May 26, 2006

Value Investor INSIGHT

The Leading Authority on Value Investing

Fashion Sense

Rather than follow tomorrow's "next big thing," Tom Gayner is perfectly content to find opportunity – and big profit – in some of yesterday's hot models.

Soon after starting his career as a staff accountant at what was then a Big Eight accounting firm, Thomas Gayner knew that being a traditional CPA wasn't exactly for him. "I realized that I was much more interested in dollars than numbers," he says.

Gayner's affinity for dollars has resulted in a stellar investment record since joining insurance company Markel Corp. in 1990 to manage its equity portfolio. With $1.5 billion now under management, Gayner has returned an average 17.6% annually, vs. 11.6% for the S&P 500.

Given the market's still-large appetite for risk, he's now finding opportunity in less fashionable but proven businesses that, he says, trade at more attractive prices than they have in years. See page 2

INVESTOR INSIGHT

Thomas Gayner
Markel Gayner Asset Management

Investment Focus: Seeks proven businesses with more attractive capital reinvestment opportunities than are currently being recognized by the market.

No Pain, No Gain

Staked in the business by legendary investor Joel Greenblatt, Brian Gaines has done his mentor proud in finding bargains where others see mostly risk.

Having started work after his first year at Wharton as an analyst for Joel Greenblatt's Gotham Capital, Brian Gaines was thrilled when Greenblatt offered to help him set up his own investment firm after graduation. "I would have been crazy to say no," says Gaines.

Since Springhouse Capital opened in November, 2002 – largely with capital from Gotham – Gaines' focus on undervalued small caps has been anything but crazy, earning an average annual net return of 29.6%, versus 13.9% for the S&P 500.

"I learned from Gotham to never be a snob about where I look for bargains and not to be afraid of calculated risks," says Gaines, who is now finding opportunity in diverse sectors such as home building, Internet services and semiconductor testing. See page 11

INVESTOR INSIGHT

Brian Gaines
Springhouse Capital Management

Investment Focus: Seeks companies with demonstrable 50% share-price upside over the coming year – with added longer-term potential from various "free options."

Inside this Issue

FEATURES

Investor Insight: Thomas Gayner
Betting on the market clout and unrecognized growth potential of General Electric, Citigroup, Home Depot and CarMax. PAGE 1 »

Investor Insight: Brian Gaines
Seeing through recent clouds over small caps Levitt Corp., Greenfield Online, Celebrate Express and ChipMOS Technologies. PAGE 1 »

Uncovering Value: Superinvestors
Uncertainty stemming from change attracted many of the superstar investors we track in Q1. PAGE 18 »

Behind the Numbers: Lessons
Whitney Tilson describes 10 traits he's identified – often the hard way – of stocks to avoid. PAGE 20 »

Editors' Letter
We hope when we're 82 that we're as quick-witted and insightful as Charlie Munger is today. PAGE 22 »

INVESTMENT HIGHLIGHTS

INVESTMENT SNAPSHOTS	PAGE
CarMax	9
Celebrate Express	16
ChipMOS Technologies	17
Citigroup	6
General Electric	5
Greenfield Online	15
Home Depot	7
Levitt Corp.	13

Other companies in this issue:

Bed Bath & Beyond, CBS, Cendant, Centex, Diageo, First Data, General Motors, Harley Davidson, H.J. Heinz, INVESTools, Kohl's, Lowe's, McDonald's, MDS, Mirant, NRG Energy, NTL, Omnicare, Pulte Homes, Reliant Energy, Schlumberger, Sprint Nextel, Viacom, Wal-Mart, Washington REIT

Investor Insight: Thomas Gayner

Thomas Gayner of Markel Gayner Asset Management describes the appeal of investing in "the world's second-oldest profession," how he takes advantage of international opportunities, why he avoids drug companies and what he thinks the market is missing in General Electric, Citigroup, Home Depot and CarMax.

Looking at your portfolio over the years, it's a bit difficult to neatly characterize your holdings? What are the common themes?

Thomas Gayner: Consultants in the investment world work so hard to pigeonhole investors that I think even the word "value" is misconstrued to just mean low multiples of book value or earnings. Ben Graham early on talked about how growth is of great value, it's just riskier and more difficult to quantify. I'm always amazed that someone would say they weren't a value investor – I wouldn't admit it even if I wasn't. It just seems silly to think about investing any other way.

There are four basic things I look for in companies – what I call my North Star of investing principles. The first is a profitable business. You'd think I wouldn't even have to say this, but there were a lot of businesses with enormous market caps in the late 1990s that had never made money and, to my mind, weren't really capable of making money. This doesn't mean I don't invest in cyclical businesses or in turnarounds that from time to time can be unprofitable, but I do want proven business models with good returns on capital in normal times.

The second thing I look for are management teams with equal measures of talent and integrity. One without the other is worthless.

We understand how to objectively judge talent, but how do you assess integrity?

TG: Part of it, of course, isn't objective. With smaller companies, I get to spend time with management in order to make some value judgments. In bigger companies you have to rely more on the paper trail. Character today is best judged in the proxy statement – what do they pay themselves and how? Is their financial self-interest truly aligned with mine as a shareholder? I have absolutely no problem with the people running huge, complicated, global businesses making a lot of money. The big problem we have now is that you're seeing a lot of superstar compensation for only minor-league performance.

I do tend to stay away from companies overly dependent on raising capital and the good opinion of the securities markets. Mark Twain used to say he was a good writer because he could "remember everything, whether it happened or not." I'm leery of situations where management has too much temptation to report great earnings, whether they really happened or not.

The same is true for cases in which management has very large option grants. The potential rewards are huge and the potential loss is zero, which, again, creates an unhealthy temptation for management to deceive the financial markets, as well as themselves.

The third thing I focus on is the reinvestment dynamics of the business. The perfect business makes very high returns on capital and can reinvest it at the same or higher return levels, becoming a compounding machine over time. Berkshire Hathaway historically has been a great example of that. The worst business in the world is the one that doesn't earn good returns on capital but still needs gobs of it going forward. Airlines are the best example of this.

Another great business is the one earning a high return on capital, but which can't redeploy it as profitably and the management is intellectually honest enough to know that. They just return the excess capital back to equity owners and let them figure out what to do with it. That tends to be fairly rare – the great temptation among managers is to think

Thomas Gayner

Not So Dismal Science

Inspiration in Thomas Gayner's investing career has come from many of the typical sources: His father, with whom he says he "talked stocks and business like other fathers and sons talked baseball and football"; Warren Buffett, whose writings he followed from a young age; and Louis Rukeyser, whose *Wall Street Week* he watched every Friday growing up.

And then there's Mark Twain. "If you really want to understand financial motivations and incentives, you should seriously study Twain's work," Gayner says. "He was rich and broke several times in his life, which comes out in the way he wrote about money and markets and human nature."

Twain's *Roughing It*, for example, describes a speculative bubble in silver that "would have been completely topical and descriptive in the late 1990s had you substituted 'Internet stocks' for 'silver,'" says Gayner. Another favorite, *The Man That Corrupted Hadleyburg*, explores how money – or the prospect of it – changes people's behavior.

"I've learned a lot more about money and finance from reading Twain than any dull Economics book," he says. "And you can laugh your head off while you're at it."

they can always reinvest capital as well as they did earlier.

You haven't mentioned price yet as a basic criterion?

TG: That's the fourth and final thing I look for. If the first three criteria are in place, it's highly unlikely the shares will be available at a knock-down, discount price. So all I ask for is a fair price, which I define as a price that will allow in five or ten years for my investment to grow at least as much as the company's per share earnings or cash flow grow. I'm very mindful of the potential for valuation compression – where the company does everything you expect it to do, but because the multiples come down from too-high a level, your investment can go nowhere, or worse.

At 40x earnings, a stock is a speculation; your returns as an investor are dominated by the level of speculative fervor. That's why I never own "hot" stocks or the things that are popular, because I'm too worried about being the last one standing when the music stops. When you're at 15x earnings or lower – given the interest-rate environment today – the returns should be dominated over time by what fundamentally happens to the business.

I often find opportunity in companies where that compression of valuation has already taken place. General Electric, which we'll talk about later, is an example. Six years ago, it was at 40x earnings. Its earnings have continued to go up, but now the shares trade closer to 15x earnings. The stock six years ago was just overpriced. The company basically did what it was supposed to do, but the share price went from $60 to under $35 today.

What publicly-traded companies are worth is roughly 90% dominated by the cash flows they produce over time and 10% by what the market will pay for these types of companies at any given time. Every investment security has some mix between these two elements of worth, and I try to pay careful attention to both.

What makes prices reach fair levels?

TG: It's when the market is either ignorant or wrong. Ignorance usually occurs in smaller companies – they're in fashion now, but that's generally an area where you can find fair prices because the companies aren't followed closely.

The other case is when it's very clear what the market thinks about a company and you just conclude it's wrong. I've been saying for the past year and a half that I thought the spreads between high and low quality assets are just too low. There's been some adjustment in that very recently, but you're still not being adequately compensated to assume the added risk of lower-quality assets. The other side of that is that you're not having to pay much extra for quality businesses, which is where I think the market has just got it wrong.

ON FINANCIAL COMPANIES:

The money business is the world's second-oldest profession – I like businesses with that kind of staying power.

How does being part of Markel impact your investing?

TG: I think it's a real advantage that as part of a successful insurance company, my main client is consistently depositing money into the account and never asks for it back. The ability to essentially dollar-cost average into positions helps me overcome both mistakes and the fact that it's very hard to be precise about timing.

We also benefit from having the time and support to consistently apply our strategy and allow our ideas to work. Nobody is going to pull money out if I underperform an index for a period of time. Making time work for you, with steady inflows of permanent capital, really helps investment returns over time.

In what industries or sectors do you most often invest?

TG: I've spent my whole life around financial companies. The money business is the world's second-oldest profession – I like businesses with that kind of staying power. In general, I think the accounting tends to be better at financial companies than at non-financial companies – the asset is money, which you either have or you don't. Money in inventory doesn't go bad, it doesn't go out of style, it isn't affected by technology. I also like that financial businesses tend to have sort of a gross royalty override on everything else – if oil or any other industry booms, the manifestation of that always plays out in financial companies.

If you think about it, it's against the law for banks to lose money. They have capital levels they are required to maintain. If a bank starts to lose money because it doesn't earn a spread between its cost of money and what it can earn on it, by law and regulation, it has to shrink its balance sheet to live within its capital. I'm kind of joking, but the core truth of that is a pretty good tailwind to have at your back as an investor.

You've historically invested heavily in real estate. Why?

TG: We're light on the sector right now, but starting in the late 1990s we put a lot of money into REITs [real estate investment trusts]. With real estate, we generally focus on the relatively straightforward question of whether the nature and location of each asset owned will justify a higher value 10 years from now, or whether there's a risk the value will be lower. One company we did very well on, which was recently bought out, was CenterPoint Properties, which owns industrial real estate around Chicago. Given Chicago's location and primacy as a distribution location, it just made sense that this type of real estate was going to be valuable for a long time. The company was also run by first-class, talented people.

We still own Washington REIT

[WRE], which is a big real-estate owner and operator in the Washington, D.C. area. I think Washington, D.C. today is the equivalent of Rome 2,000 years ago, – the Eternal City. To misquote Homer Simpson, over the next 50 years I don't think you can miss on Washington, D.C. real estate "with an electrified missing machine on the missing-est day of your life." Time is your friend if you own property in and around the Beltway there.

Any other areas of particular interest?

TG: I like to invest in consumer brands in areas like chocolate, whiskey, beer and wine. These are products that have been around for thousands of years, that people like, and I don't think that's going to change. Changes in technology or the trend toward outsourcing don't diminish the fact that people like to have a drink at the end of the day, or that they enjoy chocolate.

We've owned Diageo [DEO] for a long time. When people ask me what I like about it, I typically take a bottle of Johnnie Walker scotch and point out where it says "Since 1820" on the label. Think about what's happened in the world since 1820! Electricity. The invention of the automobile and the telephone. The Civil War, World War I and II, the Cold War, the Vietnam War ... on and on and on. Businesses with that kind of durability are very attractive to us.

I also tend to understand retailers. It's a hard business, but it's straightforward and you can know what a company is really doing. What also often happens is that hot retailers selling for fancy prices eventually stumble in some way, and the stock price goes down more than the business really does, creating opportunity. The nature of the people holding the stock changes, which tends to lead to an overreaction on the downside; the growth people sell out and the value people haven't yet come around to buying.

How concentrated is your portfolio?

TG: We may hold 85 to 90 stocks at a given time, but more than 70% of the portfolio tends to be in the top 20 names. One of my favorite generals, who I think is underrated historically, is Ulysses S. Grant. One saying of his was "When you have a big gun, shoot it." In investing, sizing the bets you make in proportion to your degree of conviction is very important.

ON GENERATING IDEAS:

My phone doesn't ring much because I don't trade. So I'm not constantly interrupted when I'm reading and thinking.

Do you follow any particular rules with respect to selling?

TG: The easiest but most painful decision to sell is when you've simply made a mistake. If the basic reason you were attracted to something turns out not to be correct, you usually need to sell right away.

Our other sale decisions are generally a function of opportunity cost. This year I bought GE for the first time. To buy the size of position I wanted in it required selling some things that I didn't think were as attractive as GE was.

Where do your best ideas come from?

TG: One great asset we have is our list of shareholders, which includes some of the best investors in the world. I'm regularly swapping ideas with and listening to a network of 50 or so investors close to us. Ariel Capital [run by John Rogers, *VII*, November 30, 2005] is our largest holder. Davis Funds is a big owner. Chuck Akre at Akre Capital. Torray Funds. Bruce Berkowitz [of Fairholme Capital, *VII*, April 28, 2006] is a good friend.

I also read everything and have for a long time. My phone doesn't ring very much because I don't trade – our turnover is usually less than 10% annually – so I'm not constantly interrupted in the process of reading and thinking about ideas.

If I were stranded on a desert island and could have only one source of information, it would be *Value Line*. Just about everything you need to know about a company to see if you're interested in it is on their one-page company summaries. I look at the page for 10 seconds to figure out if I should spend two minutes on it, then to figure out if I should spend a half hour on it, then to figure out if I should read the financial statements, call the company, ask a buddy of mine about it, and so on.

Take us through that process, say, in looking at the *Value Line* page for GE.

TG: [With the page in hand] I just circle what's good: every year when the sales per share are higher than they were the year before; when cash flow, earnings and dividends go up; when the share count goes down; when the ROE is above 15%; the fact that the P/E is lower now than it has been on average in each of the last 10 years; the fact that estimated earnings growth is accelerating; that 50% of revenues come from overseas.

So we've already started talking about your first idea, General Electric [GE].

TG: GE is a collection of great businesses. They are the worldwide leader in important markets like jet engines, power generation, medical equipment, industrial equipment, infrastructure and finance. As the world grows and countries like Brazil, Russia, India and China – the so-called BRIC countries – develop into first-world countries with rising affluence, GE is already there and supplying the goods and services those economies will use.

In more mature markets like those in the U.S. and Europe, GE still has huge opportunities as we all use more power, medical services, airline travel and entertainment each year. So I see GE as having a growing business as far as the eye can see.

I think GE's culture is a true competitive advantage. The focus on innovation, technological expertise, managerial devel-

opment, long-term thinking, performance and accountability has been in place and extremely effective for a very long time. That gives me confidence that in 10 or 20 years we'll be describing the company's bright future prospects in much the same way we do today. That's very rare in today's world.

I also believe that in many markets GE will be competing with increasingly weak competitors. Many of GE's smaller, focused competitors are being bought by private-equity firms and burdened with heavy debt loads and short-term time horizons. Companies like GE, which invest heavily in R&D and new products for the long term, will have customers' confidence and be able to improve their market positions.

Related to that, when private equity becomes less fashionable and money heads to the exit door rather than the entrance door, GE is going to be a very logical buyer of many of these kinds of businesses at favorable prices.

How do you judge Chairman and CEO Jeffrey Immelt's tenure so far against that of his famous predecessor?

TG: I think Jeff Immelt has done a marvelous job of laying out what his strategic vision is for the company. He's gotten out of the insurance business, which was exactly the right thing to do – they didn't have an edge there and are redeploying the capital in businesses in which they do. That's what you want to see in a CEO.

Part of the reason I had never invested in GE was the fact that Jack Welch was such a popular, "in-fashion" CEO. It's a personal quirk of mine that when the CEO shows up on magazine covers as a celebrity, I'm automatically hesitant to invest in the stock.

Why do you think GE's stock performance been so blah?

TG: Why do investors hold it in some disdain right now? Part of it is the negative psychological profile many investors have toward the company as they've watched the shares go from $60 to $35. People who screwed up by paying 40x earnings for GE are projecting their own mistake onto the company.

In addition, their media business, NBC Universal – which is the least obviously attractive of their businesses – is probably also weighing on the stock to some degree.

Does GE have an edge with NBC Universal?

TG: I don't know, but I can get over it. There's so much good in the company that NBC doesn't affect how I feel about it. In general, the media business shouldn't be a bad business and should be the type of business to take advantage of increasing global affluence and prosperity. As discretionary time increases, people around the world are going to want more entertainment. I believe the company will come to the right conclusion on whether they have an edge there or not.

With the shares currently under $35, how are you thinking about valuation?

TG: I tend to be a bit more qualitative than quantitative when I think about valuation. With GE, I come back to the fact that they were selling at 40x lower-qual-

INVESTMENT SNAPSHOT

General Electric
(NYSE: GE)

Business: Diversified conglomerate with six operating units: Commercial Finance, Consumer Finance, Healthcare, Industrial, Infrastructure and NBC Universal.

Share Information
(@5/25/06)

Price	**34.42**
52-Week Range	32.21 – 37.13
Dividend Yield	2.9%
Market Cap	$357.91 billion

Financials (TTM):

Revenue	$152.06 billion
Operating Profit Margin	15.6%
Net Profit Margin	10.5%

Valuation Metrics
(Current Price vs. TTM):

	GE	S&P 500
P/E	19.4	20.1
P/CF	13.4	14.3

Largest Institutional Owners
(@3/31/06):

Company	% Owned
Barclays Global Inv	3.7%
Capital Research & Mgmt	2.9%
State Street Corp	2.8%
Fidelity Mgmt & Research	2.8%
Vanguard Group	2.5%

Short Interest (As of 5/8/06):

Shares Short/Float	0.4%

GE PRICE HISTORY

THE BOTTOM LINE

Strong market positions, global scope and a competitively superior culture should fuel double-digit earnings-per-share growth for at least the next five years, says Tom Gayner. He expects additional upside from eventual multiple expansion, when GE shares are "much more in fashion than they are now."

Sources: Company reports, other publicly available information

ity earnings in 2000 and sell for 15x higher-quality earnings today. So the earnings yield is 6-7% and earnings per share – because they're repurchasing shares – should be growing in the low teens for at least the next five years. In a 5% interest-rate world, if I can envision a solid double-digit annual return – with no change in valuation – that's pretty attractive to me.

Also, given how long we tend to hold positions, sometime over the next ten years I suspect GE will be much more in fashion than it is now; so instead of being 15x earnings it will be more like 25x. I won't stick around for it to get back to 40x, but when it gets to 25x, I expect there will something unfashionable I'll want to buy with my profits from GE.

What could go wrong here?

TG: Could the stock go through more multiple compression and get to the 8x earnings it traded at in the 1980s? Maybe. I don't know. Buying into companies like GE, which aren't at all popular right now, often means signing up for short-term frustration as the stocks continue to languish. But the good news for me, being part of Markel, is that I can buy GE every month between now and the time its valuation bottoms out. As long as I'm right about the underlying economics and growth in earnings at double-digit per-share rates, I'm going to be fine.

Your next idea, Citigroup [C], is another unloved giant.

TG: There have clearly been some clouds over the company, none of which I think are systemic or permanent, that have affected the stock. Their regulatory problems, for example, are to me a function of their having 250,000 employees around the world – some of whom will misbehave at any given time – rather than an indictment of their culture. A flat yield curve also isn't helping the share price, but that's not the normal course of events I expect over my time horizon.

Financial stocks, and particularly financial supermarkets, are also just out of fashion. Things like energy, commodities and gold are occupying a lot more of the market's collective brain cells than financial assets at the moment. This won't always be the case.

The particular appeal with Citi is the worldwide spread of its businesses, with people on the ground everywhere you can think of. The rising standard of living in countries like Brazil, Russia, India and China is creating a lot of people who are going to work, getting paychecks, opening bank accounts and saving. They're also getting credit cards and installment loans to buy things. Citi is there, whether it's with retail bank branches in cities with names you can't pronounce, or with a global investment banking business. They talk about themselves as a distributor of financial products, and their pipeline goes everywhere.

CEO Charles Prince has been derided as more of a technocrat than an operating manager. How do you think he's doing?

TG: To some degree, he clearly suffers from the comparison to Sanford Weill, who has been a legendary figure in the world of finance. I think Prince is doing a better job than he gets credit for. In many

INVESTMENT SNAPSHOT

Citigroup
(NYSE: C)

Business: Holding company organized around Consumer, Corporate/Investment Banking, Alternative Investments and Wealth Management operating segments.

Share Information
(@5/25/06)

Price	**49.07**
52-Week Range	42.91 – 50.72
Dividend Yield	4.0%
Market Cap	$243.94 billion

Financials (TTM):

Revenue	$76.86 billion
Operating Profit Margin	22.9%
Net Profit Margin	16.4%

Valuation Metrics
(Current Price vs. TTM):

	C	S&P 500
P/E	12.4	20.1
P/CF	10.9	14.3

Largest Institutional Owners
(@3/31/06):

Company	% Owned
Barclays Global Inv	4.7%
Capital Research & Mgmt	3.5%
AXA	3.4%
State Street Corp	3.0%
Vanguard Group	2.5%

Short Interest (As of 5/8/06):

Shares Short/Float	0.6%

C PRICE HISTORY

THE BOTTOM LINE

The current "clouds" over the company are not systemic or permanent, says Tom Gayner, and it remains uniquely positioned to benefit from rising global living standards. As with GE, he expects solid double-digit earnings growth and multiple expansion from today's depressed levels to result in excellent long-term share returns.

Sources: Company reports, other publicly available information

cases, he's doing what has needed to be done to restore the company's reputation around the world.

Second Curve Capital's Tom Brown (*VII*, October 28, 2005) argues that Citi is an unwieldy "blob" that is unmanageable and isn't reaping its promised benefits of scale. What do you think about that?

TG: First off, Tom Brown has probably forgotten more about banks than I'll ever know, so I do respect his expertise here. But I also think it's reasonable for Chuck Prince to keep buying back what he thinks are undervalued shares while trying to make Citi's scale work more to its advantage. I can say that as a corporate customer of Citigroup, we deal with them because we can deal with them around the world – that's a big thing they bring to the table for us.

What upside do you see for the shares, now at $49?

TG: The stock is trading at only 11x earnings, for a pre-eminent, global financial franchise with returns on equity consistently over 15%. You've got an earnings yield of 9% and, with the growth and share buybacks I expect, this is a solid double-digit annual grower. Meanwhile, you've got a 4% dividend yield.

As with GE, over the next five to 10 years there will also come a time when Citi isn't beaten up every day in the press and is even celebrated, so it can sell at the high double-digit multiple it earned in the past.

Downside?

TG: With the 4% yield, I'm earning just about as much as I would from a Treasury bond while I wait for the market to recognize how valuable Citi's global franchise is as world economies grow.

Is Home Depot [HD] an example of the growth retailer that the market has turned on that you spoke of earlier?

TG: It's a classic example. When Home Depot was in its early stages, I totally missed how big it could become. As it grew rapidly and profitably, it sold at a very fancy multiple over 40x earnings – everything you could want in a company and a stock.

But all good things come to an end. They're still growing, but are no longer in the most rapid growth phase. The market's response has been to take the stock down to only 13x current year's earnings, where I've never seen it trade.

Why?

TG: Home Depot seems to be viewed as very tied to real estate prices and the health of the housing market, which have clearly slowed down. The fear is that consumers will pull back on improving their homes when they're not borrowing as much against their rising equity. That will certainly be true to some extent, but I think the market is exaggerating the impact. Houses get older and need work whether the real estate market is booming or not. I know this from personal experience, having had to put a lot of non-discretionary money into my house last year.

You also have to remember that the housing boom has created an awful lot of new "real estate" that is going to need to

INVESTMENT SNAPSHOT

Home Depot
(NYSE: HD)

Business: Largest home-improvement retailer, with more than 2,050 stores in North America operating under the Home Depot and EXPO Design Center brands.

Share Information
(@5/25/06)

Price	**38.40**
52-Week Range	37.14 – 43.98
Dividend Yield	1.6%
Market Cap	$81.33 billion

Financials (TTM):

Revenue	$84.00 billion
Operating Profit Margin	11.6%
Net Profit Margin	7.2%

Valuation Metrics
(Current Price vs. TTM):

	HD	S&P 500
P/E	13.5	20.1
P/CF	10.8	14.3

Largest Institutional Owners
(@3/31/06):

Company	% Owned
Barclays Global Inv	5.3%
Fidelity Mgmt & Research	4.7%
State Street Corp	3.1%
Legg Mason	2.9%
Vanguard Group	2.5%

Short Interest (As of 5/8/06):

Shares Short/Float	1.0%

THE BOTTOM LINE

The housing boom's creation of "new" real estate that needs to be maintained, expansion into professional supply and broad international opportunities should fuel earnings growth beyond what the market expects, says Tom Gayner. With ongoing double-digit EPS growth, he expects the earnings multiple to return to levels well above today's 13x.

Sources: Company reports, other publicly available information

be maintained going forward, requiring a lot of what's on Home Depot's shelves. That's a nice secular tailwind for Home Depot's business.

What do you think of their recent expansion in the professional-contractor supply business?

TG: The purchase of Hughes Supply and moving up from the do-it-yourselfer to the professional makes all the strategic sense in the world. That market is fragmented, as the homeowner market was, and it's a lot of the same vendors and suppliers. They're already a big buyer in everything they do, but Home Depot's pen just got bigger. We'll see how they do, but I believe they have the time and wherewithal to get it right.

What else makes you optimistic about growth?

TG: I also believe there will eventually be a big international story here. This is still a hugely domestic business. The world can be their oyster as all those people who will be banking at Citicorp for the first time also become customers of Home Depot's. I don't think you can underestimate how powerful a force that will be.

CEO Bob Nardelli has shown up on some compensation "Hall of Shame" lists for his level of pay versus Home Depot's share performance. Does that bother you?

TG: I certainly wish he was paid in a less egregious fashion, but at the same time, the earnings keep going up. At least he's delivering major-league performance. The company has made the very appropriate passing of the baton from entrepreneurial founders to a very capable professional manager who manages capital very well.

At under $39, how inexpensive are the shares?

TG: The stock has basically gone sideways for eight years, but over that time they've gone from earning 70 cents a share to closer to $3 per share this year. I believe the company is a double-digit earnings grower for a long time to come and the balance sheet is marvelous – they own more than 80% of their own real estate – but it's trading at only 13x earnings. Again, I don't have a specific target price, but if earnings grow in double digits and sometime over the next five to 10 years this comes back into fashion and trades for well over 13x earnings, this will be a great investment.

ON THE CARMAX MODEL:

They're doing the exact same thing in used cars that R. H. Macy did as a merchant on Nantucket Island 150 years ago.

Given your optimism about the sector, are you buying Lowe's?

TG: Lowe's is a wonderful business, very well run, growing faster off a smaller base and benefiting from all the same top-down trends as Home Depot. But I don't own it – it's more in-fashion now, so the stock is more expensive.

Alsin Capital's Arne Alsin [*VII*, November 30, 2005] saw your next idea, CarMax [KMX], as being in a similar position to Home Depot 25 years ago. Do you agree?

TG: This is the most open-ended and growth-oriented of the companies we've talked about. The primary attraction is that the basic business concept of selling used cars at fixed, no-haggle prices just resonates with me.

They're doing the exact same thing in used cars that R.H. Macy did as a merchant 150 years ago. R.H. Macy was a Quaker merchant on Nantucket Island, who used to outfit whaling expeditions that went out of there. Quakers, as part of their religious beliefs, sold things at fixed prices to everybody, because they believe everybody is equal before God. He took that idea to New York City, which radically changed how products were sold there and his business took off. So CarMax is another example that there's nothing new under the sun. They've taken anxiety and stress out of the customer buying process, in an industry where that has typically been a big problem.

I also like the fact that technology and the Internet are good for their business. In everything I look at, I ask whether technology is good for the business, bad for it, or neutral. In the case of Johnnie Walker scotch, technology is neutral; nothing that happens with the Internet really affects the demand for Johnnie Walker scotch. In most businesses, technology is a negative, because all of the cost savings go to the consumer.

But the fact that CarMax can offer not only a better selection of cars on the lot than anyone else, but can also go online and search 25,000 cars throughout their system that they'll bring you – that's a big competitive advantage. Given that they have the best systems set up to buy and sell used cars, one at a time, I'm comfortable that nobody else is going to be able to do what they do in a meaningfully different or better way.

So the story here is the reinvestment potential?

TG: That's what's most special about CarMax. When we first started buying it they had 12 or 13 lots, and they now have 70 or so. How many dealerships could they have? They're opening stores this year in both Fredericksburg and Charlottesville, in Virginia. If they can make it work in markets of that size – which I believe they can – they could easily get to as many as 1,000 or even 1,500 stores in the U.S.

With operating margins only in the 4% range, are you counting on improvement there as they grow?

TG: I'm not counting on it, but I do think they have upside there. I would have

expected more leverage in selling, general and administrative costs than has shown up so far. But I haven't given up hope that's going to happen as they grow without having to add much to their basic infrastructure.

At around $32, has the valuation gotten a bit steep?

TG: It trades at about 22x estimated earnings of $1.45 per share this year, so it's not cheap. But given the open-ended growth and the fact that it's still a little bit undiscovered, there's still a lot of upside. I see earnings per share growing in the high teens for a long time. If you look at retailers – Home Depot is a classic example – when they string together those kinds of high growth rates, you can expect a lot more than 22x earnings. If at the same time CarMax is growing earnings per share at over 15% per year for several years, that will produce a very attractive rate of return on your money.

The shares go in and out of fashion, but CarMax keeps selling more cars and their market share keeps going up. I don't worry much about volatility in the shares. I've been buying regularly for several years because every bit of evidence I've seen so far confirms that they can continue to roll this out and deliver on what they say they're going to do.

What businesses or sectors are you avoiding right now?

TG: I have often made the mistake of investing in businesses that needed and used more capital to operate than I thought they would. That's one reason I tend to avoid heavy industrial companies. Some very smart people own General Motors now – I hope they make money and it's probably good for the country if GM survives, but I can't figure out how to make that work as an investment. We just don't own those types of companies.

We also don't own any pharmaceutical companies. For years and years the social compact with pharmaceutical companies was that their 90% gross margins were allowed so that they could pour most of that back into developing new drugs. Society has won under that compact. Sadly, now because of the cost pressures in medicine – which are more in the non-pharmaceutical end than the pharmaceutical end – the legislators and insurers of the world are working to push that gross margin way down. I don't think that's the right answer for society, but it's certainly a challenge for the drug companies.

Have you been active internationally?

TG: My feeling is that it's beyond my skill set to try to buy local companies outside the U.S. Some people will make a lot of money doing that, but not me. What I am doing is buying companies like GE and Citigroup and Diageo, who already have tremendous expertise and operations outside the U.S. to take advantage of international growth and development opportunities.

Tell us about the private-equity investments – in a small bank and a bakery-equipment business – you've made lately.

TG: We've historically made private investments in the insurance business, but recently extended it to areas outside of insurance. Our investment philosophy is

INVESTMENT SNAPSHOT

CarMax
(NYSE: KMX)

Business: No-haggle retailer of used cars and light trucks through 70 U.S. superstores. First store in northeastern U.S. – in Hartford, CT – opened in April.

Share Information
(@5/25/06)

Price	**31.76**
52-Week Range	24.64 – 36.40
Dividend Yield	0.0%
Market Cap	$3.33 billion

Financials (TTM):

Revenue	$6.36 billion
Operating Profit Margin	3.8%
Net Profit Margin	2.4%

Valuation Metrics
(Current Price vs. TTM):

	KMX	S&P 500
P/E	22.8	20.1
P/CF	19.3	14.3

Largest Institutional Owners
(@3/31/06):

Company	% Owned
American Century Inv Mgmt	9.5%
Primecap Mgmt	8.3%
Capital Research & Mgmt	7.4%
William Blair & Co	3.9%
Lone Pine Capital	3.5%

Short Interest (As of 5/8/06):

Shares Short/Float	8.1%

THE BOTTOM LINE

Today's base of 70 superstores could eventually reach over 1,000, says Tom Gayner, as the company's no-haggle formula for selling used cars is successfully rolled out across the country. He believes today's 22x multiple of expected 2006 earnings will appear cheap as the company continues to increase earnings by at least 15% annually.

Sources: Company reports, other publicly available information

exactly the same, just applied to private companies. Both of these deals were local, where we knew the people well and there was a real commonality of values. There also were no intermediaries involved, which kept the costs down.

As I mentioned earlier, we believe that in the next three to five to seven years, the popularity of the big private-equity funds goes the other way. Returns will be disappointing and money will start flooding out. When that happens, there will be a lot of things for sale at very attractive prices. I want to have built a bit of a platform and skill set to be ready to take advantage of that when it comes.

You often make "farm-team" investments when you first get interested in a stock. What recent ideas are you pursuing?

TG: I will buy a small stake in something I'm interested in, just to make myself think about it more than if I was just on a mailing list for reports. Two names I've bought recently are Harley Davidson [HDI] and Bed Bath & Beyond [BBBY]. These are historically very profitable, well-run companies with stocks that have gone sideways, at best, and the valuations are much more compressed. Friends of mine own both and suggested I look at them.

Bed Bath & Beyond is a classic example of something I missed during its glory days. *Saturday Night Live* had a skit once about a store called Spatula City, where they were promoting how you could buy nine spatulas and get the tenth one free. When Bed Bath & Beyond came out, I thought it was like Spatula City – who would want that? It proceeded to go straight up for about 15 years. So I'm not so good at calling things like that.

But what has worked well for me is finding those things that have matured, after all the people who rode it when it was going up like a Roman candle have started to bail. Stocks like that usually go down too much – that's where we make our living.

ON ACTIVISM:

The fact is, when I have to write a letter and make noise, that almost always means I've made a mistake and should move on.

Have you become any more activist as a shareholder in recent years?

TG: Not really. The fact is, when I feel I have to write a letter and make noise, that almost always means I've made a mistake and the more productive use of my time is to sell and move on.

As a buy-and-hold investor, the perfect outcome is when a company earns high returns on their equity capital for as long as I live. I can hold and have the earnings compound in a tax-efficient way. So, as opposed to agitating for a fight, I'm better off hooking up with people who are great at what they're doing – and are going to keep being great at it for a long time. VII

Looking for investment ideas that stand out from the crowd?

Subscribe now and receive a full year of **Value Investor Insight** – including weekly e-mail bonus content and access to all back issues – for only $349.
That's less than $30 per month!

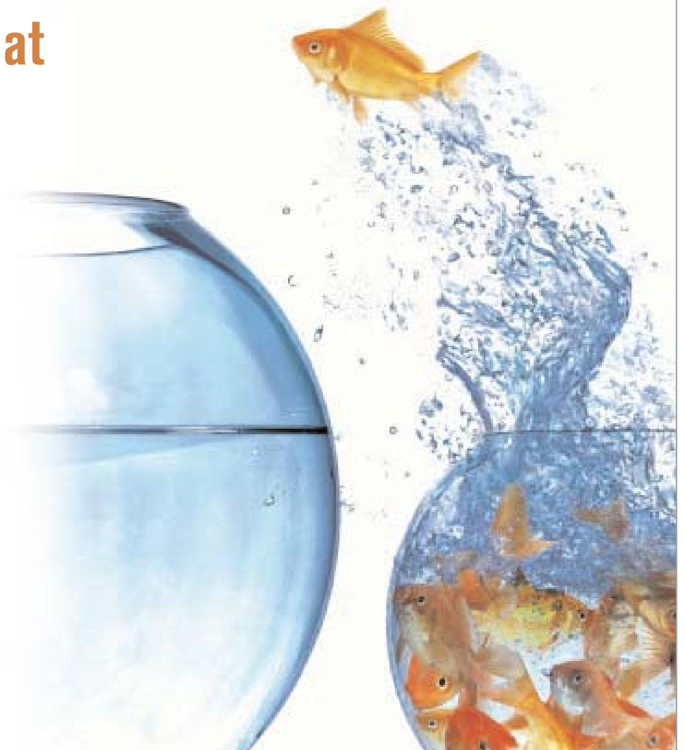
Subscribe Online »

Mail-in Form »

Fax-in Form »

Or call toll-free:
866-988-9060

Want to learn more?
Please visit www.valueinvestorinsight.com



Investor Insight: Brian Gaines

Brian Gaines of Springhouse Capital Management explains where he's finding small-cap bargains, why it's tough for investors to gain an information advantage, why he's not afraid of uncertainty and why he thinks Levitt Corp., Greenfield Online, Celebrate Express and ChipMOS Technologies are mispriced.

You've said your relatively high tolerance for risk is a key to your investing strategy. Please explain.

Brian Gaines: People hate uncertainty and that's what depresses stock prices. I don't have a problem with uncertainty – I just apply numbers to it. I can't tell you with certainty if Delphi will strike or how the housing market will play out, but I can assign probabilities to different outcomes and make a judgment on how accurately the market is pricing in the risks. The more perceived risks there are, the greater the chance of mispricing by the market.

Even in industries everybody knows are in decline – like video rental – we'll just look as rationally as possible at how accurately the stocks are pricing in the decline and what options the companies have. Sometimes the market pays you very well to take calculated risks.

How did your experience working with distressed securities inform your attitude toward risk?

BG: My first job was in Citicorp's high-yield group, working on financings and restructurings for things like Argentinian toll roads and Greek shipping companies. Working with distressed situations trains you to look at each piece of the capital structure – the public debt, bank debt and equity. As an equity investor, it's a good discipline to compare the return expectations on each of those pieces. Working in distressed is also great training for staying calm when things get ugly, which can be a real advantage for any investor.

What types of situations tend to attract your attention?

BG: With every stock we own, we want at any given time to be able to look out over the next year and see at least a 50% upside, based on conservative multiple assumptions and with minimal downside risk. We don't constrain ourselves by looking only at "value" or "growth" stocks – the upside can come from a turnaround or from high growth. Beyond that, we look for free options that can give us potential returns well beyond that 50%.

The downside protection can come from many things other than a low P/E or a lot of cash on the balance sheet. For example, the downside protection might be what they can do to restructure their operation in ways that would make it more attractive to a potential acquirer.

We constantly reevaluate the companies we own. We've owned INVESTools [IEDU], an investor-education company that you've written about before [*VII*, March 23, 2005], for some time. They're continuing to shift their product mix to their own brand, instead of using other brands like CNBC or *BusinessWeek*. They're moving more online, which can improve margins and broaden their potential market. They have a content deal with Yahoo that starts later this year, which will enhance their marketing reach. All this is just starting to play out. On top of all that, they have a very talented CEO, Lee Barba, who has a significant ownership stake and is obsessive about the business. When you have all that at a great price, we'll keep owning it as long as we see 50% upside a year out.

What you're unlikely to see us invest is in something like The Cheesecake Factory at 30x earnings. Everybody knows it's a great story and, when it comes down to it, the bet you're making is whether or not the business grows a little faster or for a little longer than people expect. Those are not the types of calls we look to make.

Brian Gaines

Perpetual Student

Brian Gaines wasn't out of junior high school in Allentown, Pennsylvania when he hit upon one of the key attractions of investing: "I was interested in a lot of different things – math, business, psychology, history, geography – and investing was unique in how it combined aspects of each," he says.

Having earned an Economics degree from Brandeis and an M.B.A. from Wharton, Gaines' broad thirst for knowledge continues to inform his style as a professional investor. "My job is to find stocks that are cheap, so I'll look at anything: good or bad industries, good management or lousy management, areas I already know or areas I need to learn about," he says.

And what about sticking to a defined circle of competence? "It's great if something undervalued shows up in an area I already know a lot about, but I won't avoid an opportunity just because I don't have that knowledge," he says. "If biotech stocks ever get cheap, I'll learn about biotech. In fact, when a sector or industry gets in trouble, I think there can be great value in coming at it with a fresh eye. You don't have all the baggage that comes from having been burned."

Your portfolio has been heavy on small-caps. Will that always be the case?

BG: My job is to find undervalued securities, so I will look at anything. We've been more small-cap oriented because that's where we've found the most attractive opportunities. I expect that always to be somewhat the case, because small- and micro-caps are more often overlooked. But we're also finding big- and mega-cap companies to own. We have a stake now in Wal-Mart [WMT], both in common shares and well in-the-money call options, that meets our return expectations.

Where do you look for ideas?

BG: Many of our ideas come from having followed hundreds of stocks obsessively for years and constantly revisiting the stories. We look at insider buy lists and daily new-low lists. I also pay attention to news in consumer-sensitive areas, such as retail and restaurants, where swings in comps and rapid change in consumer behavior can create opportunity.

Where else do you find ideas?

BG: One thing I learned in the high-yield area was to pay attention to capital flows. Money flowing into a sector makes capital more available to expand capacity and, unfortunately, makes management more likely to do something stupid because they're well funded and feeling particularly smart at the moment.

Capital-starved industries, on the other hand, are more than likely to eventually benefit from a lack of expansion. The gaming industry was unpopular in the late 1990s – people were afraid of overbuilding in Las Vegas and riverboat gambling wasn't considered attractive. So Vegas didn't get overbuilt in the 90s, which still has a beneficial impact today. When lack of capital forces capacity rationalization and sensible spending, that can give you a free option on an upturn in the future.

Investor's Business Daily lists every day the most-loved and most-hated industries, based on stock-price movements. It's interesting to check your portfolio against the top and bottom of the list, as an indicator of where capital is available or not.

What's at the top and bottom now?

BG: The five most loved are Steel Specialty Alloys, Food, Flour & Grain, Steel Producers, Metal Ores, and Oil & Gas. The bottom five, starting from the bottom, are Newspapers, Retail Jewelry, Building (Residential & Commercial), Autos and Generic Drugs.

ON SPECULATIVE POSITIONS:

I'll take smaller positions in companies that have a lot of leverage or that have business models that aren't yet proven.

Once you have an idea, where do you focus your research?

BG: We cover all the basics to make sure we understand the industry and the business – reading the conference-call transcripts, the 10-Ks and 10-Qs, speaking with management. We study key competitors to look for differences in how they're doing, what they're doing and why.

In terms of metrics, I focus on EBITDA [earnings before interest, taxes, depreciation and amortization], less capital expenditures. It's bizarre to me that people are back to looking at just EBITDA again, considering how WorldCom and a lot of other scandals showed how wrong it was to ignore capital spending. I often find interesting ideas by looking at where a company's current capital spending is relative to what it's going to need over time and what is going to flow through the income statement as depreciation.

The other key metric I focus on is the return on invested capital. I like to see at least 20% – ideally over 30% – but will invest in businesses where it's lower, if the stock's cheap enough.

On the balance sheet side, I look at the mix of fixed-income versus bank debt, so you know whether you can get taken out if things get very ugly. Bank covenants can take equity investors under, but that's far less likely with fixed-rate debt. Another important thing we pay attention to are deferred tax assets, like those from net operating losses. Their value isn't always obvious, but can be important to the value and the thesis.

Do you think one can have an information advantage?

BG: We work very hard to get as much information as possible, but it's hard to win the information arms race. There are always people who will know things you don't. Investing is about the conclusions you draw from the information you have. Just because someone speaks to seven store managers instead of the five we speak to doesn't mean they'll make a better investment decision. People in industries have as many or more biases than investors do, and often draw circular conclusions – for example, the company is bad because the stock is bad.

We focus on uncovering information that helps us understand the probabilities of what can happen. Beyond that, too many opinions can often confuse things more than help.

Is your portfolio as concentrated as Joel Greenblatt's has tended to be?

BG: I may not be concentrated by Gotham standards, but my top 10 positions generally make up 80% of the portfolio. I'll also take many smaller, speculative positions, where I think a stock is cheap, but the company may have a lot of leverage or has a nascent business model that isn't yet proven.

Some of our best picks have been in small positions that did poorly at first, but we doubled-down on because we thought we understood them better than others – who were either scared away or just thankful for avoiding the decline so far. Because the stocks had got cheaper, we had more downside protection and could take full positions.

Give us an example.

BG: We bought a small amount of Netflix in October, 2004 at $17. DVD-by-mail wasn't a proven concept, but we thought it made sense. The company's return on invested capital was excellent, the valuation compelling after backing out subscriber acquisition costs, and our experience in the video-rental business told us there was a large base of potential users.

Right after we bought, Netflix cut prices to head off Blockbuster's expansion in the mail business and the stock was cut in half, to $9. While the market clearly saw Netflix as riskier, the concept still made sense and there were plenty of factual reasons to believe the competition from Blockbuster was not going to be the problem the market was expecting – so we bought more. It's worked out very well and I still think the stock is cheap, but we have since taken most of the profits. [NFLX trades now at $28.75.]

Tell us about one of your current favorites that has been beaten down, Levitt [LEV].

BG: Levitt has three parts to it. The first is their branded homebuilder, Levitt and Sons, which many people have heard of from their development of Levittown on Long Island. They're now focused on building for recent retirees – mostly in Florida, but they're expanding into Georgia, South Carolina and Tennessee. They have comparable levels of supply to other homebuilders, with five years' worth of owned or optioned inventory.

The second part is a division that does master-planned communities, where they own many acres of land and develop it both themselves and by selling land to other builders. They have a huge tract they've started to develop in Port St. Lucie, Florida and also have land they bought last year in South Carolina.

The third asset they have is 9.5 million shares of Bluegreen Corp. [BXG], a publicly traded timeshare company.

Levitt's shares are the lowest they've been since the company was spun off in late 2003. Margins have been squeezed by rising building costs and a cooling market in Florida, where most of their business has been. They've also ramped up selling, general and administrative costs in expanding outside of Florida, which the market doesn't like at this point in the housing cycle. The extra costs in starting new developments are hitting before the revenue comes in from selling the homes.

So you believe the market is overreacting?

BG: We think about Levitt by valuing the parts. Starting with the easiest part first, the traded Bluegreen stake is worth $5.50 per Levitt share, after-tax. We think that's probably undervalued and on the upside it could be worth closer to $7.

The Levitt and Sons homebuilding business has a book value of $7.50 per share, after conservatively allocating total debt to each part of the business. It's still making money, but because of the pressures I mentioned earlier, probably only a third of the $1.50 per share it earned in 2004.

I can't tell you exactly how the homebuilding cycle is going to play out, but I can judge whether I think there will be impairment to the $7.50 book value. For a variety of reasons, I don't think there will be. The properties are well located and most have appreciated significantly since going on the books over the past several

INVESTMENT SNAPSHOT

Levitt Corp.
(NYSE: LEV)

Business: Home builder and real estate developer primarily targeting recent retirees on Florida's Atlantic Coast and in other southeastern U.S. markets.

Share Information
(@ 5/25/06):

Price	**16.80**
52-Week Range	16.01 – 33.20
Dividend Yield	0.5%
Market Cap	$333.0 million

Financials (TTM):

Revenue	$488.6 million
Operating Profit Margin	7.8%
Net Profit Margin	5.0%

Valuation Metrics
(Current Price vs. TTM):

	LEV	S&P 500
P/E	13.7	20.1
P/CF	12.7	14.3

Largest Institutional Owners
(@3/31/06):

Company	% Owned
Advisory Research, Inc	8.3%
Keeley Asset Mgmt	5.9%
Pennant Capital	4.8%
Lazard Asset Mgmt	4.3%
Wellington Mgmt	3.9%

Short Interest (@ 5/8/06):

Shares Short/Float	8.7%

THE BOTTOM LINE

Underlying asset values more than protect against any "temporary pain" from falling land prices as residential real estate cools, says Brian Gaines. Based on his sum-of-the-parts analysis of the company's homebuilding, community-development and timeshare assets, he believes the shares are worth $30, a 79% premium to today's price.

Sources: Company reports, other publicly available information

years. In general, active-adult communities are less susceptible to speculation and price collapse, and Levitt itself has avoided speculative building. I don't deny that homebuilders can trade at discounts to book, but in Levitt's case I think the $7.50 book value is achievable over time. One free option we like is that eventually the market will get comfortable with the homebuilding cycle, and this piece will likely trade at a decent premium to book. So the upside value is closer to $10 per share.

We assume the land-development piece of the business is the hardest to value.

BG: Land is clearly the most volatile piece and we're probably heading into a time when land isn't in high demand. This is an example of a risk we'll take – we're willing to live through the temporary period when land swings in value.

The South Carolina land they bought last year cost them about $2.50 per share. We think it's still worth at least that, given that they didn't buy in an overinflated geographic market and they've since received all the building permits for it. On the upside, the South Carolina land could be worth closer to $4 per share.

Of the 4,200 acres in Florida, 3,400 are residential and 800 commercial. They sold residential acreage there to Toll Brothers two years ago for the equivalent cost of about $80,000 per unfinished acre, which is what most of the remaining land is. Given that local brokers tell us land prices appreciated 25% per year in the two years since the sale, we think putting that $80,000 value on the residential acres they have left fully accounts for the risk of land values falling in an ugly market.

This is well-located land – there's almost no land left to develop south of Port St. Lucie on the Atlantic Coast – in a state that will continue to grow in population. At $80,000 per acre, that makes the residential acreage worth $10 per Levitt share, after taxes.

The only other piece to consider is the 800 commercial acres, which based on similar historical metrics is worth over $300,000 an acre, or another $8.50 per share after tax.

What about debt?

BG: Excluding debt I've taken out in the homebuilding valuation and taking into consideration the company's other real estate assets, the remaining net debt comes to about $4 per share.

So adding the conservative values of the assets and subtracting the debt brings you to a value of $30 per share, versus the current price of $16.80.

BG: Yes. There will be an ugly time as land values adjust in the short term, but the underlying asset values more than protects us. We think we'll be paid very well for living through any temporary pain.

Going from hard assets to digital assets, tell us about Greenfield Online [SRVY].

BG: Greenfield is an online survey business. They have one of the largest databases in the country of survey takers, people who have given their demographic information and have agreed to be available to answer surveys. Greenfield's target customers are 2,500 market-research firms, who hire Greenfield to help them create the surveys and then assemble the panels of people to take them.

The competitive dynamics are positive. The five primary competitors in North America control about 80% of the market, and Greenfield is the leader. There are barriers to entry in the expense, technology and expertise necessary to build and manage the panel databases. At the same time, Internet polling continues to take business from more traditional mail or phone options. The days of trying to get responses on the phone or mailing surveys with dollar bills inside are numbered.

Greenfield's stock has also had a rough ride since the company went public in 2004. Why?

BG: When it first went public, everybody loved it and the share price went as high as $24. They then proceeded to make overpriced acquisitions – which is what companies with high stock prices do – which they didn't integrate well. At the same time, too much capital flowed into the business and pricing collapsed. We first bought around $7 and then bought more when it proceeded to go to $4.50.

With the shares now trading at $7.75, it would appear they still have work to do.

BG: In September of last year they brought in a new CEO, Al Angrisani, who had turnaround experience in the market-research business, most recently with Harris Interactive. We almost always consider the fresh perspective a new CEO brings as a positive. He took a heavily options-based package – at $6.30 per share – so his interests are aligned with ours. We've found him to be very talented, willing to cut costs and focused on the right things for shareholders.

His focus so far has been on reducing expenses – he took $7 million in annual costs out of a business that is estimated to make $20 million in EBITDA this year – and on eliminating unprofitable business. The business has stabilized and he's now turning his attention to building revenues.

Are the numbers showing any sign of turnaround yet?

BG: Not in terms of revenue growth, but the first quarter did show significant cost savings and the fact that the business has stabilized. Management is being very cautious not to overpromise, which leaves the market uncertain. That's fine with us, because that's what's keeping the stock down. As the results show up over the course of the year, we'll be rewarded.

How are you valuing the company?

BG: We also look here at valuing the parts of the business – the U.S. survey business, the European survey business and a comparison-shopping business in Europe, called Ciao, which they acquired when they expanded in Europe.

The North American survey business did $2.6 million of EBITDA minus capex in the first quarter of this year. The business isn't particularly seasonal, so we

think they can do $10 million for the full year. Given that the returns on invested capital are fantastic, there's little reinvestment needed, they are the market leader in a business unlikely to see further entrants and pricing has gotten sane, we think this business deserves at least a 10x multiple. That makes it worth $100 million, or $4 per share.

The European business earned $1.5 million in the first quarter, so we believe $6 million for the full year is very achievable. The competitive dynamics are similar, so we think it's also worth a 10x multiple, which comes to $2.40 per share.

The comparison shopping business, Ciao, is a hidden gem. It did $1.5 million in EBITDA less maintenance capex in the first quarter. Revenue grew 80% in 2005, margins are 40-50% and they have the #1 position in Germany. If you straight-line the first quarter and say they earn $6 million for the year and then apply an appropriate 15x multiple to it, that's worth $3.60 per share. We think Ciao will earn $8-9 million in 2007, so that valuation is conservative.

You're not counting on any growth?

BG: Not in the U.S. or Europe, which we consider a free option. They are starting to expand in Asia and we put a value of about $1 per share on that.

So we can make a very clear case for a value of around $11 per share. On top of that, we see several upside options: U.S. and European growth picking up, a higher multiple as the turnaround is recognized, Asia growing faster than we are counting on, and Ciao getting sold for a big price. There are a lot of ways to win.

Tell us about another of your Internet holdings, Celebrate Express [BDAY].

BG: The company's main brand is Birthday Express, which sells party supplies for young children's birthday parties through the web and catalogs. They also have a smaller costume business and they sell special-occasion clothes for children. About 70% of revenues come from the Internet, up from 50% three years ago.

We had never heard of it, but found that Birthday Express has very high brand awareness in the community of affluent mothers. They are the dominant online player and compete offline with chains like Party City and the discount retailers. The party-supply business actually works much better on the Internet. A retail store has trouble stocking enough themes with enough depth in those themes – Party City may have the SpongeBob plates, but not the cups or banners. With a centralized warehouse, Birthday Express can stock triple the number of themes of Party City and double the number of items within those themes.

The company has a lot going for it. It's the online market leader, with high returns on capital and revenue growing 30% per year. People find out about it by word-of-mouth and repeat business is now 50% of the total, which should allow them to reduce marketing spending going forward. Given the fulfillment infrastructure needed with the average order having 20 different SKUs [stock-keeping units], it's not easy for someone to step into the space – it would make a lot more sense for someone just to buy these guys out before doing something themselves.

INVESTMENT SNAPSHOT

Greenfield Online
(Nasdaq: SRVY)

Business: Independent provider of Internet survey services to a target customer base of 2,500 marketing research firms, primarily in the U.S. and Europe.

Share Information
(@ 5/25/06):

Price	**7.73**
52-Week Range	4.44 – 15.25
Dividend Yield	0.0%
Market Cap	$195.9 million

Financials (TTM):

Revenue	$95.5 million
Operating Profit Margin	11.0%
Net Profit Margin	(-70.8%)

Valuation Metrics
(Current Price vs. TTM):

	SRVY	S&P 500
P/E	n/a	20.1
P/CF	n/a	14.3

Largest Institutional Owners
(@3/31/06):

Company	% Owned
Burgundy Asset Mgmt	9.0%
Integral Capital Mgmt	8.5%
Credit Suisse Asset Mgmt	5.1%
Springhouse Capital	3.2%
Barclays Global Inv	2.4%

Short Interest (@ 5/8/06):

Shares Short/Float	7.3%

SRVY PRICE HISTORY

THE BOTTOM LINE

The market appears skeptical that the company's turnaround has taken hold, says Brian Gaines. Based on current revenue and profitability run rates, he believes the shares are worth $11 per share – with "free options" from U.S. and European growth, Asian expansion, the potential sale of a division and multiple expansion.

Sources: Company reports, other publicly available information

So what's the market missing in pricing the stock at a recent $13.17?

BG: Earlier this year the company ran into some operating problems, primarily as they started upgrading their fulfillment system to an automated pick process from the current manual process. This led to some inefficiency – which we think is temporary – but will result in pretax operating margins of 3-4% on $90 million in revenues for the fiscal year ending this month. On that, the stock looks pretty expensive, trading at more than 20x operating income.

As they grow and correct the system issues, fulfillment costs are going to go down. They should have lots of leverage in spreading selling, general and administrative costs over a larger base. They have gross-margin upside from selling a higher percentage of proprietary products.

In addition, they currently spend 25% of their revenues on marketing, which we think is much more than they'll need as they move more of their business to the Internet and away from catalogs. Once you have a customer, you know when to market to them the next year and you can do it by e-mail, rather than a catalog. Management expects 10% margins over time. We think 8% should be fairly easy.

So looking at this a year from now, we think people will see $115-$120 million in revenues, with an 8% operating margin, resulting in around $9.4 million in operating income. If we get to that point, with the top-line growing at 20%-plus, that should warrant at least a 12x multiple on those operating earnings. If you add in the $35 million or so of cash they'll have then, we get a target value of $19 per share.

What's the downside protection here?

BG: One protection is from the takeout value if a big company like Amazon wanted to get into this space. An acquirer could immediately eliminate $2 million in public-company operating costs. Even if you assume Celebrate Express makes only 6% operating margins, someone would easily be willing to pay 8-9x that for a business growing like this. That comes out to around $15 per share.

A free option here is the database. Their customers are generally affluent mothers in their 20s and 30s, who are willing to pay a bit more for convenience and selection. It would not be a stretch to see them marketing related concepts to this valuable audience in the future.

The company named a new CEO last week. Has that affected your outlook?

BG: The founder took the company to this point and they decided it was best now to bring in more of an operating manager as CEO. As with Greenfield, we welcome the fresh set of eyes and think some of the things we're looking for might happen faster.

Now for something completely different. What attracted you to ChipMOS Technologies [IMOS]?

BG: ChipMOS, based in Taiwan, is the world's 5th-largest provider of outsourced semiconductor testing and assembly services, and the largest in the niche of commodity [DRAM] memory chips and the chips that drive liquid crystal displays.

There has been a large trend toward outsourcing semiconductor testing and

INVESTMENT SNAPSHOT

Celebrate Express
(Nasdaq: BDAY)

Business: Internet and catalog retailer of themed birthday-party products and supplies, girls' special-occasion apparel and children's costumes.

Share Information
(@ 5/25/06):

Price	**13.17**
52-Week Range	10.89 – 15.54
Dividend Yield	0.0%
Market Cap	$102.2 million

Financials (TTM):

Revenue	$82.4 million
Operating Profit Margin	3.4%
Net Profit Margin	2.1%

Valuation Metrics
(Current Price vs. TTM):

	BDAY	S&P 500
P/E	59.8	20.1
P/CF	36.4	14.3

Largest Institutional Owners
(@3/31/06):

Company	% Owned
Springhouse Capital	7.7%
Cortina Asset Mgmt	6.9%
Massachusetts Financial Svcs	5.8%
JP Morgan Chase	5.5%
Munder Capital	5.0%

Short Interest (@ 5/8/06):

Shares Short/Float	0.7%

THE BOTTOM LINE

The market is not adequately valuing the company's 20%+ annual revenue growth and significant potential to improve margins through fulfillment and marketing cost savings and the increased sale of proprietary products, says Brian Gaines. At 12x the operating earnings he expects within two years, he believes the shares are worth at least $19.

Sources: Company reports, other publicly available information

assembly, because it's just more efficient. It's a low return-on-capital business, so chip manufacturers would rather focus on what they do well and outsource this.

The story here is pretty straightforward. The company is coming off a bad year, but in an indication that the testing side of the business isn't nearly as cyclical as the manufacturing side, it still earned a net profit of 56 cents per share. There has been a transition going on from so-called DDR1 to DDR2 memory, and ChipMOS invested too early in DDR2. That resulted in an 80% utilization of capacity, which is generally a trough level.

In the first quarter, the business started to turn. DRAM prices have gotten much better and DDR2 is starting to come to fruition. ChipMOS's capacity utilization in the quarter rose to 83% and it earned a net profit of 25 cents per share. We consider that level of earnings – $1 per share over a year – the normal earnings power of the business.

The stock, trading around $6.60, doesn't exactly sport a premium multiple on those normalized earnings.

BG: We think there are a couple of reasons for that. Memory, ChipMOS's focus, has been out-of-favor for some time. That makes us more optimistic about the competitive dynamics today – people haven't been aggressively expanding capacity – but the market pessimism is still an overhang on the stock.

The market, to us, is also overstating the competitive and cyclical risk here. ChipMOS's focus on memory and LCD-driver chips doesn't significantly overlap with the four largest competitors in the industry. The investments they've made in their niche – including a 750,000 square foot plant they opened last November in Shanghai – have solidified their position and made it tougher for others to enter.

In terms of cyclicality, the testing side of the business is a volume business. When memory is going through a tough pricing period, it doesn't mean the manufacturers don't have to test and assemble their chips. The long-term volume cycle is positive, as people continually need more DRAM memory. We're not saying there isn't some cyclicality, but we think the market is pricing in much more risk of a downturn than is warranted.

What are you seeing as the upside here?

BG: We think there's a very good chance that the improving industry and better utilization rates could result in earnings this year of $1.20 to $1.30 per share. But even on normal earnings of $1 per share, we don't see why a business like this, with 15-17% returns on capital, can't earn a 11-12x multiple – which would give us a $11-12 share price.

Before we close, what do you consider the key lessons you've learned from working with Joel and others at Gotham Capital?

BG: Don't limit yourself in where you look for cheap stocks. Don't be paralyzed by the fear of making a mistake. Understand that the best opportunities usually carry more perceived risks, and distinguish carefully between the risks that matter most and those you can live with.

No one is saying to get comfortable losing money – I hate it as much as anyone. But as long as I know the risks I'm taking and the stock prices are compensating me to take those risks, I can live with that. VII

INVESTMENT SNAPSHOT

ChipMOS Technologies
(Nasdaq: IMOS)

Business: Provider of outsourced testing and assembly services for manufacturers of a variety of memory and flat-panel driver display semiconductors.

Share Information
(@ 5/25/06):

Price	**6.59**
52-Week Range	5.35 – 8.32
Dividend Yield	0.0%
Market Cap	$447.6 million

Financials (TTM):

Revenue	$506.0 million
Operating Profit Margin	19.7%
Net Profit Margin	8.3%

Valuation Metrics
(Current Price vs. TTM):

	IMOS	S&P 500
P/E	13.5	20.1
P/CF	7.2	14.3

Largest Institutional Owners
(@3/31/06):

Company	% Owned
Springhouse Capital	7.1%
Pennant Capital	4.0%
Lazard Asset Mgmt	2.2%
S Squared Technology Corp	1.9%
Legg Mason	1.9%

Short Interest (@ 5/8/06):

Shares Short/Float	2.5%

THE BOTTOM LINE

Because the market "is overstating the competitive and cyclical risk here," says Brian Gaines, improved industry dynamics and better capacity utilization have yet to benefit the company's shares. At the 11-12x multiple he believes IMOS deserves on its $1 in "normalized" earnings per share, he values the shares at $11-12.

Sources: Company reports, other publicly available information

Winds of Change

The best investors are often attracted to the uncertainty that accompanies corporate change – as evidenced by the first-quarter activity of the superstars we track.

When we asked him last year what tends to create cheap stocks (*VII*, December 30, 2005), Peter Langerman of fund giant Franklin Mutual Advisers didn't hesitate: "It's often when companies are in the midst of change – buying or selling divisions, installing new management, reorganizing or restructuring. Change brings uncertainty, so many investors want to wait out that uncertainty until the situation is easier to analyze. We think that uncertainty is what creates opportunities."

This quarter's *VII SuperInvestor Insight*, in which we analyze the portfolios of 25 of the most successful value-oriented hedge-fund managers in the business, bears Langerman out. Of the 13 companies in which at least three superinvestors made significant new bets in this year's first quarter – defined as establishing a new position or adding more than 20% to an existing share position – many are solidly "in the midst" of change.

NTL closed its merger with Telewest Global during the quarter, forming the largest cable-TV provider in the U.K. The combined company then finalized in early April its purchase of Virgin Mobile's cellular business. CBS Corp. was spun off from Viacom as an independent broadcast television and radio company in January. First Data Corp. announced, also in January, that it would spin off its highly-profitable Western Union money-transfer business. Cendant Corp. is reversing its acquiring ways and has announced planned sales of its travel-services, real estate and hotel businesses.

Largely absent from this quarter's prevalent buys are "new economy" companies focused on the Internet or technology. More typical are the bets on independ-

ABOUT
VII SuperInvestor Insight

Institutional money managers with discretion over $100 million or more must file a Form 13F with the SEC listing all publicly-traded U.S. equities held – including the number of shares owned and the fair market value – no later than 45 days after the end of each calendar quarter. From these filings, we track and seek insight from the holdings of an elite cadre of hedge-fund managers (plus Berkshire Hathaway), from better-known investors such as Baupost Group's Seth Klarman and Icahn Partners' Carl Icahn to those less well-known like Jeffrey Ubben of ValueAct Capital and Stephen Mandel of Lone Pine Capital. The list of investors tracked evolves as we add names of those we believe bear watching.

VII SuperInvestor Insight: Great Minds Think Alike

Great investing minds can often come to similar conclusions. Below are the stocks in which at least three of our regularly-tracked Superinvestors established new positions or increased their existing share positions by more than 20% during 2006's first quarter.

Company	Ticker	Industry	Price@ 5/25/06	Q1 2006		# Of Portfolios In Which Held	% Change In Total Shares Held
				Low	High		
NRG Energy	NRG	Electric Utilities	43.40	41.79	49.46	5	175.0%
NTL Inc.	NTLI	Diversified Communications Services	27.19	23.20	29.51	4	270.5%
Omnicare	OCR	Health Care Plans	44.46	47.37	61.94	4	All new positions
Sprint Nextel	S	Diversified Communications Services	21.57	22.47	26.25	4	43.2%
Wal-Mart	WMT	Discount, Variety Stores	49.45	44.52	48.87	4	9,581.3%
CBS Corp.	CBS	Broadcasting - TV	26.30	23.85	27.45	3	673.6%
Cendant	CD	Business Services	16.41	15.16	18.00	3	All new positions
Centex	CTX	Residential Construction	50.61	61.40	79.40	3	75.1%
First Data	FDC	Business Software & Services	46.60	41.76	48.45	3	528.4%
McDonald's	MCD	Restaurants	33.26	33.20	36.75	3	257.9%
Mirant	MIR	Electric Utilities	24.51	23.93	29.00	3	All new positions
Pulte Homes	PHM	Residential Construction	33.42	36.01	44.70	3	69.1%
Reliant Energy	RRI	Electric Utilities	11.35	9.57	10.74	3	67.9%

Sources: Forms 13F filed with the Securities and Exchange Commission for holdings as of March 31, 2006.

ent power generators Mirant and NRG Energy. As the power-generation business stabilizes after rampant capacity expansion starting in the late 1990s, such companies are on firmer financial footing and are expected to participate in – and benefit from – continued industry consolidation.

Our Superinvestors have been disappointed so far in their bets on two home builders, Centex and Pulte Homes. Both trade below their first-quarter lows, as the entire sector has been buffeted by heightened concern over rising interest rates triggering a slowing housing market. Another dud so far has been pharmacy-services provider Omnicare, whose shares are down 28% from their March high over big concerns about the impact of Medicare's new drug plan on the company's business, and Ominicare's lawsuit against UnitedHealth Group, alleging anti-competitive contract negotiations.

Agitating for Change

Change, of course, doesn't always come at a company's behest. Among the largest single new bets placed by these Superinvestors during the quarter (*see table below*) are those by activist investors likely to agitate for change. Bill Ackman's Pershing Square Capital took a large stake in food company H.J. Heinz, following longtime activist investor Nelson Peltz's increasingly public discussion with the company – so far largely one-sided – about improving its operations and share value.

In contrast, all has been relatively quiet since Jeffrey Ubben's ValueAct Capital took a big stake in mid-cap MDS, a Canadian healthcare-services company that trades on both the Toronto and New York stock exchanges. We're guessing it may not stay quiet for long. VII

Funds managed by Co-Editor Whitney Tilson own Heinz, McDonald's and Wal-Mart.

VII SuperInvestor Insight: Buying With Conviction

A willingness to put big money behind high-conviction ideas is a hallmark of superior investors. Below are the largest single brand-new positions taken by our Superinvestors during the first quarter, which also made up 3% or more of their portfolios at quarter's end.

Company	Ticker	Industry	Price@ 5/25/06	Q1 2006		Investor	Position Value@ 3/31/06
				Low	High		
Schlumberger	SLB	Oilfield Services	65.26	49.20	65.88	Lone Pine	$314.8 million
Kohl's	KSS	Department Stores	54.45	42.78	53.55	Highfields	$181.7 million
H.J. Heinz	HNZ	Food - Major Diversified	42.81	33.42	38.77	Pershing Square	$128.5 million
Viacom	VIA.B	Entertainment - Diversified	37.40	37.67	43.90	Pershing Square	$127.5 million
MDS Inc.	MDZ	Specialized Health Services	19.24	17.25	20.28	ValueAct	$123.5 million

Sources: Forms 13F filed with the Securities and Exchange Commission for holdings as of March 31, 2006.

2ND ANNUAL NEW YORK VALUE INVESTING CONGRESS

Rose Theater • Frederick P. Rose Hall • Home of Jazz at Lincoln Center
Time Warner Center • November 9 -10, 2006 • New York City

Dear Friend,

The Value Investing Congress has been widely applauded for its caliber of speakers, investment wisdom and specific profitable ideas. It has become a MUST ATTEND EVENT for serious investors looking to continuously expand their investment knowledge and a great place to network with other successful value investors.

At the 2nd Annual New York Value Investing Congress, you will learn from superb legendary investors including Bill Miller of Legg Mason, Marty Whitman of Third Avenue, James S. Chanos of Kynikos, Joel Greenblatt of Gotham Capital, Larry Robbins of Glenview Capital and William Ackman of Pershing Square.

There are *already* more than 170 paid registrations for this meeting. *Because you are a Value Investor Insight reader*, you get first crack at one of the strictly limited seats for the Value Investing Congress. Register by June 2, 2006 and you'll pay only $1,695. That's a $1,600 saving from the $3,295 others will pay later to attend. To get this heavily discounted rate, you must register by June 2nd (*no exceptions!*).

Cordially,

John L. Schwartz and Whitney Tilson

Special rate for VII Readers:

Register by June 2, 2006 and you'll save $1,600 off the $3,295 others will pay later to attend!

REGISTER ONLINE AT: ValueInvestingCongress.com

Your offer code is VICVIIA1.

Traits of Losers

Learning from mistakes – ideally others' mistakes – is key to becoming a successful investor. In that spirit, here are 10 traits I've identified, sometimes the hard way, of stocks to avoid. ***By Whitney Tilson***

Tom Gayner of Markel Gayner Asset Management put it well in our interview with him in this issue: "Having invested since I was a kid – I'm now 44 – I've lost money every single way it can be lost as an investor," he says. "The good thing about that: by process of elimination and learning things the hard way, you can figure out how things work and how they don't."

I couldn't agree more. Two months ago (*VII*, March 31, 2005) I wrote about 18 different categories of stocks in which I've made money. Now it's time to highlight the 10 traps I've identified (or fallen into):

1. Declining cash cows. There can be a fine line between opportunity and trouble when a once-strong business goes into decline. How quickly is the business declining? How much cash flow is it producing as it declines? How is management allocating that cash flow? How cheap is the stock? Deluxe Corp. (DLX), the nation's largest check printer, was once an excellent declining cash cow investment – I owned it briefly and profitably in 2002 – yet today, at roughly the same valuation, I think it's probably a value trap. What changed? In 2002, revenues were still growing, cash flows were rising and the balance sheet was exceptionally strong. Today, revenues are declining, cash flows are plunging and, thanks largely to an unwise acquisition, the balance sheet is dangerously leveraged.

2. High and rising debt. Value investors are naturally drawn to companies in trouble – that's what makes stocks cheap if the difficulties prove to be temporary – but beware of high and rising debt levels! Even if a company is well positioned to benefit from improving conditions over time, equity holders won't benefit if its debt levels trigger a bankruptcy or a massively dilutive refinancing in the near term. Specialty retailer Gander Mountain (GMTN), highlighted correctly as a good short by Mark Sellers of Sellers Capital last June (*VII*, June 19, 2005), suffers from debt levels that imperil the company. The company was never very profitable – and lost a lot of money last year – so now that its IPO proceeds are gone it has to rely on debt to fund its growth, which is not sustainable.

3. Weak or erratic cash flow. Operating cash flow, because it starts with net income and then adds back depreciation and amortization, should be higher than reported profits. If it's not, figure out why. Are there unusual line items consuming cash? Are inventories or accounts receivable ballooning? Asking such questions would have saved you from the Lucent train wreck. In the 11 quarters ending in Q2 2000, Lucent boasted of "pro-forma" profits totaling $9.4 billion. But over the same period, Lucent had a free cash flow deficit of $7 billion. Little wonder the stock quickly plunged from above $70 to less than $1!

Or consider Enron's operating cash flow in the six quarters before it blew up:

Quarter	Operating Cash Flow
Q1/2000	-$457 million
Q2/2000	-$90 million
Q3/2000	$674 million
Q4/2000	$4,652 million
Q1/2001	-$464 million
Q2/2001	-$873 million

These numbers aren't just erratic, they're bizarre. Seasonal retailers might have cash flows like this, but Enron? Of course, Enron was reporting high and steadily rising, if fictitious, net income during this period.

4. Over-reliance on one customer. In my experience, one of two things typically happen to companies that derive a large portion of sales from a single customer: at some point, the company loses the customer or, recognizing the company's vulnerability, the customer renegotiates the deal – either of which is devastating to the company and its stock. In early 2003, Boston Communications Group (BCGI) was growing rapidly, had high margins and a cash-rich balance sheet, and was trading at a modest 12x earnings, net of cash. I shorted it because 51% of its revenues came from Verizon Wireless (another 23% was from Cingular Wireless) and the contract was up for renewal. Verizon Wireless decided to bring in house the services BCGI had been providing, a major reason the stock is down more than 90% since then.

5. Consumer fads. Here's what famed short seller Jim Chanos has to say about fad-driven companies (*VII*, July 29, 2005): "This is when investors – typically retail investors – use recent experience to extrapolate *ad infinitum* into the future what is clearly a one-time growth ramp of a product. People are consistently way too optimistic and underestimate just how competitive the U.S. economy is in these types of things: Cabbage Patch Kids in the 1980s, NordicTrack in the early 1990s and, more recently, Salton with the George Foreman grills."

6. Unions and legacy liabilities. When betting on a turnaround, it's critical to understand the flexibility the company has – or doesn't have – in implementing painful, but necessary changes. Legacy healthcare, pension and environmental liabilities can serve as the same drag on a company's prospects as too-high debt. An often related problem is that a militant, unionized workforce is unlikely to appreciate how dire a company's situation is and will stonewall against the types of layoffs and cost cutting that are needed to avoid disaster. In such cases, equity holders have little hope of coming out whole.

7. Deeply cyclical industries. Many value investors have made fortunes investing in deeply cyclical industries, but generally only when they have a deep understanding of the industry, which gives them an edge, and when they're buying at the point of maximum distress and pessimism. Neither was the case when I purchased shares of niche steel manufacturer Universal Stainless & Alloy Products (USAP) in early 2002, at around $15. It's a fine little company that was coming off its best year ever, but then, due to no fault of its own, ran into the worst market for its industry in 40 years, according to its CEO. The stock fell to under $5 within six months – a very painful experience, only partially mitigated by the fact that the stock (which I no longer own) has been on a tear for the past three years and now sits at $28.

8. Focus on EBITDA. Charlie Munger once said that every time EBITDA – earnings before interest, taxes, depreciation and amortization – is used as an earnings metric, one should substitute the words "bullshit earnings." Used properly by those who understand its limitations, EBITDA can be a useful measure. But too often it's used by unscrupulous management, investment bankers or analysts to make a stock appear cheap – a stock's EBITDA multiple is always lower than its P/E multiple – or to deceive investors about the true nature of a company's capital requirements. It's not a coincidence that many big frauds, like WorldCom, were touted using EBITDA metrics.

9. Serial acquirers or mega-acquisitions. Given the research showing that two-thirds of all acquisitions are failures and the wide range of accounting shenanigans that can occur when one company acquires another, it's remarkable how frequently investors get excited about roll-up stories or big acquisitions. It's due in no small part to the cheerleading from Wall Street, which of course makes a fortune from M&A activity. While we own Tyco today as an organically growing, discount-to-the-sum-of-the-parts story, we fortunately avoided it when it was a serial acquirer. And look at Time Warner's devastated stock today vs. where it was prior to merging with AOL, the worst deal of all time.

10. Aggressive accounting. The huge gray areas in U.S. GAAP (Generally Accepted Accounting Principles) leave management with tremendous leeway in how aggressively or conservatively it represents company operations. Especially in today's post-scandal, Sarbanes-Oxley era, stay away from any company that you believe is being aggressive in its accounting. Even if it appears to be minor, imagine what other things such companies are doing that don't show up in the financials! Our largest short position today, MBIA (MBI), has been forced to restate a $170 million loss and we believe, is massively underreserved for potential losses. When a company's accounting treatment creates more questions than answers, something is likely wrong.

Mistakes are a byproduct of both action and progress, so I'm sure that I still have plenty of new gaffes to make. I'll keep you posted about them, so that you can benefit from my experiences. As Warren Buffett says, it's far better to learn from others' investment mistakes than your own. VII

Look here for insight and ideas from the best investors.

Subscribe now and receive a full year of **Value Investor Insight** – including weekly e-mail bonus content and access to all back issues – for only $349. **That's less than $30 per month!**

Subscribe Online »

Mail-in Form »

Fax-in Form »

Or call toll-free:
866-988-9060

Want to learn more?
Please visit www.valueinvestorinsight.com

The World According to Charlie

While the Berkshire Hathaway annual meeting is long past the "intimate" stage, there's still an air of informal conversation around the Wesco Financial meeting, hosted by Charlie Munger. The focus of the meeting is a lengthy question-and-answer session, in which Munger – at 82, as quick-witted and entertaining as ever – answers questions from the crowd. From the meeting held earlier this month, here is a brief sampling of his responses:

On Management Excess:

"One of our fellow value investors said the other day, considering the self-interested way most corporate managers behave, you ought to get 30-40% more in assets than you pay to allow for the depravity of the people running the corporation. That's a very harsh thing to say, but it's true in many cases."

On "Spin":

"There's just a huge amount of skill in exposition. Part of being a wise person is resisting the other person's expository – to know nonsense when you see it. If you're like me, you can conceal your contempt for the person even as they speak."

On Investment Hurdle Rates and Modeling:

"We don't do a lot of involved math. We distrust others' systems [and complex models] and think it leads to false confidence. The harder you work, the more confidence you get. But you may be working hard on something you're no good at. We're so afraid of that process that we don't do it."

On Misplaced Priorities:

"At Samsung, their engineers meet at 11 p.m. Our meetings of engineers [meaning our smartest citizens] are also at 11 p.m., but they're working on pricing derivatives. I think it's crazy to have incentives that drive your most intelligent people into a very sophisticated gaming system."

On Backdating Stock Options:

"I think backdating stock options is embezzlement. I would argue that if it happened, it was criminal. But I would also bet that the people who did it think it was God's work. [They probably reasoned:] "If options are great, then this must be even greater!" I'll bet there's no sense they did anything wrong. It's hard to believe that the human mind can play such ghastly tricks."

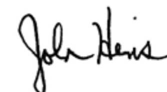
On Mistakes of Omission:

"Chris Davis [of Davis Advisors] has a temple of shame for mistakes. [A wall in his office on which he hangs stock certificates of the worst stocks he's ever bought.] But this is inadequate. You need a temple of shame squared, to include great things you almost bought and would have, had you been a little more rational. You'll be a lot better investor if you remember boners of both kinds. Reality doesn't distinguish – either way, in 10 years, you're poorer."

On Devil's Advocacy:

"[Always] ask yourself what are the arguments on the other side. It's bad to have an opinion you're proud of if you can't state the arguments for the other side better than your opponents. This is a great mental discipline."

We'll send the full Q&A notes to subscribers in next week's Bonus e-mail. VII



John Heins
Co-Editor-in-Chief

Whitney Tilson
Co-Editor-in-Chief

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

©2006 by Value Investor Media, Inc. All rights reserved. All Site content is protected by U.S. and international copyright laws and is the property of VIM and any third-party providers of such content. The U.S. Copyright Act imposes liability of up to $150,000 for each act of willful infringement of a copyright.

Subscribers may download Site content to their computer and store and print Site materials for their individual use only. Any other reproduction, transmission, display or editing of the Content by any means, mechanical or electronic, without the prior written permission of VIM is strictly prohibited.

Terms of Use: Use of this newsletter and its content is governed by the Site Terms of Use described in detail at www.valueinvestorinsight.com. See a summary of key terms on the following page of this newsletter.

Contact Information: For all customer service, subscription or other inquiries, please visit www.valueinvestorinsight.com, or contact us at Value Investor Insight, 2071 Chain Bridge Road, Suite 400, Vienna, VA 22182; telephone: 703-288-9060

General Publication Information and Terms of Use

Value Investor Insight is published at www.valueinvestorinsight.com (the "Site") by Value Investor Media, Inc. Use of this newsletter and its content is governed by the Site Terms of Use described in detail at www.valueinvestorinsight.com/misc/termsofuse. For your convenience, a summary of certain key policies, disclosures and disclaimers is reproduced below. This summary is meant in no way to limit or otherwise circumscribe the full scope and effect of the complete Terms of Use.

No Investment Advice
This newsletter is not an offer to sell or the solicitation of an offer to buy any security in any jurisdiction where such an offer or solicitation would be illegal. This newsletter is distributed for informational purposes only and should not be construed as investment advice or a recommendation to sell or buy any security or other investment, or undertake any investment strategy. It does not constitute a general or personal recommendation or take into account the particular investment objectives, financ ial situations, or needs of individual investors. The price and value of securities referred to in this newsletter will fluctuate. Past performance is not a guide to future performance, future returns are not guaranteed, and a loss of all of the original capital invested in a security discussed in this newsletter may occur. Certain transactions, including those involving futures, options, and other derivatives, give rise to substantial risk and are not suitable for all investors.

Disclaimers
There are no warranties, expressed or implied, as to the accuracy, completeness, or results obtained from any information set forth in this newsletter. Value Investor Media will not be liable to you or anyone else for any loss or injury resulting directly or indirectly from the use of the information contained in this newsletter, caused in whole or in part by its negligence in compiling, interpreting, reporting or delivering the content in this newsletter.

Related Persons
Value Investor Media's officers, directors, employees and/or principals (collectively "Related Persons") may have positions in and may, from time to time, make purchases or sales of the securities or other investments discussed or evaluated in this newsletter.

Whitney Tilson, Chairman of Value Investor Media, is also a principal of T2 Partners Management, LP, an investment adviser registered with the U.S. Securities and Exchange Commission. T2 Partners Management, LP may purchase or sell securities and financial instruments discussed in this newsletter on behalf of certain accounts it manages.

It is the policy of T2 Partners Management, LP and all Related Persons to allow a full trading day to elapse after the publication of this newsletter before purchases or sales of any securities or financial instruments discussed herein are made.

Compensation
Value Investor Media, Inc. receives compensation in connection with the publication of this newsletter only in the form of subscription fees charged to subscribers and reproduction or re-dissemination fees charged to subscribers or others interested in the newsletter content.