would translate into a share price of $8.50.

In addition to Mediacom, how else are you playing the trials and tribulations in the media business?

MJ: Elsewhere in the cable business, we own trade claims of Adelphia and bank debt of Charter Communications. Even though these companies' business models have been threatened, we see potential for excellent total returns on the debt side.

We believe media content is an area for equity upside. It hasn't worked out yet, but the split of Viacom between its cable channels and CBS creates opportunity, particularly in the Viacom [VIA.B] piece. Private-market values for cable channels are much higher than what we think is currently reflected in Viacom stock.

We also see the volatility in Activision [ATVI] creating an excellent opportunity to take advantage of the positive long-term growth fundamentals in the videogame business. As long as a company is subject to fundamental analysis and you can take a longer-term view, volatility – whether in chemicals, auto-parts or videogames – is often what makes something cheaper than it should be.

Are you finding things to buy in the distressed automotive sector?

MJ: One equity we own is in Magna International [MGA], which is a diversified parts and components supplier with a shareholder-friendly management. If U.S. original-equipment manufacturers like Magna succeed in radically restructuring their liabilities and gaining more flexibility with their workforces, we believe they have the market positions and product-development abilities to compete effectively with Japanese competitors. The changes necessary will be wrenching, but are part of a whole process of creative destruction that is inevitable.

ON GENERAL MOTORS:

GM is likely to restructure, in or out of bankruptcy. That being good for equity holders is not a bet we're prepared to make.

On the fixed-income side, we own a big position in Delphi Corp. bank debt, which is good ballast for a portfolio, earning 10% and very well secured. We also own different layers of General Motors and GMAC debt, but no equity. Even with their latest moves, GM is likely to have to restructure, in or out of bankruptcy. That may be good for equity holders, but that's not a bet we're currently prepared to make.

What lessons have you learned from some of your mistakes?

MJ: In general, checks and balances are important and my 28-year friendship and partnership with Josh Friedman provides the core of that balance.

Specifically, we spoke earlier about changes we made to our research process to more fully understand how a company's money flows through its financial statements.

While our multi-strategy approach works well for us, we've also learned that you can't always apply your experience in one asset class or sector to another. In 1998, we got hurt for the primary reason that we had started buying sovereign debt in emerging markets, believing we could judge credit quality in that type of debt similarly to how we analyzed corporate credit quality. When Russia defaulted and devalued at the same time, we took a fairly big mark-to-market hit.

We learned that we didn't have any competitive advantage in trying to judge how a country's economic policies, or even trustworthiness, would affect their ability to honor their obligations. Over time, emerging-country debt has been a great asset class in which to participate, but one where we've concluded we couldn't have an edge.

I want to come back briefly to the discussion we had on process earlier. We pay a lot of attention to dotting our i's and crossing our t's when it comes to the fundamentals of "safe, cheap and good" because we think it makes it easier to reframe things in new, flexible ways. One problem with value investors is that they can often become ideologues. But there's a big difference between focusing on the basics and being an ideologue. We've found that you have to constantly challenge your ways of thinking and re-educate yourself to remain successful as an investor.

Fortune magazine recently had an interesting article about how successful people work and one of the people they spoke with was Wynton Marsalis, the great jazz trumpeter. He said that if you want to be able to find a groove, you have to practice, practice, practice. You've got to know the scales and you've got to know the basics, if you want to improvise. VII

Investor Insight: Carlo Cannell

J. Carlo Cannell of Cannell Capital LLC explains where the market is least efficient, why he's leery of solicitous management, why loners make better money managers and – with analyst Jamil Tahir – why he thinks Ennis, Fundtech and Met-Pro are undervalued and why Sonic Solutions and Strayer Education are overpriced.

You ply areas of the market that many investors rarely see. Why?

Carlo Cannell: My central premise is that inefficient markets offer greater potential returns than efficient markets and that there is a large universe of companies for which there is imperfect distribution of information, which causes inefficiency. So we basically spend our time trying to uncover the promising turnarounds, dullards and assorted investment misfits in the market's underbrush that are largely neglected by the investment community.

There are more than 13,000 companies that have to file in some shape or form with the Securities & Exchange Commission. Most lack consistent research coverage, which we define as having three or fewer sell-side analysts publishing earnings estimates. There is no regular flow of information on these companies and our experience shows that this neglect results in a greater differential between market valuations and a company's true intrinsic value.

One of the key metrics we assign to our companies is an "analyst ratio," which is simply the number of analysts who follow a company. The lower the better – as of the end of last year, about 65% of the companies in our portfolio had virtually no analyst coverage.

How do you identify the most promising turnarounds, dullards and misfits?

CC: I wouldn't say our process is scientific, but it is automated. We start by screening for classic value. This could be a low price-to-net-assets ratio, a low premium or a discount to book value, a P/E ratio less than the return-on-equity ratio or, depending on the industry, a modest premium or a discount of the market value to revenues. We also have various screens that try to predict a build-up of cash. Companies that continually generate cash above and beyond their capital-expenditure requirements are hopefully going to do good things with that cash and shareholders should benefit.

Having an edge as an investor is a bit like having an edge as a radiologist or a mechanic or a pilot. The edge comes from being able see patterns and reliably diagnosing what they will mean. I'd like to think that the combination of inputs we use to correlate and predict is somewhat unique to us.

Give us some examples.

CC: In identifying potential short sales, for example, seeing decreasing inventory turns for a company audited by a non-"Big Six" accounting firm is an interesting correlation. You might draw some conclusions over an increase in the gap between cash flow from operations and net income combined with increasing analyst coverage of a company. We also look carefully at prepaid assets, which are generally not well scrutinized. Companies always say it's for insurance, or advertising, or spending on trade shows, but it's basically a slush fund and big changes in those assets tend to end in tears. That combined with slightly decreasing gross profit margins might be suggestive of a CFO trying to shield as many expenses from cost of goods as possible.

There are all sorts of balance sheet screens that produce interesting buying prospects, even if the income statement isn't looking so great. For example, we look for companies with improving working-capital cycles, generating increasing cash, with increasing inventory turns, decreasing receivables balances

J. Carlo Cannell

All in the Family

Although both his father and grandfather founded their own investment firms – his father, Peter B. Cannell & Co. and his grandfather, F. Eberstadt & Co. – Carlo Cannell wasn't particularly quick to pursue investing as a career. At Princeton, he abandoned his original intention to study classics and ended up with a degree in sociology in 1986. He spent time as a freelance journalist in Fiji and worked for two Japanese companies before an entrepreneurial stint – at a company using desktop publishing technology to produce musical scores – sparked an interest in pursuing graduate study in business.

Never the conformist, Cannell went to business school at Oxford's Templeton College, where, he says, he "dove into the investment process from a highly academic, theoretical standpoint." His work on market efficiency and where it tends to break down still forms the basis of the investing philosophy he uses today.

"I'm sure growing up around investing and the conversations you hear from the backseat of the car had some influence on my occupation," says Cannell, "even if that wasn't always obvious early on."

and that are tightening and cleansing prepaid assets.

Are the companies you invest in usually inexpensive because they're in trouble?

CC: You could presume that the modest prices are a result of their being somehow damaged – which is many times the case – but often it's just they're so neglected that nobody's picked up on them. We see those all the time.

We are always looking for areas of fear and panic. It could be an industry-wide problem – we all know industries go in and out of favor. Take telecom equipment, for example: pick a year and it's either very popular or it's not. It could be a scandal, such as over not filing financial statements.

With other companies, people just panic. It happened with Tyco and Kmart and Krispy Kreme. There are periods of inefficiency that come from fear about the future. We're not timid in taking positions in those companies during those moments based on somewhat reliable historical information. The media actually does a very good job of temporarily destroying the valuation of certain enterprises. Ace Greenberg [the long-time CEO of Bear Stearns] once told me that the media's maligning of otherwise good businesses was the #1 source of wealth-creation for him by creating great buying opportunities.

How important is a company's growth potential?

CC: Very. In our experience, it's revenue and earnings momentum that catapults a stock out of the swamp. Regardless of how neglected a security may initially be, it's really growth that is the most predictable precursor to an increase in the stock price – and to an increase in attention from the market.

So once we've done all the quantitative work, we need to start making assumptions about the future based on imperfect information, which requires good, basic fundamental analysis. We hired a reporter who used to cover the West Coast for CNBC, and all he does is go out to Targets and visit Best Buys and things like that. We subscribe to trade journals like those for oil and gas drillers and for the funeral industry.

We're looking for elements of positive change – fresh management blood, a changing market, a changing regulatory environment, a shift in competition – that suggests a future characterized by reliable and increasing earnings. We have to be predictors of growth to be able to buy at bargain prices.

ON GROWING COMPANIES:

There can be considerable opportunity as the perception of value pivots from the balance sheet to the income statement.

That said, when we believe in a company's growth prospects, we're willing to buy at a bit higher price than other value investors. We're often adding to our positions from the sell tickets of more traditional value investors. We find in growing companies that there can be considerable opportunity as the perception of value pivots from the balance sheet to the income statement. A lot of value investors drop out as that is happening, while the growth investors are slow to pile on until the growth is more obvious.

What do you look for in the management of companies you own?

CC: We favor companies that are lean and managed by people who have substantial equity positions. We look for certain behavior patterns in management that are consistent with an efficient and prudent guardianship of our assets. If we visit a fan manufacturer in Texas and the CEO meets us at the airport in his Lexus, spends five hours with us and then takes us out to an expensive restaurant and buys $300 bottles of wine, that is suggestive of somebody who isn't as prudent as we would like.

On the other hand, if we go to a company and see that they only painted the front of their building to save on paint, that the CEO's office is right off the factory floor and that he makes us buy him lunch, which consists of a bologna sandwich out of vending machine, that is suggestive of a more prudent steward of our assets.

We try to meet management of all the companies we own, but I must say that over the years I've become more skeptical and less believing of people. I don't really want to know or like these people any more than I need to. We generally think it's more interesting to talk to industry salespeople, ex-salespeople and customers of the company's products to truly understand what's going on.

Is your portfolio very concentrated?

CC: Not as much as I'd like. I'd ideally prefer to have 20 long positions representing 100-120% of assets, along with a more diversified 50 to 60 short positions representing 50% of the book. The neglect characteristic of what we own is often synonymous with lack of liquidity, so we're usually forced to have two to three times the number of long positions we'd want.

How long do you tend to hold positions?

CC: Our average turnover can vary considerably from year to year. I do have an aversion – perhaps to an unhealthy degree – to taxation, so as the largest investor in our funds, I prefer the holding period for both shorts and longs to be forever. As a Californian I suffer from multiple layers of taxation, so I focus on strategies that are tax-efficient and capitalize on the enormous advantage of long-term capital gains and dividends.

Do you hold cash when bargains are scarce?

CC: Generally speaking, no. Our investors are not paying us to hold cash. I've never not found places to invest.

We've given money back to investors in recent years because we think the time to do that is before you actually have a problem finding places to invest. That's much better then when you actually do have a problem finding places to invest and you're going to have a bad year. The time to pull the pitcher off the mound is when you think he might be about to have a problem.

Are there industry sectors in which you've had particular success?

CC: I have no emotional attachment to any business or sector we invest in. We do all gravitate to our preferred habitats. I'm comfortable with oil and gas and related energy assets and services, for example, because it's an inevitable business, with enormous leverage in the operating economics. I also tend to appreciate the practitioners in this industry, who often have an independent streak I like.

We also like general services businesses with great niches. Things like Roto-Rooter or Midas or uniform-cleaning businesses – niche businesses which are well managed and have above-average economic characteristics. These types of businesses tend to have strong brands and a competitive moat, with pricing power, scalability and a lower cost of capital.

We also tend to own a lot of general manufacturing businesses – gasket companies, printing equipment, whatever. These are businesses that can generate great growth because they're operating in areas they know best and are making enough money to reinvest consistently in growth.

So the duller the better?

CC: We're not specifically looking for dull companies, but because we're looking to buy companies' balance sheets and growth prospects at a reasonable price, this often involves fairly dull companies with products that don't necessarily capture the public imagination.

A perfect lead-in to your first pick, Ennis, Inc. [EBF]

CC: Ennis is a company we've owned at different times over the past five years, with what we think is competent, disciplined and honest management. Only two analysts, from small firms, follow the company. Management doesn't do quarterly conference calls, they don't do promotional roadshows and they don't ever report financial results on a pro-forma basis, after restructuring charges. We like that.

Their traditional business is selling printed business forms and promotional products through wholesale distributors, which compete with direct sellers like Standard Register and Moore Wallace. Ennis also made a company-changing acquisition in 2004 of Alstyle Apparel, which makes t-shirts for corporate events and other quick-turnaround needs. The print business is about 55% of sales and t-shirts are 45%.

Is this a milking-the-declining-cash-cow play?

Jamil Tahir: Because they're one of the largest indirect sellers of forms, they've been able to more than offset the slow,

INVESTMENT SNAPSHOT

Ennis, Inc.
(NYSE: EBF)

Business: Manufacture and sale of printed business forms, marketing-related materials and promotional apparel to wholesale distributors in North America.

Share Information (@ 3/30/06):

Price	**19.39**
52-Week Range	14.11 – 20.33
Dividend Yield	3.3%
Market Cap	$493.8 million

Financials (TTM):

Revenue	$563.4 million
Operating Profit Margin	12.5%
Net Profit Margin	6.8%

Valuation Metrics
(Current Price vs. TTM):

	EBF	S&P 500
P/E	13.4	21.4
P/CF	13.7	14.9

Largest Institutional Owners
(@12/31/05):

Company	% Owned
Cannell Capital	7.7%
Barclays Global Inv	5.5%
Royce & Assoc	5.2%
Allianz Global Inv	3.5%
Killen Group	2.5%

Short Interest (@ 3/8/06):

Shares Short/Float	4.6%

THE BOTTOM LINE

By offsetting the decline in its business-forms business with market-share gains and accretive diversifying acquisitions, Carlo Cannell expects a level of revenue and profit growth for EBF that he feels is undervalued by the market. At 8x estimated EBITDA levels within two to three years, he believes the stock is worth up to $30 per share.

Sources: Company reports, other publicly available information

steady unit-volume decline of 2% or so in their traditional business by taking market share and making accretive acquisitions. They're very disciplined about acquisitions and won't pay more than 3x EBITDA for a business-forms company. With their scale advantages, they often end up paying only 2x EBITDA. Even with that, they're the buyer of choice for mom-and-pop companies exiting the business. Families often don't like to sell to private-equity firms that are just going to fire half the people right away. So they sell to Ennis and know it's going to be run fairly and not just to be flipped in a couple of years.

Why the t-shirt company acquisition?

JT: The company has always expanded what they produce in response to their distributors changing product lines. When the distributors started getting into promotional printing, like producing displays for supermarkets, Ennis got into that business. While it seemed a bit odd at first – and the share price suffered after the acquisition was announced – manufacturing printed t-shirts for promotional purposes is just an extension of that business.

The acquisition ended up integrating well and they've executed exactly as they said they would. The market was originally concerned about Chinese competition, but the reality is that these types of t-shirts have very low labor content and overseas manufacturers can't meet the quick turn-around times.

With the stock trading around $19.40, how are you thinking about valuation?

JT: This is a case where we're not really counting on growth in order to make money. With modest growth they'll have $600 million in revenues within a couple of years. We believe they'll maintain the 15% EBITDA margins that they've had for 15 years, so should be earning $90 million in EBITDA by then.

They're also paying down debt, and could be debt free within the next two to three years. If you put a reasonable 8x multiple on that estimated $90 million in EBITDA, we're targeting a share price of close to $30. They pay a 3.3% dividend, so you're getting paid to wait for the value to be realized.

Moving from t-shirts to software, tell us about Fundtech [FNDT].

CC: Fundtech sells payment software and other cash-transfer software that enables financial institutions to receive, process and track the flow of electronic funds. HSBC and Citigroup are among their largest customers.

The company was a high flyer in the late 1990's, with the stock going as high as $40. But they had some management issues and, as the Internet boom faded, the company was almost completely neglected by Wall Street. I remember one technology investment bank had an aggressive buy out on it at around $40 and then giving it a sell recommendation at $5. That is typical of the companies to which we gravitate.

We generally love the leverage and proprietary nature of transaction-processing-type businesses, which is one of my favorite subsets in high tech. Companies like State Street, Automatic Data Processing and SS&C Technologies

INVESTMENT SNAPSHOT

Fundtech Ltd.
(Nasdaq: FNDT)

Business: Provider to financial institutions of software solutions and services that facilitate electronic cash transfer and payment processing in the U.S. and Europe.

Share Information (@ 3/30/06):

Price	**11.71**
52-Week Range	9.23 – 12.20
Dividend Yield	0.0%
Market Cap	$175.1 million

Financials (TTM):

Revenue	$74.5 million
Operating Profit Margin	5.9%
Net Profit Margin	5.8%

Valuation Metrics
(Current Price vs. TTM):

	FNDT	S&P 500
P/E	42.6	21.4
P/CF	22.4	14.9

Largest Institutional Owners
(@12/31/05):

Company	% Owned
Cannell Capital	14.6%
Fidelity Mgmt & Res	10.1%
Federated Inv	2.9%
Sterling Johnston Capital Mgmt	2.3%
Royce & Assoc	1.3%

Short Interest (@ 3/8/06):

Shares Short/Float	0.2%

FNDT PRICE HISTORY

THE BOTTOM LINE

Because it's well positioned in small, but rapidly growing markets for electronic-payment and security-clearance software, Carlo Cannell expects the company to attract acquirors as it grows. At valuations at which comparable companies have traded hands, he believes the shares are worth 2-3x their current level of $11.70.

Sources: Company reports, other publicly available information

are just great businesses.

The market for Fundtech's type of payment technology isn't currently that large, maybe only $150 million, but it's growing 15-20% per year and is not yet attracting a lot of competitors. One of the plays here is that I believe when this market gets to be a $250-$300 million category, it's more than likely a larger player will buy this company.

What is Fundtech doing well?

CC: Their products generally get the best reviews in this segment and we've gotten great reference checks from their customers. We also like that they've made accretive acquisitions to broaden their product line beyond bank payments into securities clearance. With the growth of securities exchanges around the world, there will be a greater need for multinational security-clearance software, from which Fundtech stands to benefit considerably.

The company is solidly profitable, generating cash and adding to book value. We think they'll maintain their linear growth in earnings – 33 cents per share in 2004, 44 cents in 2005, an estimated 57 cents this year and 70 cents next year. If they do that, that's the type of growth that will attract a more growth-oriented shareholder base.

How is the market's current neglect showing up in the share price, now $11.70?

CC: The market cap is about $175 million and the company has approximately $50 million in cash, so the enterprise value is $125 million. That's only 1.25x the $100 million in annual revenues we believe they'll reach in the next 12-18 months. That's inexpensive given that high-margin financial-processing companies like this are generally bought out at enterprise values of no less than 2.5x revenues, up to 4x revenues.

As I said earlier, there's a good chance they won't get to $100 million in sales before they get bought. Given the third-party demand I think there will be to own this franchise, we believe the shares are likely worth 2-3x the price at which they're currently trading.

Tell us about another niche business you're high on, Met-Pro Corp. [MPR]

JT: Met-Pro makes a variety of pumps, filters and compounds used to remove contaminants in industrial manufacturing processes and water treatment. The company has been around for 40 years and we generally find that small companies like this with long histories can be great investments. They're experts in their businesses and have a proven ability to weather different economic cycles. This company has paid a dividend for 30 years.

Though we don't usually focus on macro analysis, we generally think the market for water treatment and "green" technology has a bright future and should grow faster than GDP. There's plenty of money from the government going into improving water systems and water quality and replacing aging infrastructure. To capitalize on these trends, there have been several acquisitions in the water treatment and fluid-handling markets. Companies like Met-Pro are well positioned to benefit from all this.

INVESTMENT SNAPSHOT

Met-Pro Corp.
(NYSE: MPR)

Business: Manufacture and sale of product-recovery, pollution-control and fluid-handling equipment to industrial and governmental users worldwide.

Share Information
(@ 3/30/06):

Price	**13.20**
52-Week Range	9.69 – 13.83
Dividend Yield	2.0%
Market Cap	$147.8 million

Financials (TTM):

Revenue	$85.1 million
Operating Profit Margin	11.4%
Net Profit Margin	8.6%

Valuation Metrics
(Current Price vs. TTM):

	MPR	S&P 500
P/E	19.9	21.4
P/CF	16.5	14.9

Largest Institutional Owners
(@12/31/05):

Company	% Owned
Royce & Assoc	12.2%
Emerald Adv	3.8%
Heartland Adv	3.6%
Babson Cap Mgmt	3.3%
Deprince, Race & Zollo	3.0%

Short Interest (@ 3/8/06):

Shares Short/Float	0.1%

THE BOTTOM LINE

Cannell Capital's Jamil Tahir says the market is undervaluing the double-digit annual revenue and profit growth he expects for the company, as it capitalizes on established positions in attractive markets for water treatment and other "green" technology. A more appropriate 2x EV-to-revenue multiple would make the shares worth $20, he says.

Sources: Company reports, other publicly available information

The shares, currently at $13.20, are up 28% in the past year. Has the market caught on to Met-Pro's growth potential?

JT: The pollution-control business, which is about 60% of total sales, has grown 25% over the past year, while fluid-handling revenue was up 7%. The operating leverage is good, so earnings grew nearly 50%.

We believe Met-Pro can grow their revenues at double-digit rates and continue to manage to consistent profitability. We don't think the market has adjusted to a higher growth profile for the company and, when it does, an enterprise value-to-revenue multiple of 2x is likely. That would translate into a share price of $20.

Do you see much downside risk?

JT: Though it might be a less attractive result, ongoing industry consolidation should provide strong protection against downside here. If Met-Pro doesn't grow as quickly as we expect, we could imagine it selling to a bigger company – among public companies, it might fit into the strategy of a larger competitor like Flowserve or ITT Industries. Based on the multiples of previous transactions, we don't believe even a slow-growing Met-Pro would sell for less than $15 per share.

Before we discuss some specific short ideas, explain why you short as actively as you do?

CC: We short because I think it is the most prudent way to manage a portfolio, from a risk perspective, and because I believe the key to successful long-term investing is to never have losses.

We also short because in certain subsections of the market it's easier than buying stocks. There are always classes of companies that are dying. If you really track the mortality rates of companies, you'd conclude that the market does not have the upward bias everyone thinks it does. The market is actually a carefully pruned garden.

Look at the restaurant industry, for example, which is characterized by a high rate of mortality. This gives short sellers a potential edge: you can short the weakest members of the group knowing the wind is at your back. It's just a fact that almost all restaurants that come public go out of business. If you opened randomly a *Fortune* magazine from 1947, or 1973, and read any stories about restaurants that were hot growth companies, it would make you laugh – in hindsight it seems so clear why they didn't make it.

ON SHORTING:

It's much easier to short a public chain of karate schools or a backrub company than to try to figure out if Intel is overvalued..

Are you generally looking for potentially terminal cases?

CC: We much prefer those, where we see big accounting shenanigans, incompetent or deceptive management or bogus products. But we do also look at excessive valuations, where we believe the market's enthusiasm is short-lived.

I remember a company called All-Pro Products, which sold some sort of beverage drink out of New Jersey and had a connection to Lawrence Taylor, the former linebacker for the New York Giants. It had in excess of a $100 million market cap but you couldn't find the product, the receivables were growing and the inventory was out of control. I called the company and Lawrence Taylor's mom would pick up the phone from a location that appeared to be a residence. Of course it ended up going out of business.

Those are the types of things that are the easiest to profit from – much easier than trying to figure out if a company like Intel is overvalued at the moment or not. It's just so much easier to short a public chain of karate schools or a public backrub company.

What's your bet on the downside for Sonic Solutions [SNIC]?

CC: Sonic makes software to edit and burn CDs and DVDs. The existing business is very competitive, and we believe that ultimately the economics of DVD authoring software are likely to follow the economics of audio authoring software, such as RealNetworks' RealPlayer and Nullsoft's Winamp, now widely available for free.

There's also a good argument to be made that CDs and DVDs as a storage medium of choice, like 5.25" and 3.5" floppy disks before them, may have peaked relative to alternatives such as Flash memory, hard disk drives and hosted services like Yahoo's Music Unlimited.

So you see their main product going the way of the buggy whip?

JT: Basically, yes, or at the very least given away or bundled for free.

Usually in our short positions people are so excited about the company that it's priced for perfection. With the explosion of digital music and the burning of CDs and DVDs, Sonic's software became extremely popular. But that was last year. Now if you have an iPod, you're probably not burning much. You're certainly not going to spend a lot of money on upgraded versions of Sonic's products.

When companies are priced for perfection, if anything goes wrong – let alone if your actual thesis happens – you'll make good money on the short side.

Trading at around $18, how priced for perfection is Sonic?

JT: The current market cap is $456 million and the enterprise value is 3x revenue. But enterprise software companies that may have a lot of cash but aren't growing tend to trade closer to 1x revenue, which we don't think is an unreasonable multiple expectation for Sonic

over the next year or two. Even if a strategic buyer came along, based on comparable deals, we wouldn't expect a price higher than $8 per share.

The risk in bets like this is that they come up with something entirely new to offset a decline in their core business. But in this case we think the risk of their doing that against the reward if they don't is in our favor.

Over 25% of Sonic's public float is sold short. Is that a positive or negative?

JT: When so many people are agreeing with us on the short side, the shares can sometimes be more volatile because many of the people that are short may not hold the same level of conviction in the position that we do. But over time, if revenue and profits stop growing, it doesn't matter at all how high the short ratio is, the stock is going to go down.

Why do you think Strayer Education [STRA] shares are ahead of themselves?

JT: The macro story for for-profit higher-education providers like Strayer makes a lot of sense and investors have made a lot of money on these companies over time. But the shares of many of these companies – though not Strayer – have taken big hits in the past year or two because of the high number of investigations into things like overstated graduation rates, education-loan cheating and the filing of misleading financial statements.

So are you expecting Strayer to be next in that regard?

JT: No. The short case has more to do with what's happening to their business.

So far the company been kind of a niche player, with fewer than 40 campuses, which has insulated them somewhat from competition. But two things are happening that are starting to impact their growth potential. First, as competitors have expanded, the overlap with Strayer's campus base has increased considerably. Something like 60% of Strayer's existing campuses now compete with nearby campuses of the much bigger Apollo, which itself is under stress to grow. That's going to impact organic growth and put pressure on existing margins.

What's also happening is that the whole market for these types of educational services continues to move online, where Strayer has to compete with everyone else in the space, most of whom have much better known brands than it does. Online is clearly less like a local business and is going to be more competitive. We've already seen this hurt Apollo for more than a year now, as they've had to spend so much on marketing to get enrollment growth online. If all the companies are spending more to market, that's going to incrementally hurt the lesser-known players like Strayer.

Has Strayer missed its numbers?

JT: They did have a miss a year ago and the stock went from $103 to $84 in a day. But even though they've continued to miss enrollment and revenue numbers, the stock today is still back over $100 and trading at a 31x P/E on a trailing basis and 6.6x revenue.

INVESTMENT SNAPSHOT

Sonic Solutions
(Nasdaq: SNIC)

Business: Supplier of DVD-creation software sold through retailers, online and bundled with other devices for professional, industrial and consumer applications.

Share Information
(@ 3/30/06):

Price	**18.02**
52-Week Range	13.70 – 22.02
Dividend Yield	0.0%
Market Cap	$456.6 million

Financials (TTM):

Revenue	$143.8 million
Operating Profit Margin	12.7%
Net Profit Margin	12.9%

Valuation Metrics
(Current Price vs. TTM):

	SNIC	S&P 500
P/E	26.7	21.4
P/CF	18.5	14.9

Largest Institutional Owners
(@12/31/05):

Company	% Owned
Mazama Capital Mgmt	8.6%
Munder Capital Mgmt	7.7%
Earnest Partners	6.0%
Pioneer Inv Mgmt	5.0%
Barclays Global Inv	4.0%

Short Interest (@ 3/8/06):

Shares Short/Float	25.3%

THE BOTTOM LINE

Hard times await the shares of this maker of DVD-creation software, say Carlo Cannell and Jamil Tahir, as alternative storage technologies and pricing pressures dampen unrealistic growth prospects. At multiples more appropriate to the growth profile they expect, they believe the shares are worth no more than $8 per share, vs. $18 today.

Sources: Company reports, other publicly available information

So while the company has exhibited some stress, the share price hasn't?

JT: Yes. They haven't had a clean quarter for more than a year. Meanwhile, Apollo keeps missing also, which tells you there's competitive pressure in the industry. We don't know when all the misses will eventually result in another drop like last time, but we're fairly confident it's going to happen.

We assume you don't expect this to be terminal?

JT: No. But when the growth rate for a growth company starts slowing it's very hard to turn around. From a risk-reward standpoint, we can't see this getting a lot more expensive.

If you believe Strayer can earn $3.40 per share this year, which is what the consensus estimate is, we think a more reasonable multiple given their actual growth rate is 15-20x earnings. It's always possible that when it blows up, the market will decide it's willing to pay 15x 2009 earnings, or something like that, so the shares won't go below $70. We'd still have a very nice gain on our short if that happened, but we'd reevaluate when it did.

INVESTMENT SNAPSHOT

Strayer Education
(Nasdaq: STRA)

Business: For-profit provider of post-secondary educational services to more than 27,000 students at 39 campuses, primarily in the eastern U.S., and online.

Share Information
(@ 3/30/06):

Price	**102.21**
52-Week Range	77.24 – 115.21
Dividend Yield	1.0%
Market Cap	$1.46 billion

Financials (TTM):

Revenue	$220.5 million
Operating Profit Margin	33.9%
Net Profit Margin	21.8%

Valuation Metrics
(Current Price vs. TTM):

	STRA	S&P 500
P/E	31.0	21.4
P/CF	27.2	14.9

Largest Institutional Owners
(@12/31/05):

Company	% Owned
Morgan Stanley	14.8%
Bamco	10.1%
Axa	8.1%
Massachusetts Fin Serv	6.6%
Wasatch Adv	6.5%

Short Interest (@ 3/8/06):

Shares Short/Float	17.7%

STRA PRICE HISTORY

THE BOTTOM LINE

With company shares trading at 31x trailing earnings and 6.6x revenue, the market is missing building competitive pressures in both offline and online markets, says Jamil Tahir. As the market adjusts to the slower and less profitable growth he expects, he believes the shares will fall at least 30% from today's price of $102.

Sources: Company reports, other publicly available information

Tell us about a recent investment mistake you've made.

CC: We last year made a big bet on PX Reinsurance, a Bermuda-based retrocession and reinsurance underwriter. We bought it after the valuation was dramatically reduced following the disclosure of greater-than-anticipated losses from hurricane damage last fall. Generally speaking, when you have a series of disasters it hardens up the reinsurance markets so that those who remain generally benefit from what becomes a more attractive pricing environment. It's the perfect contrarian opportunity.

The problem was that the company kept revising upward their damage estimates, which indicated a level of either cluelessness or incompetence that the market wanted nothing to do with. I think the fact that we didn't have a lot of experience with the industry led us to trust management more than we should have. I've also concluded that reinsurance is more of a commodity business, where it's very difficult to maintain an edge, than I originally thought.

What's gone wrong with your activist investment in money manager BKF Capital [BKF], which you bought between $30 and $40 and has fallen to around $13?

CC: This has clearly been an unsuccessful investment. We chose to be activist in going after both the board and management out of a belief that the poor financial returns of the company were almost exclusively a result of poor management and relatively easy to fix.

I did not anticipate the emotion of management's response. I underestimated the extent to which the CEO, John Levin, was concerned about his place in New York society versus acting to the benefit of shareholders. I believe he used a lot of shareholder funds to fight an indefensible, losing battle just to protect his image. Then after he was removed as CEO, he sold a lot of his stock in a sloppy fashion, which is a big reason the share price is down.

Haven't assets under management also taken a hit as some of the lead portfolio managers left?

CC: Assets are down, but some wildly overpaid cancers have been removed. The company is now more stable than it was two years ago, and I expect it to start generating cash flow again this year for the first time in a very long time.

So you're still optimistic?

CC: We haven't given up on it and still believe the right stewardship can create an enormous amount of cash flow. Imagine you bought this business – with $4 billion under management – and paid $40 million, which is the current enterprise value. Say through good performance you can increase the level of assets to $5 billion. Then say the alternative-asset funds – which make up 20% of assets – have an okay year, with a 15% return. Those funds have a 20% carry and a 2% management fee. If you run the math, apply a 40% pretax return and use 7.5 million shares as the denominator, you're going to come up with per share earnings of $3, $4 or even $5 – and the stock's at $13. You're making some assumptions obviously, but not ridiculous ones.

If you compare BKF against its publicly-traded peers, it's not like there's a little arbitrage – the comparison of valuations on some normalized basis are so far apart it's mind numbing.

You've said that the best fund managers are often "loners and misfits." Why is that?

CC: If you subscribe to the thesis – as I do – that the greatest amount of money is made from having great confidence in contrarian positions, I think you'd find the people who are comfortable taking these positions don't tend to fit in with the mainstream. Think of the ridicule you would have suffered seven years ago if you had suggested selling short DrKoop.com and aggressively buying Arch Coal. But the DrKoop.com short would have earned 100% and Arch Coal is up something like *15 times*.

Going against the grain is clearly not for everyone – and it doesn't tend to help you in your social life – but to make the really large money in investing, you have to have the guts to make the bets that everyone else is afraid to make.

You took a sabbatical in 2004. Why?

CC: I decided in February 2004 to take time off to spend more time with my wife and kids – and that's what I did. I went fishing, went to Bermuda, went diving and just did a lot of thinking. I don't share the obsession of some of my money-manager colleagues with how the person with the most gold when they die wins. I don't find it necessary to live in a $45 million apartment. My scorecard is different.

My sabbatical was rewarding and very healthy. But in the fall, I missed the business and the business was not doing as well as I'd anticipated, so I decided it was too much value just to throw away and I came back. It's made me a better investor. My skin is thicker now and I'm more focused than I've ever been. VII

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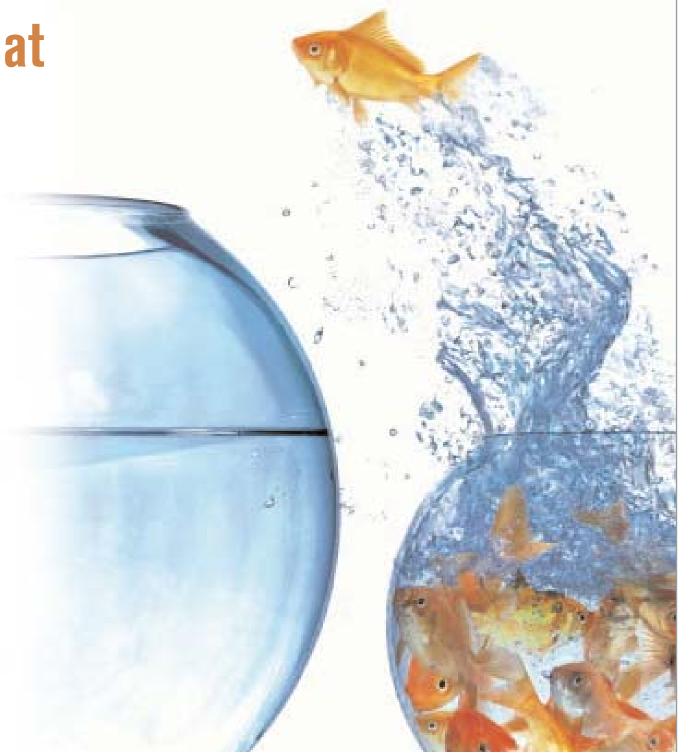

To Find Value, Know Where to Look

As Albert Einstein once said, the best source of knowledge is experience. Here are the 18 types of stocks on which I've made money in my experience as an investor. ***By Whitney Tilson***

While history never repeats itself exactly, it sure does rhyme, so gaining experience – both in identifying opportunities and avoiding traps – is critical to investing success. This is a lifelong process. Even Warren Buffett and Charlie Munger, after more than half a century of knocking the ball out of the park, aren't resting on their laurels. They're still reading voraciously, learning from their mistakes and expanding their circle of competence.

One of the key benefits of experience is the ability to quickly recognize and categorize an investment opportunity. Being able to do so is extremely valuable in finding new investment opportunities, analyzing them quickly and accurately, understanding potential pitfalls and building a properly diversified portfolio.

In preparation for the seminar I taught on "Becoming a Better Value Investor" before last November's Value Investing Congress, I went through every investment I'd made in my career and grouped them into categories. I was stunned to find that I'd made money in eighteen different types of stocks, and lost (or almost lost) money in ten different ways.

I'll discuss the traps in a later column, but here are the eighteen types of value opportunities I've exploited so far:

1. Out-of-favor blue chips. Even the world's greatest companies encounter problems or otherwise fall out of favor. Correctly differentiating between those suffering temporary rather than permanent issues is the key to success here. McDonald's a few years ago, when it fell below $13 thanks mainly to management missteps, was a classic out-of-favor blue chip. Examples we own today – though not as cheap or out-of-favor – are Wal-Mart, Microsoft and Anheuser-Busch.

2. Out-of-favor cyclicals. Success here usually involves correctly anticipating when a cyclical industry will rebound. A good example that we owned until recently is Universal Stainless & Alloy Products, a niche steel manufacturer whose stock is up nearly five-fold from its 2002 lows.

3. Distressed industries. Buying a good company in a distressed industry is often a great way to make money. Warren Buffett buying Clayton Homes is a good historical example and today I believe Lear Corp., a leading maker of automobile seats and interiors, will prove to be as well. We own Lear because we believe it's actually a decent business that will survive the industry's currrent distress and that the stock is a good bet to double from its current price of around $18 per share.

4. Turnarounds. Here one is typically betting on reversion to the mean. Lear might also be grouped into this category, but a better example is CKE Restaurants, which hit a low of almost $3 three years ago thanks to Hardee's dreadful performance. But the new Thickburger menu triggered a spectacular turnaround and the stock, which we still own, has soared to today's level of $17.

5. Overlooked small-caps. Among the thousands of publicly traded U.S. stocks that have no analyst coverage are fine businesses that are cheap because no one is paying attention to them or the stocks are thinly traded. A good example is Weyco Group, the maker of Florsheim Shoes. It's a well-managed business that we invested in a few years ago after the company announced an exceptionally good acquisition. The stock has doubled, but so have earnings, so we continue to hold it.

6. Fallen growth angels. When growth companies stumble the growth and momentum junkies often sell indiscriminately, which can be a great opportunity for value investors if – and this is a big if – the high growth resumes or the stock falls so much that it's a bargain even at lower growth levels. For example, Robert Half International grew 40% annually for most of the 1990s, but the stock collapsed by two-thirds when growth slowed markedly from mid-1998 through late 1999. It remained an outstanding business, however, and the stock was a bargain, so we bought it and doubled our money in a year.

7. Growth at a Reasonable Price (GARP). These are also high-quality growth businesses, but unlike fallen angels, the stocks haven't fallen. They may not appear cheap on traditional valuation metrics, but the stocks can be excellent investments if the high growth can be maintained. Starbucks over the years is a great example.

8. Activism. This is a hot area these days, and one doesn't have to be an activist to participate. There are numerous examples, such as Wendy's (which we still own), in which great money can be made by understanding whether there's opportunity for genuine value creation via a recapitalization, spin-off, better capital allocation, management change, etc., analyzing the support for change that exists and, if the situation is favorable, investing alongside the activist.

9. Spin-offs. Joel Greenblatt covers this area well in his brilliant first book, *You Can Be A Stock Market Genius*, in which he explains why many significant stock-price inefficiencies can occur when a company is spun off. A good recent example is Freescale Semiconductor – recommended by Greenlight Capital's David Einhorn in the March 23, 2005 issue of *VII* – whose shares have doubled since its spin-off by Motorola in mid-2004.

10. Post-bankruptcies. Like spin-offs, there are many reasons why companies emerging from bankruptcy can be inefficiently priced. A good example today is footwear retailer Footstar, which we bought in bankruptcy and continue to own now that it's emerged.

11. Stubs. Stubs typically occur when a public company owns a significant stake in a subsidiary that is also public. When the value of the subsidiary – especially when it's absurdly overvalued – is not reflected in the share price of the parent company, an

investor can reap big gains by going long the parent and shorting out the subsidiary. A successful example for us was going long technology direct marketer PC Mall and shorting its publicly owned Internet subsidiary, eCost, which we highlighted in the May 22, 2005 issue of *VII*.

12. Let someone else do the investing. It can pay to let others do the investing for you – if you can invest with them at a reasonable price. The best example over time has been to buy Berkshire Hathaway (which we own), but other examples include Leucadia National, Alleghany Corp. and White Mountains Insurance.

13. Net-nets. These are traditional Ben Graham and Walter Schloss "cigar-butt" investments – companies trading at a discount to the value of their current assets minus all liabilities. These are few and far between today, but we've made a decent profit over the past few years owning one net-net, golf apparel company Sport Haley.

14. Stocks at a discount to cash. These stocks are even cheaper than net-nets: they trade at less than cash on hand minus all liabilities, but are usually severely cash flow negative. We bought busted dot-coms in this category such as TheStreet.com and Register.com in late 2002. Remarkably, Register.com was even generating positive cash flow!

15. Free/mispriced option. In these situations, an investor gets a potentially valuable option for almost nothing. One example a few years ago was Apple Computer, which traded at only a slight premium to its cash and wasn't losing money, so an investor was paying almost nothing for the possibility that Apple might develop a hit product or otherwise get its house in order. Driven by Apple's spectacular hit with the iPod, the stock is up eight-fold in the past three years.

16. Declining cash cow. At the right price – and if management wisely milks the business and allocates capital – the stock of a declining business can be a great investment. Deluxe, the leading check printer many had considered destined for quick obsolescence, was a good example from late 2000 through early 2002, when its stock price more than tripled.

17. Oddball companies. Some companies have economic characteristics that are very different from the typical company in their industry, resulting in analysts and investors initially misunderstanding them and mispricing the stock. Classic examples are Southwest Airlines, Dell Computer and Kinder Morgan, all of which came to be industry leaders only after a period of skepticism and misreading of their future prospects.

18. Discount to the sum of the parts. Many companies lend themselves to valuing their different pieces and can be a great buy if the whole is trading at a sufficient discount to the pieces – especially if a break-up is likely. We own Tyco today based on this thesis.

This is by no means a definitive list of the ways to skin the value cat. My goal is for this list, and the examples on it, to grow as quickly as possible. The alternative isn't pretty. As Charlie Munger likes to say, "If you don't keep learning, other people will pass you by." VII

Whitney Tilson's next pre-Congress seminar is May 9th in Los Angeles – for more information, see www.ValueInvestingCongress.com.

Funds managed by Whitney Tilson have long positions in the following stocks: McDonald's, Wal-Mart, Microsoft, Anheuser-Busch, Lear, CKE Restaurants, Weyco Group, Wendy's, Footstar, PC Mall, Berkshire Hathaway, Sport Haley and Tyco.

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Castle in the Sand

Oil-company giants are spending billions to capitalize on the vast oil reserves in the sands of northern Canada. So why might little-known Western Oil Sands be this sector's most attractive investment opportunity?

It's not surprising the world's largest oil companies have committed $70 billion over the next decade to tap the estimated 170 billion barrels of oil residing in vast sand deposits of Northern Canada. Oil prices are 2 1/2 times their level of five years ago, marginal recovery costs at more traditional fields have risen sharply and nearly all oil companies are producing reserves faster than they replace them.

For all the attention oil-sands development has received, Alex Rubalcava of Rubalcava Capital Management believes the market isn't giving the few pure-play companies in the sector their due. "Oil-sands companies are still misunderstood and misvalued by the market," he says.

Rubalcava's primary case in point: Western Oil Sands Inc. [WTO], a 20% partner, with Shell and Chevron, in the Athabasca Oil Sands Project in northeast Alberta. The project is fully operational, highly profitable and on track to double Western's share of production to nearly 60,000 barrels per day by 2010.

Yet based on Western's enterprise value per barrel of total reserves – the most appropriate measure, Rubalcava argues, because the reserves so dwarf current levels of production – the company trades at a significant discount to traditional exploration and production firms. WTO's enterprise value of US$2.73 per barrel of total reserves is less than one-third the level of Plains Exploration (US$9.42/barrel) and Anadarko Petroleum (US$10.82/barrel). Even oil-sands competitor Canadian Oil Sands Trust, with comparable reserves adjacent to Western's, trades at a sharply higher EV of US$4.58 per barrel.

It is more expensive to extract and upgrade oil from oil sands – roughly $25 per barrel versus half that for traditional fields – but the cost differential diminishes due to traditional oil companies' much higher expenses for exploration, depletion and amortization. Oil sands companies, with no exploration risk and minimal depletion of reserves, can largely avoid such added expenses.

Rubalcava also thinks the market has not recognized the profit potential of established oil-sands operations. Experienced operators Suncor Energy and Canadian Oil Sands earned 20% returns on capital in 2005, a level he believes Western should match as it grows. "Every established oil-sands company is profitable at $30-per-barrel oil," he says.

Two-thirds of Western's production through 2009 is hedged – to sell at per-barrel prices between $50 and $90 – mitigating the risk of a fall in oil prices. Western is also less susceptible to rising production costs – "In Fort McMurray, you've got 22-year-olds with high school educations driving trucks for C$100,000 per year," Rubalcava says – because its oil is piped to upgrading facilities in lower-cost Edmonton.

It may take some time for valuations between traditional and oil-sands companies to converge, says Rubalcava. In the meantime, he sees no reason for Western to trade at a discount to companies such as Canadian Oil Sands. At that company's enterprise value per barrel of reserves, Western's shares would trade at C$56, 70% over today's price. VII

INVESTMENT SNAPSHOT

Western Oil Sands
(Toronto: WTO)

Business: Owns undivided 20% interest in Athabasca Oil Sands Project in Alberta, Canada. Project partners are Shell Canada (60%) and Chevron Canada (20%).

Share Information
(@3/30/06, Exchange Rate: $1 = C$1.1609):

Price	**C$32.81 ($28.26)**
52-Week Range	C$17.34 – C$38.90
Dividend Yield	0.0%
Market Cap	C$5.3 billion ($4.5 billion)

Financials (TTM):

Revenue	C$910 million ($784 million)
Operating Profit Margin	30.8%
Net Profit Margin	16.3%

Valuation Metrics
(Current Price vs. TTM):

	WTO	S&P/TSX
P/E	36.0	21.7

THE BOTTOM LINE

The market's undervaluation of oil-sands reserves is particularly acute for this well-run and profitable company, says Alex Rubalcava. At the EV-to-total-reserves multiple of its most-comparable competitor, the shares are worth C$56, he says.

Sources: Company reports, Rubalcava Capital Management, other publicly available information

Sanity Check

Social psychologists devote considerable effort to trying to understand why people do self-defeating, stupid things. Investors, take note.

It's not surprising that the study of irrationality and self-destructive behavior is one of the most fertile areas of psychological study. After all, there's plenty of such behavior to go around and whole industries – think tobacco, gaming, weight-loss, etc. – are built either to benefit from or help ameliorate such human frailties.

While much of the research into "why people do stupid things," as Florida State social psychologist Roy Baumeister puts it, is not specifically focused on investing, the findings are highly relevant to investors. Ill-conceived decisions that are contrary to one's rational self-interest should clearly be at the top of any investor's list of things to avoid.

Based on his own and others' extensive research, Baumeister has identified five key reasons why rational, self-enlightened action breaks down:

1. Emotional Distress

Emotional distress makes people far more likely to favor options with high risks and high rewards, even if these options are objectively bad choices. When research-study subjects were first asked to decide between playing one of two games – the first with a 70% chance of winning $2 and the second with a 2% chance of winning $25 – most chose the first, opting for the choice with the higher expected value of $1.40 vs. $0.50.

Subjects who were put under stress, however, were far more likely to choose the riskier option with the much lower expected value. Baumeister attributes this to the simple fact that those under duress just don't think through the options. He confirmed this by specifically prompting certain subjects to first list the advantages and disadvantages of each option before deciding. When forced to reflect, even the stressed group of test subjects generally made the rational decision.

2. Threats to Self-Esteem

When a favorable self-view is questioned or undermined by events, people's rush to prove otherwise can result in bad decisions. Baumeister offered test subjects a chance to bet on their skill in a video game they all had learned, but subjected one subset of the group to the news that the results of an earlier test of creativity they'd taken showed they did poorly – in fact, the worst the experimenter had seen.

How did the bruised-ego group respond? Eager to wipe out the loss of face by winning a large bet, they made far larger bets than justified by their skill levels – and ended up losing most of their money.

3. Failure of Self-Regulation

The rational pursuit of self-interest often requires delayed gratification – the forgoing of short-term benefits in order to achieve greater future gains. People generally self-regulate themselves to override immediate responses, but the breakdown of this self-regulating mechanism often results in self-defeating behavior. Stress is again one big cause of this mechanism breaking down, but the problem is also exacerbated when short-term

gains are reliably predictable, while the longer-term costs are uncertain. Consider smoking, in which the uncertain long-term risk of developing lung cancer can be easily outweighed by the short-term and certain pleasure of lighting up.

Interestingly, Baumeister found that the capacity for self-regulation operates somewhat like a muscle – when constantly tested over relatively short periods it loses strength. Subjects who were hungry and were told not to eat freshly-baked chocolate chip cookies on a nearby table were far less likely to persevere in solving a variety of challenging puzzles than those who had not been similarly deprived. Such findings give strong support to the notion that "sleeping on" important and difficult decisions is a sensible strategy.

4. Decision Fatigue

People's ability to make rational decisions similarly decreases as the number of decisions to be made increases. This likely explains why people love routines and habits, which preserve the limited "resources" available to make decisions. Says Baumeister: "People can only really make a few serious choices at a time, and then the capacity for choosing has to recover and replenish before they are fully effective again."

5. Rejection

The need to be accepted by others is a central feature of human motivation, so it's not surprising that rejection – or the fear of rejection – can result in self-defeating behavior.

In one study, subjects were brought together and spent some time getting to know each other before being put into separate rooms. They were then asked to list with whom they wanted to work on the next project in the study. In the end, everyone worked alone on the next project, but half the group was told it was because nobody chose to work with them and half were told it was because everyone chose to work with them and it was too difficult to accommodate everyone's wishes. In subsequent tests, those that were "accepted" generally behaved rationally, while those "scorned" were far more likely to be aggressive and make irrational choices. Those who thought they had been rejected even performed worse on intelligence tests than those who thought they had been accepted.

What are the implications for investors? "Pretty much all the elements that lead to the psychology of irrationality are likely to be present in large quantities for investors," says equity strategist James Montier of Dresdner Kleinwort Wasserstein. In particular, he cites the holding of unpopular stocks that are going down as particularly likely to trigger many of the pressures that often lead to bad decisions.

Irrationality in investor decision-making isn't going away, of course, and the markets would be far less interesting – and profitable – if it did. But an awareness of what the triggers of self-defeating behavior are can go far in mitigating the damage from irrational, bad decisions. Forewarned is forearmed. VII

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Carlo Cannell's Articulate Activism

Business correspondence is hardly a reliable source of riveting prose. Let's just say that by the time the lawyers, PR experts and investor-relations staff sign off, clarity – and often sanity! – have fallen victim.

In preparation for this issue's interview with Carlo Cannell, we read letters he wrote last year to the board of money manager BKF Capital Group that refreshingly break this mold. Cannell certainly leaves nothing to interpretation. We think what he has to say is of general interest to all investors, activist or not:

On strategic options:

"[Our] preference is for BKF to grow substantially once its productivity is enhanced and performance for clients is increased. But if you insist on running BKF like a private fiefdom, ladling out most of the income to you and your messmates, then yes, we would prefer that you buy the Company and squander privately. This would free you from the annoying interference of fiduciary obligation, corporate governance and owners who focus on irritating performance metrics."

On the trappings of wealth:

"My visit to your offices left me astounded that such an unprofitable company would house itself in some of the most expensive office space in America. Your 56,000 square-foot office in Rockefeller Center immolates cash at the expense of BKF's shareholders. Not all meretricious trappings are poor business expenses. I appreciate the lavish spending of casinos as they lure "whales" to their tables, but this acceptance is predicated upon such adornments being accretive to earnings, to bringing in profitable bacon. Your Rockefeller Center pork just stinks."

On nepotism:

"We love our daughters too. But we do not put our daughters on the company payroll, endowing vast sums for questionable services. Jennifer [Levin Carter, the daughter of BKF's then CEO] should neither be overpaid nor underpaid. If she's worth the $665,074 you paid her over the last four years, we'd like to know what she did to earn it. Show us the data."

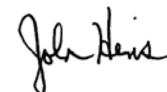
On board composition:

"Your [slate] may indeed be [composed] of "outstanding individuals," whatever that means. They are not, however, outstanding money managers, nor do they evince much in the way of understanding good corporate governance. BKF needs a board with an outstanding track record of governing, investing and operating."

On finding a new CEO:

"I want BKF to hire a frugal, energetic, and fiercely independent CEO who will apply to the hedge-fund industry the management principles of Billy Beane, the Oakland Athletics' General Manager … who can recruit and motivate overlooked talent. That talent should get a fraction of the wages BKF has traditionally paid in salary, but, rather, enjoy a significant stake in the upside of the entire organization through tax-advantaged long-term capital gains. Let's find a team player who will work for $1 per annum but who will receive a million shares at rising strike prices over many years."

For full text, visit donkeynation.com. VII



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