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Value Investor INSIGHT

The Leading Authority on Value Investing

On the Offensive

His portfolio companies are the "highest-quality ever" and trade overall for less than 60% of intrinsic worth, says Mason Hawkins. More than worthy of note...

As classic practitioners of concentrated, long-term value investing, Mason Hawkins and Staley Cates of Southeastern Asset Management are typically unmoved by today's chaotic market environment. As they put it in their latest investor letter: "Widespread angst and concomitant volatility have helped us find new opportunities."

They're particularly enthused today by opportunities outside the U.S., where the Longleaf Partners International Fund they co-manage with Scott Cobb and Ken Siazon has earned a net annualized 8.3% since inception in 1998, vs. 2.6% for the MSCI EAFE index. Among the diverse sectors attracting their interest: discount retail, computers, gambling, online games and construction. See page 2

INVESTOR INSIGHT

Southeastern Asset Management
(l to r) Ken Siazon, Staley Cates, Mason Hawkins, Scott Cobb

Investment Focus: Seek competitively entrenched companies trading at 60% or less of a conservative appraisal of value.

Keeping It Simple

Even the best companies – or their industries – go out of favor from time to time. That's when Francois Rochon's "capitalist antennae" are their most receptive.

INVESTOR INSIGHT

Francois Rochon
Giverny Capital

Investment Focus: Seeks companies with what he considers premium prospects for earnings growth at times when they're trading at discount-to-the-market prices.

Though interested in the stock market from an early age, Francois Rochon didn't put investing high on his early list of career choices. "I saw the market as a big casino populated by shady characters – not the place for a serious career," he says.

After three years as an engineer, the casino's lure proved strong. Rochon joined Montreal investment firm Montrustco in 1996 and two years later started his own firm, Giverny Capital. Since the beginning of 1999, investing mostly in U.S. stocks, he's earned a net annualized 7.6% for his investors, vs. a 0.8% gain for the S&P 500.

Finding plenty of what he considers high-end companies trading at pedestrian prices, he sees opportunity today in areas such as restaurants, flooring, entertainment and medical devices. See page 10

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Investor Insight: Mason Hawkins

Mason Hawkins, Staley Cates, Scott Cobb and Ken Siazon of Southeastern Asset Management describe what about the latest bear market was unique, the selling guideline they learned from John Templeton, why they see particular opportunity outside the U.S., and what they think the market is missing in Carrefour, Dell, Hochtief, Genting and Shanda.

Mason, since founding Southeastern 35 years ago you've been touting the same "business, people, price" investment philosophy. Please give us a brief summary.

Mason Hawkins: Our view is simply that superior long-term investment performance can be achieved when financially strong, competitively entrenched, well-managed companies are bought at prices significantly below their business value and sold when they approach that corporate worth. The quantitative piece of that is that we only want to buy when we can pay less than 60% of a conservative appraisal of a company's value, based on the present value of future free cash flows, current liquidation value and/or comparable sales.

On the qualitative side, we're looking for two things to line up. The first is that management consists of capable operators focused on generating the most free cash flow possible, and that once they generate that cash flow they redeploy it in a value-generating way. When a company is selling at a big discount to a conservative appraisal of value, the default option – against which other uses of capital should be compared – is typically buying back shares, which creates value per share and increases our percentage ownership in the business. The second qualitative assessment we make is on the quality of the business, where we're looking for the types of competitive advantages that produce sustainably high returns on capital and free cash flow that can grow.

What about how Southeastern operates do you hope sets you apart in the execution of that strategy?

Staley Cates: I'd list a few things. One is being truly long-term in our approach, which shows up in an average holding period of five years and in how long we've held some of our positions, like FedEx for 20 years and Yum Brands for 15. That's rare in this industry, and it allows us to capitalize on price dislocations due to short-term uncertainties that scare so many other investors away.

The second thing is our policy that all analysts have all their equity money invested in our funds. It's a simple thing but also extremely rare, even though we believe there's no question it brings an added level of focus and discipline to our research and portfolio management.

This is harder to prove, but I also believe our valuation appraisals go further and deeper than what most other people do. Since Mason started out the focus has been on truly understanding the accounting, in order to do things like turn earnings per share into a meaningful free cash flow figure or value disparate parts of a business. Everybody believes they're buying cheap stocks, but I'd argue the technical skill and methodology used in arriving at those conclusions often wouldn't hold up to close inspection.

The fourth advantage I believe we have is independence. We're owner-operators and it's not a coincidence that we've built our record outside of a major financial center. When you see your boss in the mirror in the morning, you can assess your career risk solely on your investment results and not on things like politics and relative returns.

The last thing I'd mention is the cumulative benefit of an experienced team doing this for a long time. We have a 35-year network of contacts across numerous companies and boards that we can call on to assess any company or manager we might consider partnering with.

Following up on your point about aligned interests, why doesn't everyone require that managers and analysts invest almost exclusively in their own funds?

(l to r) **Ken Siazon, Staley Cates, Mason Hawkins, Scott Cobb**

Researcher's Paradise

Since founding Southeastern Asset Management in 1975, Mason Hawkins has never been one for organizational complexity. Managing nearly $30 billion in assets, his firm's research and portfolio-management operation has only ten professionals – "really 9.5, since that includes me," he says – all of whom are generalists with no constraints on where to look for ideas. "It's a researcher's paradise," says Scott Cobb, co-manager of the firm's Longleaf Partners International Fund.

The generalist approach is just good business, says President Staley Cates: "We live or die by our research and if you want to get the best and most motivated analysts, you say to them, 'You're free to look at anything, anywhere.' If the alternative is, 'Here are ten companies I want you to spend all your time learning inside and out,' guess where the analyst will want to go?"

Entrepreneurial analysts are also more likely to uncover interesting ideas, says Hawkins: "Great ideas often come from following different paths extending from a given company or industry. We want our people to go down those paths, not stop at some artificially drawn border."

SC: If you're in a shop driven by assets under management, there's a high likelihood you're catering more to your client than going for the best risk-adjusted return, and a lot of clients just want shadow indexing. That's not what good analysts would do with their own money, so they don't want to be forced to invest that way. Some firms also make the argument that our sort of Texas hedge, where both our livelihoods and our savings depend solely on the Longleaf funds, is a bad idea. We understand that line of reasoning, but just don't agree with it.

What types of situations typically result in great companies with great management having attractive stock prices?

SC: One key situation is unrepresentative accounting that we believe obscures the true value of the business. With DirecTV [DTV], the largest position in our Longleaf Partners Fund, subscriber acquisition costs are expensed immediately rather than capitalized over time, which hides the true free cash flow. With Dell [DELL], reported EPS does not capture any of the free cash flow that comes from negative net working capital, from the amortization of deferred taxes or from excess depreciation over required capital spending, nor does it capture all the cash on the balance sheet. With Chesapeake Energy [CHK], the best deals they've done have been percentage interests they've sold in many key fields, but they haven't booked any of them so that doesn't show up in returns on equity, it doesn't show up in earnings, and it doesn't even really show up in book value as receivables. I'm using these three examples because they're our three biggest positions, but "bad" accounting is a common denominator in almost all of them.

A second common situation is when the market seems to be making massively negative qualitative judgments that we believe on deep analysis are misplaced. In the case of Dell, everybody now hates its traditional PC business and seems to have no confidence in Michael Dell, but that overlooks the important and expanding "solutions" side of the business – incorporating servers, storage, and services – that now represents over 25% of revenues and over half of gross profits. With Chesapeake, everybody appears to hate natural gas forever and is angry at Aubrey McClendon [the co-founder and chairman, who was forced to liquidate nearly all his company shares in 2008 to meet margin calls], so the incredible assets they have sort of get lost in the discussion.

The last common thread would be when companies have an absolute jewel of a business that gets lost in the shuffle of a bigger conglomerate. Our success in Disney [DIS] so far and we believe in the future is about ESPN, which nobody asks about on conference calls because they want to hear about movies or the animation business. With Olympus Corporation in Japan [7733:JP], it's about their medical-device business, not their cameras. Ruddick [RDK] is about the Harris Teeter grocery business, not textiles. Worthington Industries [WOR] is about gas containers, not the steel business.

ON BEAR MARKETS:

We've been through seven – what's unique about this one is the opportunity it's created in the highest-quality stocks.

MH: Another classic opportunity for us gets back to time horizon. A company reports a bad quarter, which disappoints Wall Street with its 90-day focus, but that might be for explainable temporary reasons or even because the company is making very positive long-term investments in the business. Many times that investment increases the likely value of the company five years from now, but disappoints people who want the stock up tomorrow.

SC: One of our new purchases in the second quarter was Campbell Soup [CPB]. For a while the market was excited about Campbell's because soup was going to be so popular in a double-dip-recession world where people were living in bunkers eating out of cans. But when luxury and high-end products came back, the idea of soup got boring again, and then the company reported a lousy quarter in soup. The result was a stock price that we felt – and still feel – overlooks all the positive things going on in the overall business.

After the rollercoaster ride of the past couple of years, how would you characterize the opportunity set available to equity investors today?

MH: We've operated through seven bear markets, and what's been unique about this one is the opportunity it has created in the highest-quality stocks. From the third quarter of 2008 through the first quarter of 2009, we were given an opportunity to own best-in-class companies at price levels I've never seen in my experience. Coming out of the 1974 bear market, for example, you were lucky to buy one or two industry leaders, because they all went into the bear market so overpriced that they still weren't cheap enough. Today our portfolio companies have collectively never had as strong competitive positions and you can buy them at 55-60% of our conservative appraisal of their intrinsic values. That compares with our long-term average price/value ratio of around 68%.

You've been expanding your international efforts. Why?

MH: We've always pursued opportunities regardless of geography. We formalized that a dozen years ago in launching our Longleaf Partners International Fund and today we have research offices in London, Tokyo and Singapore.

SC: The specific trigger to launching the stand-alone international fund was the Asian crisis in the late 1990s, which created so many bargains in Japan, Hong Kong and the rest of Asia that we didn't have the capacity for them in Longleaf Partners, which could only buy 30% international names. That was purely opportunity-driven – we were buying Ben

Graham "net-nets" in the meltdown and that worked out very well for us.

In the aftermath of the most recent crisis we've tried to go on the offensive, and one reason we're especially excited about international and global is to take advantage of the huge fallout in the industry outside the U.S. So many funds have either folded or quit doing equities that we believe there's less competition and less market efficiency in some key developed international markets.

How broadly do you cast your international net?

Ken Siazon: Our basic premise is that we'll only invest in a country – or individual name, for that matter – in which we'd be comfortable putting our entire net worth. That means we're primarily in the most developed countries. As of the end of June, our top five country weightings, in order, were Japan, France, Canada, the U.S. and Hong Kong, comprising about 65% of the International Fund's net assets. Wherever we feel business, people or price are compromised in one way or another by an unstable regulatory or cultural environment, we just won't play. We just made our first investment in a Chinese company – two actually, Shanda Interactive [SNDA] and Shanda Games [GAME]. The numbers are based on U.S. GAAP because both are listed solely on NASDAQ, but our willingness to buy them is the culmination of a lot of work to get comfortable with putting investors' money to work in mainland China.

Why does the U.S. have a high country weighting in your international fund?

Scott Cobb: We can own in the fund U.S.-domiciled companies with 50% or more of their business coming from outside the U.S., which is the case with Dell and Yum Brands, which are the two primary American holdings. In Yum Brands, a significant majority of the value we see has for some time been in China, where KFC is head and shoulders above the competition. It's not the norm for us to have U.S. companies in our international portfolio – it usually reflects a legacy holding or just a very high level of conviction in a given stock.

Longleaf Partners was 14% in cash as of June 30, but the International Fund had only 1%. Why?

S.Cobb: It's purely a function of the number of opportunities we're finding internationally relative to in the United States. Our on-deck list of companies that we're prepared to buy when the price cooperates has gone from the typical five names to around 15. Given that we run concentrated portfolios with only 20 or so names, that's a pretty full non-U.S. opportunity set.

ON HEDGING:

We concluded the time spent on currency hedging would be better spent appraising the value of companies.

Why did you recently stop hedging currency exposure vs. the U.S. dollar?

S.Cobb: We stopped hedging last year after doing an analysis since the fund's inception and finding that hedging didn't add at all to overall returns. Currency values are taken into account in our appraisals, but we concluded that the time we spent on currency hedging would be better spent appraising the value of individual companies.

Turning to some specific non-U.S. ideas, describe the upside you see in France's Carrefour [CA:FP].

S.Cobb: Carrefour is the second-largest retailer in the world, with primary franchises in France with its hypermarkets, in Brazil, where it's the largest retailer, in Spain, where it's dominant in the hard-discount area, and in China, where it's a large player and growing rapidly.

In France quite often the biggest companies are considered national champions that for political reasons aren't subject to the same kinds of corporate governance expectations or to activism by shareholders. Carrefour fell into that category and was managed that way for many years, resulting in a fat, bloated, inefficient company. From 1999 through 2007, the company spent €20 billion in growth capex and its EBITDA was flat – they created zero value by spending €20 billion. Talk about poor capital allocation!

In 2007 the French arm of U.S. private equity firm Colony Capital partnered with Bernard Arnault, the chairman of LMVH and one of the richest people in the world, to buy a big stake in Carrefour – now around 14%, but with voting rights above 20%. Colony's focus has traditionally been real estate, so one big reason they were interested was because Carrefour owns a ton of their own real estate – something like 85% of their stores in France, for example. The idea was to in some way spin out the properties and sell them, unlocking significant value and returning the proceeds to shareholders.

The second angle was operational: Carrefour had been mismanaged for a decade, so by bringing in new management that knew how to run a giant company efficiently and with the operational standards of world-class companies like Wal-Mart and Tesco they expected to significantly improve earnings.

Over the first 12 to 18 months they did create the separate property company and prepared to IPO it, but because of the financial crisis they had to shelve it. On the operational side, in late 2008 they brought in as CEO Lars Olofsson, who had been the #3 at Nestle, and charged him with overhauling how the company operates. He replaced most of the top management team and has now defined a three-year transformational plan that in a first pass is expected to take out €3 billion in costs. To put perspective on that, the company should end up earning about €3 billion in operating income this year. So if they do nothing else but pull out costs, operating income doubles in

INVESTMENT SNAPSHOT

Carrefour
(France: CA:FP)

Business: Second-largest retailer in the world, primarily operating grocery and discount stores in key geographic markets of France, Spain, Brazil and China.

Share Information
(@8/26/10, Exchange Rate: $1 = €0.79):

Price	**€34.58**
52-Week Range	€28.99 – €39.22
Dividend Yield	3.1%
Market Cap	€24.38 billion

Financials (Full-year 2009)

Sales	€85.36 billion
EBIT Margin	2.0%
Net Profit Margin	0.5%

Valuation Metrics
(Current Price vs. TTM):

	CA	S&P 500
P/E	72.0	16.5

THE BOTTOM LINE

The market's wait-and-see attitude toward the company's three-year plan to take out some €3 billion in annual operating costs is likely to prove misplaced, says Scott Cobb. Placing separate values on its real estate and its French, other-European, Asian and Latin operations, he believes the shares are worth around €60 per share.

Sources: Company reports, other publicly available information

three years. I'd add that we consider these stepping-over-one-foot-hurdle cuts, of costs a decently run company would have never had in the first place.

That essentially is the investment thesis. Most of the sell-side community looks at these types of transformational plans and says, "Yeah, I'll believe it when I see it." We actually believe management can do it, and that there's much more to be done beyond this three-year plan.

The company must have been doing something right to establish the footprint it has, no?

S.Cobb: Because the market in France for a long time had regulations limiting retail competition, Carrefour earned outsized margins and cash flow, which it redeployed into a shotgun approach to geographic expansion. They threw money just about everywhere, which did help create the core non-French franchises in Spain, Brazil and China. It also took them into places like Malaysia, Thailand, Poland, Romania, Turkey and Argentina. Lars Oloffson has already said that in markets where they can't be #1 or #2, they should get out and use the capital elsewhere.

Trading at a recent €34.60, how are you valuing the shares?

S.Cobb: We basically value the retail franchises in France and in Europe (ex-France) on their operating incomes after implied rent. For the businesses in Latin America and Asia our valuations rely more on comparable local retailers, which trade for 60-70% of revenues and 9-11x multiples of EBITDA. Those are higher multiples than we're using in Europe, reflecting the higher growth in Latin America and Asia. For the real estate, we use a conservative 7% cap rate on implied rent.

Add it all up and we ascribe €18 per share in value to France retail, €12 to the rest of Europe, around €13 to Latin America, €8 to Asia and close to €20 for the company-owned real estate. After subtracting out net debt and making a few smaller balance-sheet adjustments, we arrive at an intrinsic value for the shares of around €60.

We've learned in Europe the importance of boards with a clear focus on driving capital-allocation decisions that increase long-term shareholder value. There's no question we have that here both at the board and management levels. In addition to all the operational improvements underway, the company in the spring announced it was buying back 7% of its shares over the next year. We just believe the market's wait-and-see attitude here is misplaced.

Explain your investment thesis for Germany's Hochtief [HOT:GR].

S.Cobb: If you dial this up on Bloomberg it comes up as a German construction company, but that's only a small piece of the business. It's really a conglomerate in a few different areas that are widely geographically dispersed.

The biggest asset is a 55% ownership in Leighton, Australia's biggest infrastructure construction firm and also the largest contract miner in the world. It owns roughly 80% of the Australian market for large-scale projects like high-speed rail, toll roads, tunnels and bridges, which is a nice place to be given that Australia is pursuing a massive infrastructure development plan and actually has the financial wherewithal to fund it. The contract-mining business works with most of the big players like BHP and Xstrata, primarily in Australia and also in places like Mongolia, where

business is booming because of Chinese demand. Hochtief bought into Leighton in the early 1980s as a means of diversification outside of Germany and the business has just become a powerhouse, now accounting for 85% of Hochtief's operating income.

Another important asset is what they call their concessions business, which consists of revenue-generating stakes in things like airports, toll roads and hospitals mostly in Europe, but also in Australia and Latin America. Many of these entities have to file public financial reports, so the cash flows passed on to Hochtief are fairly easy to assess.

The third big business is in commercial real estate development, the operating model for which had been to develop properties to be sold immediately. They had 22 projects in various stages of construction when the financial crisis hit, so as buyers dried up, Hochtief took those projects on their balance sheet and are now managing them even after they've been completed. The projects tend to have grade-A tenants like Deutsche Telekom, Siemens and Unilever, and they typically aren't started unless 75% of the available space has been pre-leased. We consider these to be excellent assets that will eventually get sold, and a few recent deals have been made at prices above book value.

The last piece is a construction business, which includes a well-established legacy operation in Germany, as well as two U.S. companies, non-residential builder Turner and infrastructure construction firm Flatiron.

INVESTMENT SNAPSHOT

Hochteif
(Xetra: HOT:GR)

Business: Diversified global construction, infrastructure and real estate company with primary assets in Western Europe, Australia and the United States.

Share Information
(@8/26/10, Exchange Rate: $1 = €0.79):

Price	**€50.30**
52-Week Range	€45.09 – €65.60
Dividend Yield	3.0%
Market Cap	€3.52 billion

Financials (Full-year 2009)

Sales	€18.17 billion
Operating Margin	2.9%
Net Profit Margin	2.2%

Valuation Metrics
(Current Price vs. TTM):

	HOT	S&P 500
P/E	15.6	16.5

HOT PRICE HISTORY

THE BOTTOM LINE

"How long it takes the market to recognize value here is anybody's guess," says Scott Cobb, who believes the upside makes it worth the wait. Using what he considers conservative values for the company's stake in Australia's Leighton Group and for its concessions, construction and real estate units, he sets intrinsic value at €100 per share.

Sources: Company reports, other publicly available information

Against a current share price of €50.30, are you summing the parts to arrive at an intrinsic value?

S.Cobb: Yes. Leighton is publicly traded in Australia and the value of Hochtief's stake in it alone is worth the current market value of the entire company. We actually think Leighton is worth at least 20% more than its current value, so we estimate Hochtief's stake is worth around €63 per share.

The board in its semi-annual and annual reports breaks down its valuation of the concessions business, using 12-14% discount rates on the cash flows of the various assets. We think the directors' value is prudent, but to be conservative we apply a 25% discount to it, making it worth another €18 per share.

We also discount the real estate by 25% from book value, even though they are doing some deals at above book. That adds another €10 per share in value. The construction business – at a multiple of normalized cash flow – we value at around €12 per share. Including the market value of shares they bought back last year held now in treasury, the balance sheet has net cash, so all in, we believe Hochtief has an intrinsic value of more than €100 per share.

How is corporate governance here?

S.Cobb: One big positive is that the Spanish conglomerate ACS [ACS:SM] – which is in many similar businesses and whose stock we also own – owns a 29.9% stake in Hochtief and we believe helps bring an excellent capital-allocation focus to the board.

One example that the board is looking out for shareholder value: Last year it looked at IPO'ing the concessions business to unlock the value there, but they cancelled it after the investment banks changed tack and wanted to price the IPO at a 25% discount to the company's estimate of net asset value. They have since said they'd revisit the issue in 2011, but won't do any deal unless it's at something much closer to NAV. We think that's exactly the right approach.

Are there other risks of note?

S.Cobb: The biggest risk is probably time – how long it takes the market to recognize value here is anybody's guess. It's fascinating to me that most of the sell-side analysts who follow the company value the business at €80 to even €120 per share, but then because they don't want the career risk of being out there with targets that high relative to the current share price, they apply some sort of minority discount or conglomerate discount. I read a report this morning that tacked a 30% discount on a €100 share value because … well, just because. That should eventually work to our benefit: you know over time as the stock rises, they'll start reducing that discount to justify raising their price targets.

Moving across the globe to Asia, describe your interest in gaming holding company Genting Berhad.

KS: This is a holding company based in Malaysia with primary operations in the gaming business in Malaysia and Singapore – both of which are separately listed – and with secondary operations in power generation, oil and gas, and palm-oil plantations.

Genting Malaysia operates the only casino in Malaysia. It's been around since the early 1970s and is in fact the single largest casino by EBITDA in the world. Twenty million visitors per year go through that facility, driven in no small part by the large Chinese population in the country, and its EBITDA margins run in the mid-40s.

Genting Singapore was set up to run the company's gaming business outside of Malaysia and its biggest asset by far is one of only two licensed casinos in Singapore (the other is owned by Las Vegas Sands). Genting's casino and resort, called Resorts World Sentosa, opened in February and also includes Southeast Asia's only Universal Studios theme park.

In the short time it's been opened, the new operation has already dramatically exceeded expectations: analysts expected Genting Singapore to earn 800 million Singapore dollars in EBITDA in its first year, but after only one full quarter it earned 500 million in EBITDA. We believe it's so far capturing about two-thirds of the market share in Singapore, and based on experiences in other Asian markets, Singapore should still have years of significant growth ahead of it.

With the stock up 40% since March, to 9 Malaysian ringgit, what upside do you see from here?

KS: The stock was down earlier this year on concerns about the impact of Las Vegas Sands' Singapore casino opening in April, which has not negatively impacted Genting. For our valuation, at a 12x multiple on estimated 2011 EBITDA, we value Genting's Singapore stake at around 5.50 Malaysian ringgit. The stake in Genting Malaysia, a more mature business, at a 9x multiple of EBITDA is worth another 5 ringgit per share. Adding in the other much smaller assets, our total value on the gaming business is 10.70 ringgit.

We're very conservative in putting a value on the non-gaming assets, the bulk of which is in some large power-generation plants. We believe that's all worth an additional 1.60 ringgit, which brings our intrinsic value for Genting Berhad to around 12.30.

One interesting free option here is Genting's plans for operating New York City's first gambling parlor, at the Aqueduct racetrack in Queens. Initial approval is for them to put in 4,500 slot machines and electronic table games, but their ultimate goal is to create a destination resort that would attract both local

INVESTMENT SNAPSHOT

Genting Berhad
(Malaysia: GENT:MK)

Business: Holding company for casino resort businesses in Singapore and Malaysia, in addition to smaller energy, power generation and palm-oil units.

Share Information
(@8/26/10, Exchange Rate: $1 = MYR 3.14):

Price	MYR **9.00**
52-Week Range	MYR 6.20 – MYR 9.06
Dividend Yield	0.8%
Market Cap	MYR 33.35 billion

Financials (Full-year 2009)

Revenue	MYR 8.89 billion
Pre-Tax Profit Margin	28.4%
Net Profit Margin	11.7%

Valuation Metrics
(Current Price vs. TTM):

	GENT	S&P 500
P/E	20.9	16.5

GENT PRICE HISTORY

THE BOTTOM LINE

While the share price has rebounded from what has turned out to be unfounded concern over new competition for the company's giant Singaporean resort and casino, it still doesn't adequately reflect the company's growth prospects and high profit margins, says Ken Siazon. His sum-of-the-parts value on the shares: 12.30 ringgit.

Sources: Company reports, other publicly available information

and international visitors. We're not ascribing any value to that and it could be some time before it has a material impact on the company, but it's clearly a potential opportunity to invest cash that's earning very little into an asset with high potential returns.

We assume you're comfortable with the corporate governance here.

KS: The CEO is Tan Sri Lim Kok Thay, whose family owns around 40% of the shares. I've worked in Asia for some time and they have a well-deserved reputation for allocating capital in a way that benefits all shareholders. They've continued to build the business over time, and will issue shares when multiples are high and buy them back when the stock is cheap.

Is regulatory risk a concern?

KS: In Singapore, no. The government tends to be consistent and fair in dealing with business interests, which is why the country has been a magnet for investment. They've clearly laid out the terms under which the duopoly in Singapore is based and on the tax rates to be paid, none of which we expect to change.

In Malaysia the situation is less reliable, but Genting Malaysia is one of the country's largest taxpayers and employers and has operated since 1972 without any big regulatory problems. That gives us confidence that nothing will happen to materially harm its business.

We wouldn't expect a company with "Chinese" and "Internet" in its business description to have a value-priced stock. Why do you consider that the case with Shanda Interactive?

KS: Shanda Interactive is a leading online entertainment media company in China, basically providing the platform for players of online games created by its publicly traded and 70%-owned subsidiary, Shanda Games. They run more than 30 online games, the blockbuster being Legend of Mir II, a multi-player online role-playing game akin to Activision Blizzard's World of Warcraft. The business model varies, but for the most part the network's 100 million registered users can start playing any given game for free, but they then pay to upgrade their capabilities or powers to advance further into the game.

Shanda's stock got hit earlier this year after they tweaked Legend of Mir II so that it was easier to just buy new powers than have to earn them, which turned some hardcore players off. Usage went down and they had to revise earnings expectations, which sent the stock in January from almost $60 to less than $40. We saw that as a temporary problem they will work through, so that gave us an excellent buying opportunity.

On a consolidated basis, Shanda Interactive has cash on its balance sheet worth 65% of its current market cap, so obviously whether value is created or destroyed going forward has a lot to do with how they spend that cash. We like that the CEO, Tianqiao Chen, owns more than 40% of the company and has his entire net worth invested in it. He also has a clear eye on increasing shareholder value and has spent more money in the past two years on share repurchases than on anything else by far. At one point he issued convertible debt with a strike price

INVESTMENT SNAPSHOT

Shanda Interactive
(Nasdaq: SNDA)

Business: Based in Shanghai, creator, developer and marketer of electronic games, distributed through its own large online gaming platform in mainland China.

Share Information
(@8/26/10):

Price	**40.91**
52-Week Range	36.33 – 60.35
Dividend Yield	0.0%
Market Cap	$2.73 billion

Financials (TTM):

Revenue	$801.6 million
Operating Profit Margin	35.5%
Net Profit Margin	26.8%

Valuation Metrics
(@8/26/10):

	SNDA	S&P 500
Trailing P/E	13.3	16.5
Forward P/E Est.	13.2	12.9

Largest Institutional Owners
(@6/30/10):

Company	% Owned
Orbis Holdings	9.9%
Fidelity Mgmt & Research	3.8%
Invesco	2.4%
Wellington Mgmt	1.9%
Manning & Napier Adv	1.7%

Short Interest (as of 8/13/10):

Shares Short/Float	8.7%

SNDA PRICE HISTORY

THE BOTTOM LINE

Ken Siazon believes the market is overreacting to an operational hiccup caused by a pricing change on a big product and is wrongly expressing no confidence in management's ability to successfully reinvest the company's giant cash position. He estimates intrinsic value at more than $70 per share, 75% above today's current price.

Sources: Company reports, other publicly available information

of $35 and used the proceeds to buy back stock at an average of $28 per share.

How cheap do you consider the shares today, at a recent price of $40.90?

KS: The current market value is around $2.7 billion and they have nearly $1.9 billion in net cash, so the enterprise value is only about $800 million. We estimate the company will make $270 million in free cash flow over the next twelve months, so the multiple of that on an EV basis is only about 3x. That makes no sense to us for a company with 35%-plus operating margins, an attractive network effect, a sticky revenue model, and still-vibrant growth prospects in an underpenetrated market.

We value Shanda Games on its own at $11.25 per share [versus a current market price of around $5.80], which assumes a 7x multiple of free cash flow (after cash) for a business that should grow at least at a low-teens rate. That valuation translates into roughly $42 per share in Shanda Interactive value.

There's another $20 per share in cash at the holding company level. On top of that is the "rent" Shanda Interactive receives from Shanda Games for access to its online network – at 17x free cash flow, that's worth another $10 per share. That brings our intrinsic value estimate for the holding company to more than $70 per share. If we're right about management investing the cash wisely, that could easily turn out to be conservative.

Speaking generally again, do you follow any particular guidelines when it comes to selling?

MH: We sell for four primary reasons: when the price reaches our appraised value; when the portfolio's risk/return profile can be significantly improved by selling, for example, a business at 80% of its worth for an equally attractive one selling at only 40% of its value; when the future earnings power is impaired by competitive or other threats to the business; or when we were wrong on management and changing the leadership would be too costly or problematic.

In what category did your sale in the first quarter of Berkshire Hathaway fall, after owning it for only a year?

MH: We sold it when the company's entry into the S&P 500 index pushed the stock up over 20% and it approached our appraisal. Sticking to our sell discipline can force us to end even brief partnerships with our most admired corporate partners.

ON 2009 LESSONS:

Becoming macro-driven "generals fighting the last war" would have left us on the sidelines at the wrong time.

Is the example you gave of trading an 80-cent dollar for a 40-cent one indicative of the incremental upside you want to see when swapping one holding for another?

MH: Given the tax implications of selling, the cost of trading, and the challenge of getting two appraisals right, John Templeton used to have what he called the 100% rule, meaning the upside should be at least twice as high before swapping out one position for what you consider a more attractive one. We similarly want to improve our position materially when we trade an undervalued business.

Can you give a recent example of a sale due to impaired earnings power or losing confidence in management?

KS: We sold Daiwa Securities in the first quarter when its capital-allocation strategy became unattractive. Its two primary businesses are asset management, which is stable and highly profitable, and investment banking, which is volatile and higher-risk. Last year they came out with a plan to issue stock at basically a market low and put the money into investment banking, which we consider an inferior business. It would have been bad enough if they were planning to do that just in Japan, where they have a strong market position, but instead they're pouring a lot of the new money into expanding outside Japan, where they have zero competitive advantage. The stock was still cheap on a price-to-book basis, but it wasn't something we were comfortable owning.

You lamented in your 2009 shareholder letter about everyone being more interested in the lessons you learned from 2008 than from 2009. What were the key lessons for you of 2009?

SC: The first was that bottoms-up fundamental company analysis still matters quite a bit and that ignoring the experience of Graham, Buffett and our 35 years to become macro-driven "generals fighting the last war" would have probably left us on the sidelines at exactly the wrong time. Parking ourselves in cash to wait for clear signs the misery was over would have caused us to miss the best purchase point for equities in my lifetime. People are still obsessed with macro issues, which we believe creates bottoms-up opportunity.

A second lesson is that comfort in investing comes at a high cost. Selling stocks in 2007 would have uncomfortable, but in retrospect we all should have done more of that. Buying or even holding stocks in early 2009 was equally uncomfortable, but investors should have done that as well. We get comfort from the consensus, but making the same investment choices as a large number of other intelligent people almost mathematically insures you'll do the wrong thing at the wrong time because security prices reflect that consensus.

Did your enthusiasm for the game wane even a little in 2008?

MH: The mark-to-market of 2008 wasn't fun to experience, but my enthusiasm doubled because it was the opportunity of a lifetime to buy the types of companies we did at those kinds of prices. That's why we're so excited about what's in store over the next five years. VII

Investor Insight: Francois Rochon

Francois Rochon of Montreal's Giverny Capital explains why he believes buy-and-hold investing is far from dead, why he lives with stocks first before "getting married," why it's rare that he's not fully invested, and why he sees significant upside potential in Medtronic, Walt Disney, Lumber Liquidators, Omnicom and MTY Food Group.

You've said complication scares you when it comes to investing. How does that manifest itself in your strategy?

Francois Rochon: I look for great companies in businesses I understand and which I believe have competitive advantages. Warren Buffett had a wonderful quote, that if a company has a bad past and a great future, he'll miss it as an investment opportunity. We want companies that have had great pasts and then focus our analytical attention on whether and why the future should be great as well.

The complications that scare me are things like overburdened balance sheets, regulation and less-than-transparent accounting. The fewer liability items on the balance sheet the better, and I'll typically filter out companies that can't at least pay off their debt, including any negative working capital, with four years' of current net income.

One classic mistake I made in not keeping things simple was owning for some time the shares of Health Management Associates, a hospital chain. Fighting through all the regulatory issues, dealing with public and private insurers, the complicated accounting for uninsured patients, all that made the business extremely difficult. Those are not the types of businesses we favor.

How would you define your investable universe?

FR: I say we'll look at anything, but in reality we have several filters that narrow the universe pretty quickly. One is that the company has to be profitable, which removes roughly 50% of the stocks traded worldwide. Our filters on debt levels screen out a great number of companies and I also take out just about everything commodity-related – like oil and gas, gold, steel, copper or timber – where it's almost impossible for companies to have a competitive advantage. There are some rare steel companies I admire like Nucor and Posco, but only when I don't think investment success rests primarily on the price of the commodity, which I don't believe I have any edge in predicting.

Most of our initial research is on finding the true standouts in any given business. That's largely a numbers-driven exercise, focusing on returns on equity, margins, and growth in key sales and profitability metrics – all in comparison with the competition. We've identified more than 400 companies – primarily in the U.S., but not exclusively – that we could imagine owning and that we try to keep fairly close track of.

Does cap size matter?

FR: The quality of a business is not necessarily linked to size, so market cap isn't a criterion for us. We have owned very big names such as Microsoft or Procter & Gamble, but we're also happy to invest in small gems as well. One good example we've owned for a few years is Bank of the Ozarks [OZRK], a small regional bank based in Little Rock, Arkansas. The founder, George Gleason, started the company with something like $10,000 when he was 24 and has built it very methodically and conservatively over the past 30 years. It earns a high return on assets, controls costs very well and has a great loan-quality track record. When we met with Mr. Gleason, it seemed like he knew almost every loan the bank had made. Warren Buffett says there are far more banks than there are good bankers, and we think Gleason is one of the best. We doubled our position when the stock went down in 2008 and still don't believe the share price reflects the fact that earnings can grow maybe 15% annually for many years.

Francois Rochon

Institutional Bias

As with many self-taught investors, Francois Rochon's informal education started with the books of investing legends: Benjamin Graham's *Intelligent Investor*, Philip Fisher's *Common Stocks and Uncommon Profits*, and Peter Lynch's *One Up on Wall Street*. He wrote to ask Warren Buffett for copies of his annual shareholder letters, a full package of which arrived in the mail a short time later. "I came to understand the market wasn't the big casino I thought it was," says Rochon, "but instead a place where you could use intelligence, judgment and rationality to build wealth."

After moonlighting as an investor while working as an electrical engineer, Rochon took the plunge in 1996, joining well-known Canadian money manager Montrustco in his native Montreal. While he learned a lot, he concluded he wasn't cut out for a large institution. "They said the right things about being fundamental long-term investors, but then at the end of every month that you didn't beat the market you had to explain in great detail why you were underweight this or overweight that. The focus was too much on short-term performance, which to me just isn't the best way to invest."

You're based in Montreal, so why is your portfolio so American?

FR: The primary reason is that the American pond is ten times bigger than the Canadian one. Add to that the fact that probably 50% of the companies traded in Canada are resource-based and therefore we typically avoid them, the ratio of potential ideas in the U.S. is even higher.

We consider the U.S. very close to home, physically (we're closer to New York than Cleveland is!) and culturally. It's easy for me to understand companies like Buffalo Wild Wings or Outback Steakhouse or Wal-Mart, where I've eaten or shopped. It's harder for me to get the same feel for a company based in Brazil or Poland.

What situations tend to catch your eye for further study?

FR: We don't have a regimented idea-generation process. I find screens tend to focus you too quickly on valuation, when I'm most interested first on the quality of the business.

I like to say my capitalist antennae are always on, so most often our ideas just come from tracking what's going on at the 400 or so companies we follow on a regular basis. We've had our eye on both MasterCard and Visa since they went public, because they enjoy many of the classic elements of a high-quality business. But for a long time neither traded at a price we were comfortable paying, until a few months ago when concerns over changing regulation for debit and credit card fees hit the stocks, with Visa falling 25-30% over the course of a few weeks. In our judgment, the market was overreacting to the actual impact Visa is likely to see from fee restrictions, making the stock – at our purchase price of around $70 – highly undervalued. [*Note*: Visa shares currently trade at just under $70.]

Of course just because the stock of an interesting company cracks doesn't mean we always buy. In the case of Starbucks, for example, we weren't convinced even after the valuation fell sharply in 2007 and 2008 that the company's growth prospects in what we considered a saturated market were sufficient to justify owning the stock. Similarly for Whole Foods, when the stock went down sharply in 2008 we didn't buy because in our view they had taken on too much debt in buying Wild Oats Markets. In retrospect, we certainly would have done well to buy in either case, but we felt we had safer options that have also turned out quite well.

ON OUTPERFORMANCE:

We expect our companies to grow at twice the long-term average of the S&P 500. That's how we'll outperform.

What's a love-to-own-at-a-better-price stock for you today?

FR: We own a few shares of Hennes & Mauritz [HMB:SS], the value-priced fashion retailer based in Sweden but with operations all around the world. We consider it an excellent company with bright prospects, but the stock price is a bit too high for us to build a more substantial position.

Going back to the types of situations that catch our eye, another common theme for us is to buy into market leaders when their sector or the overall market is out of favor. We believe Omnicom [OMC], for example, is the best and most geographically diverse advertising company in the world, but in 2008 its shares got below 10x earnings – from 20-25x typically – because it was fairly obvious its near-term prospects were poor. While there's a lot of turmoil in the advertising business, we think Omnicom provides an essential service and that the business will continue to generate high incremental returns on capital. Because we take a longer-term perspective than the market usually does, we're thrilled to invest in the best companies in good-quality businesses that we believe will eventually recover.

Describe your valuation methodology.

FR: It's quite simple. We estimate what we think a company can earn in five years and then apply the P/E we believe the market should give it. If the resulting price is at least double the current share price – giving us a 15% annual return – we're willing to buy.

Our strong preference is for the upside to come primarily from earnings growth rather than a P/E increase. We want to believe our companies can increase earnings on average by twice the long-term 6% average annual growth of S&P 500 companies. That's how we're going to outperform: since 1996, earnings at our portfolio companies grew an average of 12% per year, twice the rate of those in the S&P 500. Over that time our stocks did the same 6% per year better than the market.

Using one of my favorite stocks today as an example, we think Wells Fargo [WFC] on a normalized basis five years out should earn roughly 1.5% on assets, which translates into more than $5 per share in net income. With that kind of performance, the market should apply at least a 12x multiple to the stock, which would result in a share price of $60. At today's price [of $23.50], we believe Wells is a better investment today than it has been in the past 20 years.

How many positions do you typically maintain?

FR: Generally around 25, so a full position is 3-4%. We will own more of what we think has the most upside, although it's very rare for us to let a position go above 10% of the portfolio.

Since I consider buying a stock a long-term commitment – our average holding period is more than five years – I'll typically start with a 1-2% position and then see how it goes. No matter how hard I try, there's just nothing to focus one's attention like having money on the line. If I get more comfortable with the management and the business and feel I understand it better and better, we'll increase the position as long as the valuation is still compelling.

Are you usually fully invested?

FR: Yes. At our asset size and especially as time horizons in the market have contracted, I haven't yet found it difficult to find ideas that meet our criteria.

Given your turnover, we take it you haven't concluded, as many have, that buying and holding is passé?

FR: Maybe it makes me old-fashioned, but investing to me is about owning great companies for many, many years. Managing through cycles has always been a part of running businesses and of investing, but I'm not convinced it's possible over time to accurately judge when the next recession will be, when interest rates will go up or down, or when the market is about to reverse course. At least I don't believe I can do it.

People look at what happened from the peak of the Internet bubble to the bottom of the financial crisis and seem to forget that stocks pay off in the long run because companies earn higher profits – of 6-7% per year – while paying dividends on top of that. So equity investors would do fairly well just owning the market, but I think I can improve on that by buying companies that grow their intrinsic value faster than the market and holding on to them. I can't imagine trading a strategy that I feel puts the odds in my favor for one I don't believe I'll ever be able to execute.

Turning to more specific ideas, describe your investment case today for Walt Disney [DIS].

FR: I consider Disney a crown jewel of American capitalism, with unparalleled assets. I like to say that Mickey Mouse has three great qualities: he's highly popular worldwide, he's immortal, and he has no agent. That's an excellent metaphor for what the company does – create franchises that it owns and controls and can benefit from across a wide variety of businesses and geographies.

They released this year a new movie version of *Alice in Wonderland*, which was first created in 1951. With that first version, they basically just made money selling movie tickets. Since then they've re-sold the same content to recurring generations, through different media and around the world. It's like owning an oil field that never runs out and costs very little to maintain. That's a good business.

The newer parts of the business are equally impressive. ESPN is virtually a monopoly national sports channel, with extremely high market power and benefiting from strong secular consumer demand. In theme parks, when Disney World opened in Florida in 1971, the price of a daily ticket was $3.50. They've since increased price every year but one, to today's $82, which comes out to an impressive 8% growth per year, much higher than inflation.

One key part of our thesis is confidence in Bob Iger, who we believe is making all the right moves since taking over as CEO in 2005. He's gotten out of less attractive businesses such as radio and the Miramax movie studio, while investing in businesses like Pixar and Marvel, which play perfectly to Disney's strengths. He's reoriented the business focus to making great animated movies, which has a positive impact over long periods on so much of what they do.

INVESTMENT SNAPSHOT

Walt Disney
(NYSE: DIS)

Business: Diversified entertainment and media company with five operating units: TV networks, movie studios, parks and resorts, consumer products and interactive.

Share Information
(@8/26/10):

Price	**31.94**
52-Week Range	25.25 – 37.98
Dividend Yield	1.1%
Market Cap	$61.09 billion

Financials (TTM):

Revenue	$38.19 billion
Operating Profit Margin	17.8%
Net Profit Margin	10.5%

Valuation Metrics
(@8/26/10):

	DIS	S&P 500
Trailing P/E	15.4	16.5
Forward P/E Est.	13.4	12.9

Largest Institutional Owners
(@6/30/10):

Company	% Owned
Fidelity Mgmt & Research	4.8%
State Street	3.6%
Vanguard Group	3.5%
BlackRock	2.6%
Southeastern Asset Mgmt	2.5%

Short Interest (as of 8/13/10):

Shares Short/Float	2.6%

THE BOTTOM LINE

Francois Rochon considers the company a classic example of an exceedingly high-quality business trading at a surprisingly pedestrian price, of less than 15x estimated 2010 earnings. He believes the company can double its earnings per share in the next five years and earn by then an 18x multiple, translating into an $80 share price.

Sources: Company reports, other publicly available information

Weighing at least somewhat on all media companies is concern over the economics of changing distribution in an Internet age. How do you assess that here?

FR: I don't profess any unique insight into how that plays out, but I fall back on the premise that if you own what people want to see, it's not going to matter so much how they access it. What you want is to create enough excitement around your content that people will pay for it, regardless of the distribution method. Disney has proven over a long period of time its ability to create that excitement.

There is certainly risk that cable companies over time try to pull back on what they're willing to pay for ESPN, or that Internet distribution of movies doesn't prove as profitable as DVDs were. But in the five years I've owned Disney stock – as the distribution of media continues to evolve – the company's earnings have increased 68%. That's 10% per year over a pretty tough period, which makes me optimistic about their ability to navigate a changing environment.

How can such an admired company have an undervalued stock, currently trading just under $32?

FR: At less than 15x the $2.20 or so we expect the company to earn this year, the stock doesn't at all reflect the earnings growth we expect over the next five years. We think earnings per share can double over that period, through a combination of revenue growth, much of it international, and margin improvement from a more attractive business mix and operating leverage in all its key businesses. We see net margins going from 10.5% today to closer to 12.5% in five years.

The stock has historically traded at 20-25x earnings, but even at 18x our 2015 earnings estimate, we arrive at a target price of close to $80. It may not always be a smooth ride, but that would be a quite satisfactory destination.

Is Medtronic [MDT] a great-company-in-an-out-of-favor industry type of idea?

FR: The company is a leader in almost every product category in which it competes and has done an excellent job of broadening its product mix beyond pacemakers, defibrillators and heart valves to include devices such as insulin pumps, glucose meters and spinal implants. The products mostly address non-discretionary problems and either save lives or dramatically improve lives. You can postpone the purchase of a car, but you don't postpone getting a defibrillator put in. The same goes for insulin pumps if you're diabetic, or for spinal implants if you're suffering from acute back pain. Given how essential the products are to customers' health, the business isn't too cyclical and earns very high net margins of 20%.

We like that the device business tends to be much more stable than other healthcare areas like pharmaceuticals. They've obviously grown and diversified since then, but if I compare Medtronic's business from when I first started researching it in the mid-1990s with today, they're basically still in the same businesses with the same market positions. You constantly have to improve your products' capabilities, but for the most part, doctors are reluctant to switch from devices they know and trust.

INVESTMENT SNAPSHOT

Medtronic
(NYSE: MDT)

Business: Worldwide developer and marketer of a broad range of medical devices, including pacemakers, defibrillators, insulin pumps, heart valves and stents.

Share Information
(@8/26/10):

Price	**32.28**
52-Week Range	30.80 – 46.66
Dividend Yield	2.9%
Market Cap	$34.96 billion

Financials (TTM):

Revenue	$15.82 billion
Operating Profit Margin	32.5%
Net Profit Margin	19.6%

Valuation Metrics
(@8/26/10):

	MDT	S&P 500
Trailing P/E	11.6	16.5
Forward P/E Est.	9.3	12.9

Largest Institutional Owners
(@6/30/10):

Company	% Owned
Capital World Inv	5.5%
Wellington Mgmt	4.7%
Vanguard Group	4.0%
Primecap Mgmt	3.9%
Capital Research Global Inv	3.7%

Short Interest (as of 8/13/10):

Shares Short/Float	1.3%

MDT PRICE HISTORY

THE BOTTOM LINE

The market's assessment of the company's prospects is at odds with Francois Rochon's expectation that secular demand for its products and share buybacks can help lift earnings per share at a 10% annual clip. At what he believes would be a reasonable 15x his $5 EPS estimate five years' out, the shares would trade at $75.

Sources: Company reports, other publicly available information

The market's perception of Medtronic has changed dramatically. Ten years ago the stock got as high as $60 and traded for 55-60x earnings. Revenues and earnings have tripled since then, but the stock is down 40% and the P/E is now 10x.

What's going on?

FR: Part of it is that the stock was overvalued ten years ago. Part of it is that the growth prospects of a company three times bigger usually don't warrant the same P/E. But what seems to most trouble the market is concern about what healthcare reform will do to Medtronic's business. In particular, medical-device companies were singled out for specific taxes to help fund the reform package. The market seems to be saying not only that that's bad, but that there may be more yet-to-be-defined pain as well.

We're not nearly so pessimistic and believe the revenue benefits of tens of millions of new people having insurance coverage for Medtronic products will more or less compensate for any incremental taxes. If we're right, the question then is whether Medtronic is well-positioned to grow in the future, and we think they are. They spend heavily on product development, which has allowed them to at least maintain leading shares in what should be continually growing markets – the incidence of the problems their products treat will only go up as the population ages. From top-line growth of 5-7%, some margin improvement and some share buybacks, we expect annual EPS growth of at least 10%.

What upside do you see in the shares, now near a 52-week low of $32.30?

FR: The company should earn $3.40 per share this year. If we're conservative and assume that grows only 8% – less than we actually expect – that would result in an EPS five years from now of $5. At even a 15x multiple – again, less than what we would consider justified – that would result in a share price of $75.

There's always some risk a superior competitive product hurts one of their key businesses, but that hasn't really happened since the company sold its first pacemaker in the 1950s. We just think there's a very large margin of safety here. This isn't some run-of-the-mill business, it's the best medical-device company in the world – trading at 10x earnings.

Switching gears, describe your interest in discount flooring retailer Lumber Liquidators [LL].

FR: I knew very little about Lumber Liquidators when I saw it listed maybe six months ago in a ranking of the best small companies. They basically buy wood at wholesale and transform it into hardwood and laminate flooring that they sell in company-owned retail stores, mostly serving urban areas from suburban locations. They claim to sell at a 20-30% price discount to the industry, passing on efficiencies by selling greater volumes from larger-footprint stores in less-expensive areas. The average ticket is about $1,500.

Over the past five years the company has grown from 76 stores to more than 200. Revenues increased from $245 million in 2005 to $545 million last year, from both same-store-sales growth as well as all the new stores. The profitabil-

INVESTMENT SNAPSHOT

Lumber Liquidators
(NYSE: LL)

Business: Discount retailer of hardwood and laminate flooring sold through more than 200 company-owned stores located almost exclusively in the United States.

Share Information
(@8/26/10):

Price	**19.99**
52-Week Range	19.33 – 33.41
Dividend Yield	0.0%
Market Cap	$548.1 million

Financials (TTM):

Revenue	$597.5 million
Operating Profit Margin	8.4%
Net Profit Margin	5.2%

Valuation Metrics
(@8/26/10):

	LL	S&P 500
Trailing P/E	18.2	16.5
Forward P/E Est.	16.7	12.9

Largest Institutional Owners
(@6/30/10):

Company	% Owned
Fidelity Mgmt & Research	15.0%
T. Rowe Price	4.3%
Friess Assoc	3.9%
Aster Inv Mgmt	3.6%
Century Capital	3.4%

Short Interest (as of 8/13/10):

Shares Short/Float	24.6%

THE BOTTOM LINE

The company's low-cost model has allowed it to grow smartly through the residential real estate downturn and positions it well for future growth in a fragmented market, says Francois Rochon. If a doubling of the store base results in the $2.70 EPS he expects in five years, he believes the shares will trade then at closer to $50 per share.

Sources: Company reports, other publicly available information

ity record is equally impressive: net income last year was $27 million on average shareholders equity of about $130 million. Given that the equity included $35 million in cash, the return on operational equity was 28%. All of this, by the way, has happened during a time in which the real estate market has been mostly awful. I've heard it said that if you sell for less, consumers will find you even if you're in the middle of the ocean. Lumber Liquidators appears to be taking clear advantage of that.

Describe the company's current competitive environment.

FR: In hardwood flooring, Lowe's and Home Depot combined have about 23% of the market, while Lumber Liquidators now has around 11%. The other two-thirds of the business is fragmented among smaller independent retailers, from which we expect Lumber Liquidators to continue to take market share.

Are you still expecting significant growth?

FR: Management expects to double the number of stores to around 400 over the next five years, which we think is a plausible target. We also believe there's an excellent chance that same-store sales will grow over that time as well. That's partly because hardwood flooring and laminates are increasingly preferred over carpet and should continue to take a bigger share of the flooring market. At some point the housing market might even rebound a little bit, which would also improve same-store sales.

We estimate that revenues will grow at least 18% per year over the next five years, 15% coming from new stores and 3% from an uptick in same-store comps. With no expected margin improvement, that would result in earnings per share of around $2.70 in 2015. Given how well Lumber Liquidators has performed in such a difficult industry environment, we think that might turn out to be conservative if the residential real estate market comes back from the dead earlier than anticipated.

What five-year target do you have for the shares, now around $20?

FR: If they hit our growth numbers, we'd expect the shares to trade for at least 18x earnings five years out. That works out to a target price of close to $50 per share.

The short interest in the stock is nearly 25%. Why do you think that is?

FR: It's difficult to say. It's lower today, but the P/E has recently been above 20x, which may strike some short sellers as too high for a company serving the residential real estate market. We'd argue that skepticism is unfounded in this case, given that the company now has $50 million in net cash on its balance sheet and has continued to grow so well through a terrible part of the cycle.

Looking closer to home, what do you think the market is missing in MTY Food Group [MTY:CN]?

FR: This is a Montreal-based company that franchises 25 different restaurant banners in Canada. They have every type of chain you can imagine, from sushi to Greek to burgers, with most of the locations in mall food courts.

The company at one point consisted of a computer-services business and a small restaurant division. In 2003 management decided that franchising restaurants was a much better business than

INVESTMENT SNAPSHOT

MTY Food Group
(Toronto: MTY:CN)

Business: Montreal-based franchisor of more than 20 branded restaurant concepts, with 1,600 current locations found primarily in Canadian shopping-mall food courts.

Share Information
(@8/26/10, Exchange Rate: $1 = C$1.06):

Price	**C$11.44**
52-Week Range	C$8.06 – C$12.98
Dividend Yield	0.0%
Market Cap	C$218.7 million

Financials (FY ending 11/09)

Revenue	C$51.5 million
Pre-Tax Profit Margin	34.8%
Net Profit Margin	23.8%

Valuation Metrics
(Current Price vs. TTM):

	MTY	S&P 500
P/E	15.3	16.5

MTY PRICE HISTORY

THE BOTTOM LINE

The company's growth-by-acquisition strategy makes it difficult to forecast earnings, says Francois Rochon, whose thesis for MTY's stock comes down to price. After cash, he says, the shares trade at 11x this year's expected earnings: "For a company that has grown 30% per year with a shareholder-focused CEO, that's pretty cheap."

Sources: Company reports, other publicly available information

computer services, so they got out of computers and have since grown the food business very quickly and profitably, mostly through acquisition. The number of restaurants has increased at a 28% compound rate since 2003, to more than 1,600, while earnings per share has grown 30% per year, to over 90 cents (Canadian) this year. The recession hasn't really hurt them much: earnings this year will be 80% higher than they were in 2007.

Isn't growth tough to forecast when the strategy is based on acquisitions?

FR: Yes, so this is a case where we're putting a lot of faith in management doing the right thing. The CEO is a Hong Kong national named Stanley Ma, who owns 26% of the company and has proven to be an excellent steward of shareholder capital. The company has a clean balance sheet, uses conservative accounting, and has been extremely disciplined in allocating capital. One company he acquired last year originally balked at his offer price three years ago and he walked away. It was only when they agreed to a reduced price that a deal got done.

We still see plenty of potential for further consolidation in the industry, but are comfortable that if earnings can't be wisely reinvested, management will pay the money out to shareholders. As Warren Buffett says, most managers are willing to grow intelligently if they can, or in other ways if that's not possible. We don't consider that to be a risk with Stanley Ma.

What upside do you see from the recent share price of C$11.45?

FR: It's difficult here to estimate a target price. The way we look at it, after netting out C$1 in net cash, the stock currently trades at only 11x estimated EPS this year of 92-93 cents. For a company that has been growing 30% per year and is run by a disciplined and shareholder-focused CEO, that's pretty cheap.

Do you have general advice on selling?

FR: Our bias toward buying and holding has at times made us too quick to rationalize a problem that hits one of our companies as temporary and "already priced into the stock." If the problem turns out to be more long-term and fundamental, it's likely not fully discounted into the current price at all. We've been blind at times to fundamental changes in a company's business because we think the quick 25-30% drop in the share price makes the stock too cheap to sell.

ON MISTAKES:

We've been blind to fundamental changes at times, thinking a quick 25-30% drop makes the stock too cheap to sell.

One technique that helps me avoid that is to regularly look at what we own and ask as objectively as possible if we would buy the exact same portfolio if we were starting over from scratch with the same amount of money. For positions where the answer is probably no, the likely reason is that the company's situation has fundamentally changed, but I just haven't fully admitted it yet.

We're not hearing the pessimism from you that many money managers tell us they feel today. Why?

FR: One of the biggest mistakes investors make is to look at the last few years and assume that's the new norm. If recent years have been volatile and unrewarding, that's what people generally expect the next few years to be like as well.

Normalized earnings for the S&P 500 over time have grown 6-7% per year. Given the recession, earnings today are still probably depressed 20% from what would be a normalized level. If earnings get back to the normalized trend, the S&P 500 would be earning something like $120 per share in five years. Put a 16x P/E ratio on that, and you've got a 1,900 target. That's not a market call, but it tells me that the earnings power for many companies today is not being reflected in their share prices. We believe we own such undervalued companies and we'll be patient for the value to be recognized.

Whatever the environment is we try to remain humble, which means maintaining our discipline of buying only great companies with strong balance sheets when they're priced with a wide margin of safety. It's when you're not humble that you end up doing things that will make you humble. VII

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Lab Results

A company's intrinsic value can be obscured for a variety of different reasons, many of which, says Nicusa Capital's Paul Johnson, appear to be at play today for life-sciences software firm Accelrys.

While no two investment scenarios are exactly the same, value investors regularly find opportunity in situations they've seen before. Three common examples cited as sources of mispricing: when new management overhauls operations; when a flagging legacy business obscures new growth prospects; or when a merger clouds a company's business outlook.

Each of those situations applies today to software firm Accelrys, says Nicusa Capital's Paul Johnson. The company – fresh off its just-closed merger with Symyx Technologies – is a top provider of software used to manage and organize research and development projects, primarily in the life sciences.

Weighing for years on Accelrys' shares has been a slow decline in its legacy simulation and modeling software business, which Johnson attributes to previous management's inattention to more innovative competition. While new management has helped arrest the decline in the legacy business by investing in product improvements, he says, the bigger story today is the emergence of two key product lines – Pipeline Pilot and Electronic Lab Notebook – as drivers of the company's future growth.

Pipeline Pilot provides a "dashboard" for cataloging all data and activity relating to large-scale R&D efforts. Having reached less than one-third of its available market, Johnson expects Pipeline Pilot to grow at least 20% annually for the next three or four years. "It's an innovative technology that allows organizations to conduct R&D more efficiently, which they desperately need," he says. "And there's no real competition for it." While not as unique a product, Electronic Lab Notebook – which standardizes and automates the detailed written notebooks kept by scientists conducting research – should grow at a 15-20% annual clip, he says. Together the two businesses will account for 40% of Accelrys' revenues next year.

The market appears unconvinced of Accelrys' potential. After netting out $160 million in net cash, the company's $175 million enterprise value is less than 9x the $20 million in net income Johnson expects it to earn next year. That assumes 5% revenue growth, an 85% gross margin and a 40% tax rate. It also includes some $15 million in merger cost savings, in line with management targets and reasonable given that, "Accelrys in particular has been chronically undermanaged," he says.

Tweaking his model to assume 7% revenue growth and a tax rate closer to 30% (due to the use of net operating loss carryforwards), Johnson's estimate of 2011 net income is around $23 million. That makes today's P/E on an enterprise value basis around 7.5x – hardly a typical software-company multiple. "If we're right, a year from now the growth investors should find this compelling," he says. "Given what they typically pay, we'll most likely be perfectly happy to sell to them." VII

INVESTMENT SNAPSHOT

Accelrys
(Nasdaq: ACCL)

Business: Develops and markets software used primarily in organizing and managing life sciences-related research projects.

Share Information (@8/26/10):

Price	**6.03**
52-Week Range	4.92 – 7.55
Dividend Yield	0.0%
Market Cap	$333.8 million

Financials (TTM):

Revenue	$142.6 million
Operating Profit Margin	(-0.3%)
Net Profit Margin	0.3%

Valuation Metrics
(@8/26/10):

	ACCL	Nasdaq
Trailing P/E	n/a	11.7
Forward P/E Est.	22.3	14.9

Largest Institutional Owners
(@6/30/10):

Company	% Owned
Brown Capital Mgmt	10.6%
Wells Fargo & Co	4.5%
Vanguard Group	4.0%

Short Interest (As of 8/13/10):

Shares Short/Float	3.6%

THE BOTTOM LINE

As two key products emerge to drive overall-firm growth and the company cuts costs following a merger, Paul Johnson believes it can earn up to $23 million next year – which will warrant a far higher EV multiple on those earnings than the current 7.5x, he says.

Sources: Company reports, other publicly available information

End of the Tunnel

We're hard-wired to filter out the "noise" and zero in on salient facts in making decisions. But when the stakes are high, as in making investment decisions, discarding alternate views too quickly can get people into trouble.

While it has a negative connotation, a certain amount of tunnel vision is critical in everyday life. With an unending stream of data and information influencing hundreds of daily decisions, we're hard-wired to filter out the "noise" and focus on what's most important and relevant. With the vast majority of decisions – What should I have for breakfast? What's the best route to work? – the stakes are sufficiently low that discarding most potential inputs to a decision is clearly the optimal course of action.

But this natural tendency toward tunnel vision can be dangerous when the stakes are high, as is often the case when making investment decisions. "Our minds are just trying to get an answer – the proper diagnosis for a sick patient, the right price for an acquisition, what will happen next in a novel – and have routines to get the answer quickly and often efficiently," writes Legg Mason's chief investment strategist Michael Mauboussin in his new book on decision-making, *Think Twice*. "But getting the right solution expeditiously means honing in on what seems to us to be the most likely outcomes and leaving out a lot of what could be. For most of our evolutionary past, this worked well. But the causal patterns that worked in a natural environment tens of thousands of years ago often do not hold in today's technological world. So when the stakes are sufficiently high, we must slow down and swing the light over the full range of possible outcomes."

Shining such a light isn't easy, of course, undone by several natural human behavioral biases. We give great weight to evidence that confirms what we already believe, while ignoring information that contradicts it. We surround ourselves with people who tend to agree with us, rather than endure the psychic pain that comes with dissent. We anchor on ideas or experiences that are recent or particularly memorable, not even entertaining equally valid input that doesn't come quickly to mind. We take the shortcut of accepting conventional wisdom simply because it's easier.

Such mind-narrowing biases can result in missing investment opportunities altogether. Eric Cinnamond explained in his interview in last month's *Value Investor Insight* (July 30, 2010) how when one of his firm's analysts first broached the idea of buying the stock of rent-to-own retailers Rent-A-Center and Aaron's earlier this

year, his first reaction was, "No, that must be a horrible business." Upon further reflection – something investors don't do often enough – he changed his mind. "I try to be open-minded and once I understood the business, I got more interested," he says. "If you think about it, my initial reaction probably indicated it was exactly the type of idea I should have pursued further."

The more insidious tunnel-vision problem for investors is that it can lead to flawed individual-company analysis that doesn't adequately consider scenarios other than what is "most likely." At the extreme, this manifests itself in inefficiently priced assets. Home prices rise at double-digit annual rates for longer than ever before, fueled by new demographic justifications or "this-time-it's-different" economic arguments. "Can't-miss" Internet and telecom stocks go through the roof with nary a question over whether it's possible for five companies, say, in the same business to justify their market values by growing at 30% per year for a decade. "It's human to imitate and conform," says Mauboussin. "But the result is often that alternatives to the conventional view are not adequately explored, which can get people into trouble."

Mauboussin suggests combating tunnel vision in a variety of ways:

Explicitly consider alternatives. This means not just identifying alternate scenarios for a company's prospects, but forcing yourself to attach probabilities to those potential outcomes. "The financial crisis sort of alerted people to how important this is," he says, "but investors typically think they do this more than they actually do."

Seek dissent. In his groundbreaking work on experts' decision making, psychologist Philip Tetlock concludes that those who make the best decisions over time are "eclectic thinkers who are tolerant of counterarguments." Most investment organizations fall short of fostering open dissent. "It feels better when people agree with you," Mauboussin says, "but it's unlikely to result in the best decisions."

Keep track of previous decisions. People after the fact naturally attribute more foresight to their predictions than actually existed. The problem with that is that it can result in unwarranted confidence and ill-informed probabilities being attached to future events. Well-documented decision processes can provide the "brutally honest feedback" needed to better inform decisions to come, he says.

Don't act at emotional extremes. Making decisions under ideal conditions is tough enough, says Mauboussin, but "stress, anger, fear, anxiety, greed, and euphoria are all mental states antithetical to quality decisions." Investors or no, advice worth remembering. VII

Extreme Measures

We're not often prone to hyperbole, but this is the strangest market we have ever seen. Investor sentiment is usually fairly uniform, but today we're seeing remarkable extremes: there appears to be no bottom in the yield investors will accept for bonds perceived to be safe, yet people are also snapping up emerging-market and junk-rated U.S. bonds at a record pace. In equities, the least risky stocks are trading at their lowest valuations ever relative to the market, while there's huge overvaluation or outright speculation elsewhere.

Investors are clearly fearful and defensive. Through July, mutual fund investors this year withdrew $33.1 billion from domestic equity funds, which annualized would be the second-highest level since the 1980s, trailing only 2008. Over the same seven months investors plowed $185.3 billion into bond mutual funds, a rate approaching the record set last year.

With so much money seeking safety, yields for the safest bonds are at all-time lows. The two-year Treasury yields a barely-perceptible 0.53%, while 10-year Treasuries yield a mere 2.54%. Corporate America is taking advantage: Two weeks ago Johnson & Johnson issued bonds at an all-time low yield for 10- and 30-year corporates: 2.95% and 4.50%. Some market pundits have cleverly dubbed this madness "return-free risk."

It's understandable why some investors might buy Treasuries regardless of yield, because they can't take any risk of principal loss, but we struggle to understand why any long-term investor would favor owning J&J bonds yielding 2.95% over its stock paying a dividend yield of 3.7%. One answer could be that the stock is overvalued, but J&J shares are downright cheap, trading at a modest 12x trailing earnings and 11.5x 2011 estimates. Our best guess is that there's a 90% chance that the stock will be a better investment than 2.95%-yielding bonds over the next 10 years – probably by a huge margin.

This is all great news for equity investors, as the mixed-up market is providing wonderful long and short opportunities. Large-cap blue-chip stocks are the cheapest they've ever been relative to other investments – they were cheaper in absolute terms in early 2009, but other investments were much cheaper – so Whitney's T2 Partners has been buying them in volume: in addition to J&J, its portfolio today includes AB InBev, American Express, Berkshire Hathaway, Kraft, Goldman Sachs, Intel, Microsoft, Pfizer and Yahoo. The market's selective angst is investors' opportunity.

Smart Money

The love affair that the superstar investors we track in *SuperInvestor Insight* have had with the shares of financial services firms abated somewhat in this year's second quarter, but volatile markets opened up buying opportunities for them in a broad range of other areas, including (surprise, surprise) blue-chips in technology, energy and healthcare. To see what's been attracting the attention of the best investors in the business, don't miss the new issue of *SII*, due out next Tuesday. For more information, visit www.superinvestorinsight.com. VII

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