ValueInvestor INSIGHT

The Leading Authority on Value Investing

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Shifting Fortunes

It's easier for companies to fall from the market's grace than to earn it back. David Samra and Dan O'Keefe excel at identifying those poised to do the latter.

Among the many traits value investors should have, says David Samra, one of the more important is having a thick skin. "You learn quickly you're not going to look smart all the time, which inevitably brings criticism," he says, "We always remind ourselves of that great Jean-Marie Eveillard quote, 'I'd rather lose clients than lose clients' money.'"

Samra has done little of either since joining Artisan Partners in 2002 to launch the Artisan International Value Fund, which has earned an annualized 12.8% return, versus 7.0% for the MSCI EAFE Index.

In charge of $2.3 billion in international and global portfolios, Samra and co-manager Dan O'Keefe are finding value today in such diverse areas as packaged goods, banking, consulting and gaming. See page 2

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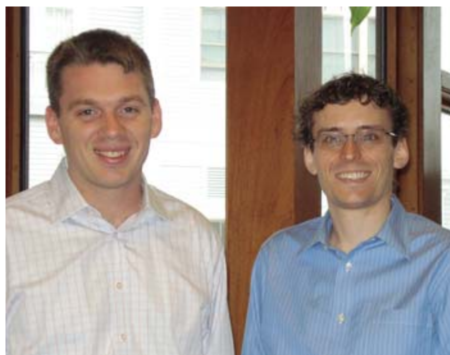
Artisan Partners
Dan O'Keefe *(l)*, David Samra *(r)*

Investment Focus: Seek out-of-favor companies that, because of their underlying business quality, financial strength and management, are least likely to remain so.

Divide and Conquer

By isolating investment bets on only the risks they're willing to take, Nantahala Capital's Wil Harkey and Dan Mack are producing eye-popping returns.

INVESTOR INSIGHT



Nantahala Capital
Wil Harkey *(l)*, Dan Mack *(r)*

Investment Focus: Seek companies whose equity or debt appears relatively mispriced for identifiable reasons that are expected to correct in the near future.

He was hardly long in the tooth when Wil Harkey decided to strike out on his own as an investor in 2004 at age 26. "A skeptic might question if I was old enough to know better," he says, "but it was what I wanted to do even if not the most immediate wealth-maximizing route."

Investors in Harkey's Nantahala Capital couldn't be happier that he made the long-term decision he did. From August 2004 through the end of April, his fund has earned a remarkable net annualized 19.1%, vs. -5.9% for the Russell 2000 index.

Harkey and partner Dan Mack consider today's environment well suited to their "factor-neutral" strategy, and are finding excellent opportunities – long and short – in a diverse mix of equities and debt. See page 11

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Investor Insight: Artisan Partners

Artisan Partners' David Samra and Dan O'Keefe describe why counting too much on growth makes them uncomfortable, why they highly favor developed over emerging markets, how they organize their staff to "cover" the world , and why they think the market is mispricing Unilever, Bank of New York Mellon, Sankyo and Accenture.

David, did following in the footsteps of Graham and Buffett at Columbia Business School set you on the path toward value investing?

David Samra: I went to Columbia in part because that's where Buffett went and where Benjamin Graham taught, but unfortunately the focus of the education when I was there was much more on the efficient-markets hypothesis. One adjunct professor, however, exposed us to a book by Bennett Stewart called *The Quest for Value*, which popularized the idea that management should focus on "economic value added," or maximizing operating profits less the cost of all the capital employed to produce those profits. That drilled into my head the distinction between a good business and a bad business, and why a good business should be more valuable over time. Combining that with the core value-investing concept of buying things at big discounts kind of set how I've thought about investing since.

You both worked for Harris Associates, which in addition to seeking out discounts to intrinsic value puts emphasis on the potential growth of that intrinsic value over time. How important is growth potential to your strategy?

DS: We expect to generate the vast majority of our returns not from the growth in the value of the business, but from the unwinding of the value discount. We're more than happy to see growth potential and we recognize how valuable it can be, but higher-growth businesses typically expose us to more valuation risk than we're comfortable with.

No one can argue with buying high-quality businesses at a discount, but the two don't often go together. What in your experience tends to make that happen?

DS: This is particularly true of late, but it's often when some macro view about an industry, geographic region or the entire market causes share prices of good and bad companies alike to go down. When the decline in price diverges widely from what we consider to be the decline in value, that creates opportunity.

Dan O'Keefe: A perfect example of that was in the fourth quarter of last year, when the market didn't discriminate in its carnage. Even a company like Google [GOOG], which it might be hard to imagine being under-appreciated, traded down to 12x earnings (excluding the cash on its balance sheet). In our opinion, that was ridiculous for a company of its quality and with its prospects.

DS: A more traditional example from outside of the U.S. is Société Télévision Française 1 [TFI:FP], France's largest TV broadcaster. While it's certainly true that the company is battling both increased competition in the digital age and a cyclical downturn in advertising revenue, we think the market is significantly underestimating how profitable the company can be when the cycle turns, given how it has cut costs and invested in its own digital businesses. Here we also see significant asset value in TF1's stakes in pay-TV programmer and distributor Canal+Plus and in sports channel Eurosport. Given our estimate of what those stakes are worth, the core business of TF1 today carries a very depressed valuation.

There are also a whole host of company-specific reasons companies get cheap – including upheavals in management, strategic mistakes and botched acquisitions – where the investment opportunity rests on our assessment of how temporary or permanent the problems are. Our judgment on the inherent profitability and sustainability of a company's business

Dan O'Keefe, David Samra

The Right Track

Their paths crossed in joining Chicago's Harris Associates at the same time in 1997, but David Samra and Dan O'Keefe certainly didn't start out with similar career aspirations. Samra earned an MBA from Columbia with an eye toward investing professionally, while O'Keefe studied philosophy at Northwestern and landed his first job out of college at Morningstar "not because I had any actual business skills or training," he says, "but because I convinced them I was a good writer."

Samra's and O'Keefe's skills have since proven more than complementary. In 2002 they joined Artisan Partners to launch the Artisan International Value Fund, the success of which last year earned them Morningstar's "International-Stock Fund Manager of the Year" award.

Has the past year caused them to rethink any aspects of their strategy? "We look for good businesses, with good management and strong balance sheets when they're cheap," says Samra. "We won't always be right, but we're more convinced than ever that investing when we see those factors in combination will continue to serve us well regardless of the macro environment."

model goes a long way to helping us make that distinction.

How do you generate ideas?

DS: We screen a lot on the metrics you'd expect for companies with a combination of low valuation and high business quality, but we also like to search article databases using keywords that indicate problems or big changes at a company – things like "profit warning," or "spin-off" or "restructuring."

DO: As with all screening, it's valuable only to point you in a direction. Our research is then very focused on the context in which a company is operating and on understanding why the valuation is so low. If you're buying a house, you don't ask your real estate broker to blindfold you and take you to the cheapest house in town and just look at it from the inside. You have to stick your head out of the window and walk around the neighborhood to really understand what it's worth.

So when we look at banks, we want to know the leverage ratios for consumers in their primary markets. When we look at cement companies, we want to know where construction activity is historically relative to GDP in the relevant markets and what import prices are. Just buying cheap stocks without paying enough attention to those contextual issues can get value investors into trouble.

DS: Screening can also prompt you to take a new look at something you already know quite well or to discover a connection that you didn't know existed. For example, a sector that appears to be out-of-favor now but is one we like is the advertising-agency business. When ad spending is bad and valuations are low, we try to take advantage of price inefficiencies and add back positions in companies like Publicis [PUBGY] that we've followed for years.

IGM Financial [Toronto: IGM] is another company that showed up on one of our screens and, as we looked into it, we found out that the controlling shareholder, Power Financial, is a group we respect and have invested alongside in the past. When IGM's shares got slammed by the financial crisis, it was a big softball to hit at the right price.

How do you organize your team to "cover" the world?

DS: We break the world into geographic regions, but within those regions we want our analysts to be generalists looking across all industries. Part of that is so people can apply a broad knowledge of business models, industries and markets to every company they analyze. It also allows people to more naturally gravitate to where the opportunity is right now. If you're a generalist you can more easily ignore banks if they don't look interesting, while the bank expert will inevitably find one bank or another they want to buy. As Charlie Munger says, "To the man with a hammer, everything looks like a nail."

We're not big on relative-value arguments like saying a tech stock during the Internet bubble is cheap because it trades at 65x earnings rather than 80x like its peers. We want the expected cash-on-cash return from today's price to generate an attractive absolute return above the risk-free rate. If a given sector isn't offering that at the moment, which can often happen, we want people looking elsewhere.

ON EMERGING MARKETS:

Valuations have only rarely gotten low enough relative to the developed world for us to step over the border.

You have not been particularly active in emerging markets. Why?

DO: The foundation of our process is the ability to arrive at a reasonable estimate of intrinsic value, which is often undermined in emerging markets by a variety of reporting, governance, legal and regulatory obstacles. In South Korea, for example, consolidated financial statements aren't always available. In Russia, the government hasn't kicked the habit of controlling companies that are supposed to be owned and controlled by shareholders. Even in countries where government is less intrusive, regulation can be inconsistently and unfairly applied, adding uncertainty to business models that makes forecasting very difficult.

At a low enough valuation, of course, the incremental uncertainty can be worth taking on. But valuations have only rarely gotten low enough in emerging markets relative to the developed world for us to step over the border. It's not for lack of effort – we're always looking – but so far we've found plenty of opportunity elsewhere to keep us busy.

DS: People tend to lump international investing into this general bucket of opportunity, which to us is kind of silly. We expect a closing of the relative GDP-per-capita gap between the developed world and many emerging markets, but as that happens we believe you're still going to have stocks be cheap or expensive based on cyclical ups and downs and on valuations that overshoot and undershoot. Unless you're smart about picking your spots, you're not going to be successful no matter where you invest.

Can you generalize about where you're finding relative value by geography today?

DO: At the end of April, the Artisan Global Value Fund was 49% in the U.S., 39% in Europe, 10% in Asia and 2% in Mexico. That doesn't reflect any macro calls on various parts of the world, just where we're finding relatively more and less good values.

Deep-value hunters that you are, why hasn't Japan attracted more of your interest?

DS: On a price-to-book basis many Japanese companies are exceedingly

cheap, but we still find too many of them managed in a way that shareholders are not at the top of the pile. With board structures and cross-shareholdings as they are, corporate governance changes happen very slowly and the huge cash and securities holdings everyone points to aren't really available to drive shareholder value. Beyond that, another legitimate reason stocks look cheap there based on assets is that the economic picture isn't pretty, with fairly dim long-term growth prospects. We can find equities to buy (one of which we'll talk about later), but they're not easy to come by.

In general, when does something qualify as cheap enough for you to buy?

DS: Our intrinsic-value estimates attempt to capture what a business should be worth based on its earnings power in a normal economic environment and in a normal, liquid market. As a starting point, we'll only be interested if the current price is at least 30% below our estimate of intrinsic value.

DO: We would stress, though, that it's less about the math than the work that goes into understanding the business and assessing the risks. Eighteen months ago the math might have told you that Bank of Ireland or Allied Irish Banks were cheap, trading at 5-6x earnings when they normally trade at twice that. But then you'd see that their loan books had been growing at an unsustainable 20% per year, that the financing of the business had moved to a reliance on wholesale funding, and that their provisions for loan losses were way down. The earnings and the returns were overstated and there was too much leverage for us to buy at even the cheapest valuations.

One mistake value investors can make is to focus too literally on the absolute difference between an estimate of intrinsic value and the stock price as the valuation cushion. If the range of potential outcomes is very wide, you may have much less of a cushion than you think. One big reason we focus on better-quality businesses with great balance sheets is that the variability in outcomes – and therefore the risk of blowing through the valuation cushion – is lower.

You have a long-held aversion to commodity-related businesses, but have recently been buying energy stocks. Why?

DS: For the most part, capital-intensive businesses without much product differentiation – which is what commodity businesses generally are – generate low returns over time. They can obviously do well when the relevant commodity price is high, but that sets off a cycle of increased supply and reduced demand that pushes the price down to a much less attractive level.

ON HEDGING:

We've found it extremely difficult to figure out the underlying value of any given currency . . . so we mostly run unhedged.

DO: When commodity prices get pushed far below their marginal cost of production, however, we have found opportunity in low-cost producers with strong balance sheets whose stock prices have gotten very cheap. When oil got down to $40 per barrel – versus a marginal cost of production that we estimate to be between $60 and $80 – we started buying Total [TOT] and Royal Dutch Shell [RDS], which fit the profile we wanted to see.

With markets and the economy as volatile as they have been, have you been more actively trading?

DS: I wouldn't say there's been a big change, but we're quite mindful not to look for reasons to hold on to something when underlying fundamentals change. One example is Swiss private bank Julius Baer, which we bought in the fourth quarter of last year because it was trading at only 10x earnings and we thought its private-banking business was likely to attract new clients and to poach top-producing bankers from troubled competitors. Soon after we bought it, though, regulators in the United States and elsewhere aggressively went after the secrecy provisions that underpin the private-banking business. When that happened, we sold.

DO: Another fairly recent exit prompted by changing fundamentals was in Nokia, the big cellphone company. We expected it to report improving market share from a new line of high-end smartphones, but the latest results have shown the opposite. We think that bodes ill for the brand and for the company's future margin structure.

What is your strategy with respect to currency hedging?

DS: We've found it extremely difficult to figure out the underlying value of any given currency, let alone to understand how political considerations may or may not affect exchange rates. So the simple answer is that unless we see particularly unusual exchange-rate relationships – and we don't today – we mostly run an unhedged portfolio.

Describe how Unilever [ULVR:LN] fits your profile of an attractive opportunity?

DO: Unilever is a global packaged-goods company, with roughly half its business in food and half in home and personal care. Geographically, roughly half is in developed markets and roughly half is in emerging ones. Among the big brands that are well-known in the U.S. are Lipton tea, Pond's skin cream, Dove soap and Breyers ice cream.

We inherently like these types of businesses because the products are consumed, have a high degree of customer loyalty and have good margins. Because marketing, advertising and promotion spending can be high, they have flexibility to turn it on and off as market conditions warrant.

The primary headline here is valuation. On estimated 2010 earnings of about €4.2 billion, Unilever currently trades at an 11-12x multiple. Given the characteristics of the business, that multiple has historically been 15-20x. As a general observation, we think the whole packaged-good sector, including companies like Procter & Gamble and Kraft, is very attractively priced, trading at some of the lowest multiples we've seen in our careers.

What makes Unilever's situation particularly interesting?

DO: We like very much the product brand and geographic mix. Particularly in home-care lines, they have very strong positions in faster-growing emerging markets – much better overall than P&G, for example. Relative to many other large consumer-goods companies they have a higher share of revenue coming from personal-care products, which have higher margins and a higher growth profile. After a significant restructuring of the brand portfolio under the previous CEO, Patrick Cescau, some 50% of their brands have #1 local market shares, with about 75% at #1 or #2.

What most impresses us, though, is the cultural transformation going on at the company, which we believe is fundamentally changing both how profitable it is and how it will be perceived by the market. The company in May 2007 named its first non-insider chairman, Michael Treschow, who had overseen turnarounds at the Swedish companies Electrolux and Ericsson, and he has since brought in from outside both a new CEO (Paul Polman, who spent most of his career at P&G and Nestle) and CFO (Jim Lawrence, who came from General Mills). All of this is unprecedented for Unilever, which has historically been criticized for being insular, slow to innovate, slow to respond to market conditions, and not particularly shareholder focused.

What changes are underway?

DO: Paul Polman said he wouldn't make any grand pronouncements or give guidance, but would methodically go through the organization and operations and manage the business rationally and sensibly for the long term. The market seemed to want more specifics, but we think his approach – and his track record, which checks out extremely well – make him an excellent fit for the job.

One area on which he's focusing is new-product development, partly by making an additional financial commitment to it, but also by streamlining product-launch decisions and accelerating the time to market. The holy grail for big packaged-firms companies is to regularly update the product mix toward higher-margin products, reinvest the incremental margin in more product development and marketing spending and then keep repeating. Given how Unilever has operated in the past, we believe there's significant room for improvement on that front.

We also believe there's upside in improving operational efficiency. When we benchmark Unilever against competitors around the world, its margins are typically a few hundred basis points lower. We don't expect that gap to close tomorrow – part of it is a function of having a higher percentage of sales in emerging markets, where margins tend to be lower – but if Polman drives the kind of efficiency through manufacturing and the supply chain that we think he can, margins will improve.

Given all the changes going on and the benefits of the product and geographic mix, we think earnings can grow in the

INVESTMENT SNAPSHOT

Unilever
(London: ULVR:LN)

Business: World's second-largest consumer-goods company by revenue, with key brands such as Knorr, Hellmann's, Lipton, Breyers, Dove, Ponds and Suave.

Share Information
(@5/29/09, Exchange Rate: $1 = £0.6177):

Price	**£14.50**
52-Week Range	£12.26 – £16.96
Dividend Yield	4.6%
Market Cap	£43.98 billion

Financials (For year ended 12/31/08)

Revenue	€40.52 billion
Operating Profit Margin	17.7%
Net Profit Margin	13.0%

Valuation Metrics
(Current Price vs. TTM):

	ULVR	S&P 500
P/E	10.5	15.2

ULVR HISTORY

THE BOTTOM LINE

The market is underestimating the cultural and operational change underway at the company and the impact it will have on growth and profitability, says Dan O'Keefe. If earnings grow over the next couple of years at the double-digit rate he expects, multiple revaluation alone would result in 40-50% upside from today's share price, he says.

Sources: Company reports, other publicly available information

next couple of years at a double-digit rate, with the longer-term annual growth potential in the 5-10% range.

From a recent £14.50, what upside do you see for the shares?

DO: We think a multiple of 15-20x earnings reflects fair value, so a simple revaluation as the company executes and the investment community warms up to the strategy gives us potential 40-50% upside. If we're right about revenue growth accelerating and margins expanding, the upside is quite a bit higher. In the meantime, we're getting a 4.6% dividend yield. There are many different ways to win here.

After shunning financials for some time, what attracts you to Bank of New York Mellon [BK]?

DO: This is a good example of the type of situation that attracts us. As the financial crisis unfolded and all financial stocks got hit hard, we focused in the sector on fee-generative businesses, as opposed to the highly leveraged banks and investment banks. Bank of New York makes the majority of its money through asset and custody services like holding funds in trust for debt issuers, securities lending, clearing government securities and calculating net asset values for mutual funds. These are highly consolidated markets and Bank of New York is oftentimes the clear number one, benefiting from regulatory barriers to entry, scale advantages and reputational advantages. The result is high – 35%-plus – operating margins.

The company is also a leading global provider of investment management products, in everything from mutual funds at subsidiaries like Dreyfus to an extensive private-banking operation. In addition, because they hold so many assets in trust or in transit, they have a significant amount of float to invest.

As you might expect, these last two areas have been hurt by the crisis, but the servicing businesses – which makes money on the volume of capital-markets activity as well as the level at which markets trade – has done very well. It's also been a positive from a market-share perspective that the major servicing competitor, State Street, has had far more problems with excess leverage and toxic assets. Overall, Bank of New York earned as much in 2008 as it did in 2007, around $3.50 per share.

Is it difficult to estimate a normal level of earnings here?

DO: To be conservative, we actually use $3 per share as the level of normal earnings power. We don't expect the volatility and asset churn the company benefited from last year to be the norm. But at the current share price [of just under $28], the shares trade at only 8x trailing earnings and just over 9x what we consider normal earnings. That's extremely cheap for an oligopolistic, high-barrier-to-entry, high-return business that is taking market share. We believe that kind of business could eventually be worth a minimum of 15x earnings, and 20x is not out of the question.

The key for us in financial services today is to get comfortable with the sustainability of earnings going forward. We have that comfort with Bank of New York and are thrilled to buy something of

INVESTMENT SNAPSHOT

Bank of New York Mellon
(NYSE: BK)

Business: Diversified financial services provider with primary focus on capital-markets execution and servicing activities as well as asset and wealth management.

Share Information (@5/29/09):

Price	**27.78**
52-Week Range	15.44 – 44.99
Dividend Yield	1.3%
Market Cap	$32.04 billion

Financials (TTM):

Revenue	$12.64 billion
Operating Profit Margin	19.1%
Net Profit Margin	8.2%

Valuation Metrics (@5/29/09):

	BK	S&P 500
Trailing P/E	33.3	15.2
Forward P/E Est.	10.6	15.9

Largest Institutional Owners (@3/31/09):

Company	% Owned
Davis Advisors	4.1%
Barclays Global Adv	4.0%
State Street Corp	3.8%
Capital Research	3.8%
Vanguard Group	3.2%

Short Interest (as of 5/12/09):

Shares Short/Float	1.2%

THE BOTTOM LINE

The company's focus is on capital-markets execution and servicing businesses with high barriers to competitive entry and high returns, but the market is valuing it like any other bank, says Dan O'Keefe. At a more reasonable 15x what he considers the company's normal earnings power of $3 per share, the shares would trade at $45.

Sources: Company reports, other publicly available information

this quality when it's cheap based on earnings at the bottom of the market. To us, it's one of those proverbial babies being thrown out with the bathwater. If capital markets came back strongly, which we're not counting on, it could earn $4 per share.

Any company with such a giant asset base can't be without potential risk in this environment.

DO: It certainly isn't without risk, but the company's pre-loss-provision operating profit – adjusted for merger expenses and amortization – was around $6 billion in 2008. The lower quality portion of the securities portfolio, which they've already written down by almost 40%, is now worth something like $15 billion. That level of cash flow relative to the total value of the questionable securities is huge, which should allow them to relatively easily absorb any further write-downs. Given that they've been conservative in their markdowns to date, there's actually a chance the portfolio ends up being written back up over time.

Explain why Sankyo [6417:JP] stands out as an opportunity in Japan.

DS: The company is one of the largest manufacturers of gaming machines in the world, but specifically makes the pachinko machines that are incredibly popular almost exclusively in Japan. These are sort of combined slot machines and pinball machines, in which you drop balls into holes that make their way down in a variety of ways that can ultimately result in you getting more balls, which then translates into winnings.

People play the machines in pachinko parlors, which are all over Japan, and they don't really carry the stigma that some people attach to gambling or playing the slots in the U.S. It's more considered a form of entertainment, played on a more regular basis, and the machines are set up so people can play for hours without losing much money. All that translates into a highly profitable business for the leading machine makers – Sankyo is typically #2 or #3 in the market, given product cycles – which earn profit margins over time in the 20-30% range.

The business is highly regulated, and changes in regulation from year to year can create valuation opportunities. In the fiscal year ended this March, for example, parlors heavily bought pachinko machines with higher but fewer-in-number payouts, which seem to drive more play. The reason for the rush to buy was that at the end of March, by regulation, the sale of those higher-payout machines was going to be heavily restricted. Because Sankyo's product line hasn't been focused on the higher-pay machines, that has hurt their business and stock price. But because that sales dynamic should reverse itself this fiscal year, we believe the market is much more pessimistic than it should be about the company.

At a recent ¥5,050 per share, how cheap is the stock?

DS: In dollars, the company has net cash – not cash and securities, but cash – of around $3.3 billion, versus a market value of $5.4 billion. Against that enterprise value of $2.1 billion, we believe the normal level of operating profit is around $600 million, which we think they could get back to as early as this fiscal year. So on a pre-tax normalized basis, it trades at a 3.5x multiple.

What should a business like this trade for? We think an 8x pretax multiple (10-11x net earnings) is perfectly reasonable. With that multiple and adding back the

INVESTMENT SNAPSHOT

Sankyo
(Tokyo: 6417:JP)

Business: Develops, manufactures and sells Japanese "pachinko" pinball machines, slot machines and related peripherals and equipment, primarily in its home market.

Share Information
(@5/29/09, Exchange Rate: $1 = ¥95.455):

Price	**¥5,050**
52-Week Range	¥3,450 – ¥7,520
Dividend Yield	3.0%
Market Cap	¥492.87 billion

Financials (Fiscal year ended 3/31/09)

Revenue	¥187.88 billion
Operating Profit Margin	21.6%
Net Profit Margin	14.8%

Valuation Metrics
(Current Price vs. TTM):

	Sankyo	S&P 500
P/E	17.5	15.2

THE BOTTOM LINE

Regulations that temporarily favored machines made by the company's competitors expired in March, which should cause recent sales shortfalls to correct themselves, says David Samra. At 8x what he considers the level of normal operating profit – adjusting for $3.3 billion in cash on the balance sheet – the shares would be worth ¥8,000.

Sources: Company reports, other publicly available information

cash on the balance sheet, the share price would be above ¥8,000.

Has management proven to be on the side of common shareholders?

DS: The company is majority controlled by the Busujima family, one of the wealthiest families in Japan, and we like the way they operate the business for the long term. They also have been sharing more of the company's cash pile with shareholders, having repurchased shares in the past few years and fairly aggressively raised the dividend, which now pays a 3% yield.

What are the biggest risks?

DS: Regulatory whim is always a risk, as is the fact that the pachinko market is slowly shrinking over time. Because the market contraction is a drawn-out process and the company has proven adept at building market share over time, we don't see that as a particular threat to our thesis, especially from today's share price. Also, given the size of the cash pile, what management does with it will be a key determinant of final value.

We first bought Sankyo a few years ago when it also had what we thought were temporary market-share problems, and we ended up selling a big chunk of our position when the shares revalued significantly upward. Now that the shares have sold off again, we've significantly increased our stake as we believe the revaluation history could repeat itself.

You've also done well investing in Accenture [ACN] in the past. Why are you expecting to do so again?

DS: We consider Accenture the class act in the consulting business, focusing on management consulting, IT consulting and outsourcing. Against their biggest competitors, IBM and Hewlett-Packard (after its purchase of EDS), they benefit from not having any conflicts in trying to promote their own hardware. Against smaller competitors like Cap Gemini, they can offer the global expertise and scale that most multinational clients require. Those types of competitive strengths, along with a unique partnership culture, have resulted in one of the better client lists in the business and healthy underlying profitability. Gross margins – the difference between what Accenture charges clients per hour and what it has to pay its consultants – typically are in the 30% range. After selling, general and administrative expenses, that usually results in 10-13% pre-tax margins. Returns on equity are around 80%.

The key issue here is to determine what "normal" is for the business. The market seems to fear that an unsustainable amount of IT consulting – which accounts for more than half Accenture's total operating profits – has gone on in recent years. We take a different view and see a long-term positive trend for the types of IT consulting and IT outsourcing the company offers. Its fundamental value-add is to look at a client's cost structure and find ways to apply information-technology solutions – including Accenture sometimes taking over certain client IT functions – to save money or improve operating effectiveness. Given the speed at which technology changes and competitive environments change, we see increasing demand for that.

INVESTMENT SNAPSHOT

Accenture
(NYSE: ACN)

Business: Global provider of consulting, technology and outsourcing services primarily serving the communications, financial, high-technology and media industries.

Share Information (@5/29/09):

Price	**29.93**
52-Week Range	24.76 – 43.04
Dividend Yield	1.7%
Market Cap	$18.35 billion

Financials (TTM):

Revenue	$25.28 billion
Operating Profit Margin	12.4%
Net Profit Margin	7.1%

Valuation Metrics (@5/29/09):

	ACN	S&P 500
Trailing P/E	10.7	15.2
Forward P/E Est.	11.0	15.9

Largest Institutional Owners (@3/31/09):

Company	% Owned
Wellington Mgmt	6.3%
Fidelity Mgmt & Research	5.1%
Franklin Resources	4.9%
T. Rowe Price	4.6%
MFS Inv Mgmt	4.0%

Short Interest (as of 5/12/09):

Shares Short/Float	0.7%

ACN PRICE HISTORY

THE BOTTOM LINE

David Samra believes the market is being overly pessimistic about the long-term growth prospects for the company's core IT consulting and outsourcing businesses. If the company regained last year's earnings level and the shares traded at what he considers a more appropriate 17x multiple, the stock price would be in the low $40s.

Sources: Company reports, other publicly available information

How significant is the threat from the big Indian outsourcing firms like Infosys and Wipro?

DS: For all the talk about the big Indian firms moving into higher value-added projects, they've had a tough time competing in that part of the market with the Accentures and IBMs of the world. At the same time, Accenture has built a huge presence of its own in India, so can compete very effectively for lower value-add projects as well. As global clients look for more comprehensive services and solutions, Accenture is quite well positioned against the Indian firms.

Another thing we like about the way Accenture competes in outsourcing is that it typically doesn't take on projects that require huge upfront hardware and software investments. That way they're able to benefit from the relative stability of outsourcing revenues, without the added risk of heavy capital investment.

With the shares trading just below $30, how are you looking at valuation?

DS: We're assuming a significant decline in the company's higher-margin consulting businesses this year, which means earnings are likely to come in at around $2 per share, vs. the $2.50 they did in 2008. So the shares trade at 12x last year's earnings and around 15.5x this year's. As the cost base is adjusted and the business starts to grow again, which we think can happen in fiscal 2010, we think a multiple in the high-teens is more reasonable. If they just get back to last year's earnings level, with say a 17x multiple, that would result in a share price in the low $40s.

As the shares have bounced off their lows this isn't the cheapest stock we own, but for a company that's a first-class competitor in a high-return business, it's still an excellent value.

ON "NORMAL":

The difficulty in defining normal is probably greater today than it has been in our investment lifetimes.

You mentioned the difficulty of defining "normal" for Accenture. Isn't making that particular call one of the biggest general challenges facing investors today?

DS: Absolutely. Have we reset to a permanently lower level of economic activity? Can normal profits at individual companies return to prior levels? Should valuations be set differently in a changed environment? It's not new that we have to address those questions, but I'd argue the difficulty in doing so today is probably greater than it has been in our investment lifetimes.

What's important is to think about the issue of what's normal in the context of the quality of the business you're looking at. Can they cut costs? Can they win market share? Is their balance sheet an asset? The answer to those questions can make a huge difference in how successful they'll be in a less buoyant economic period.

In the end, this environment should be an opportunity for truly price-sensitive and risk-averse investors. How well we assess risk and how little we pay against intrinsic value is our best protection against uncertainty, macro or micro. VII

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Investor Insight: Nantahala Capital

Wil Harkey and Dan Mack of Nantahala Capital explain how they "avoid exposure to events we can't predict," why catalysts are so important, why they're indifferent to the market's overall level, why they're short Haverty Furniture, and why they're long Meta Financial and Walter Investment stock and Delta Petroleum and Stanley Works bonds.

Wil, new hedge funds were a dime a dozen when you started Nantahala in 2004. How did you hope to set yourself apart?

Wil Harkey: The idea from the beginning was to combine a fundamental Graham and Dodd way of looking at equities and credit with an arbitrageur's mindset for isolating and offsetting risk. We're basically trying to isolate what it is about a given opportunity that we consider to be mispriced, and then use available hedges so that we're exposed as much as possible to only that mispriced factor. We stick mostly to small-cap situations, in the hope that we're competing against a less-sophisticated crowd.

You've described your strategy as "factor neutral." What does that mean?

WH: Our goal is to limit exposure to all systemic risks, whether they be to the overall equity or credit markets, a particular industry, a particular asset class, a particular investor type, or just about anything we can't predict. While we'll have positions in securities exposed to those factors, we offset those positions to minimize the volatility caused by changes in the factors. Hopefully this will leave us uncorrelated to pretty much everything.

As an example, in the early fall of last year we noticed that retailers, including many with large real estate holdings, were priced very pessimistically when compared to commercial REITs, whose business it is to be their landlord. REITs' market cost of equity was still near historical lows, but our feeling was that brewing tenant problems – which hadn't yet shown up in actual broken leases and increasing vacancies – would eventually become landlord problems. Based on that, we shorted what we thought were particularly vulnerable REITs with heavy retail exposure, like Simon Property and Saul Centers, and went long pessimistically-priced retailers with good balance sheets and real estate holdings. That focused our bet on the fact that we thought REITs were overpriced, without exposing us to the risk that the retail real estate situation didn't turn out as bad as expected. As the market sold off in late fall, the decline in commercial REITs of 50% to 75% outpaced the 30% or so decline in retail stocks, resulting in nice profits for us on the trade.

Dan Mack: A central idea of our fund is to have our short book look a lot like our long book, with the obvious exception that we think our longs are likely to outperform in the short to medium term and our shorts are likely to underperform over the same period. The argument for underperformance or outperformance is usually valuation based and catalyst driven.

So we do things like match the market caps of our longs and shorts overall, so we're not sensitive to moves in sentiment between large caps and small caps. We'll match our credit longs against credit shorts and equity longs against equity shorts, so we're not exposed to the market all of the sudden valuing bonds more or less favorably relative to stocks.

We also avoid making sector bets. We own a small bank called Meta Financial, for example, because it has a fast-growing payments-processing subsidiary that we expect to start producing significant profits, resulting in future returns on equity for Meta that are substantially higher than its peers, while the stock currently trades at a book value multiple at or below its peers. In this case we pair our long in Meta with short exposure to more highly valued peer banks. That way we hedge out the risk of credit deterioration that would hurt all banks, including Meta, and focus the bet on the payments-processing business taking off.

Wil Harkey, Dan Mack

Bias for Action

Having met in 2002 as arbitrage analysts at Sagamore Hill Capital, Wil Harkey and Dan Mack discovered a common affinity not only for the quantitative aspects of making relative-value bets between securities, but also for understanding the fundamental reasons mispricings occurred. "The arbitrage model based on being a more sophisticated trader is saturated," says Mack. "We both thought the best way to get an edge was to know the companies' businesses better than anyone else."

Harkey put that notion into practice in starting Nantahala Partners in 2004, and Mack joined him as a partner three years later. Their collaboration makes for better and faster decisions, says Harkey. "We go back and forth on every idea to make sure we know all we need to and to agree on the potential returns versus the risks," he says. "It's just us, so that shortens the process from start to end – which often makes a difference in the returns."

The origin of the firm's name? "It's a river in the Smoky Mountains my family visited when I was growing up," says Harkey. "I wanted a name that wasn't too austere but reflected my roots." Adds Mack: "Plus, it's so easy to pronounce."

If you know that bonds outperform equities this month or energy stocks beat financials, we don't want that to tell you anything about how our portfolio performed. If you're able to guess how we did without knowing our actual positions, then our portfolio is not set up as we intended.

Explain your focus on small caps.

WH: We've consistently found the most attractive risk/reward situations in companies with enterprise values of, say, $100 million to $750 million. That's a function of several things. There's less competition in these names, as most of the best investors are deploying so much capital that they're not interested in looking at them. There's less information, as sell-side analyst coverage is usually limited (and getting more so), which creates an opportunity to come up with some sort of edge if you really dig. There's also just a larger universe of small-cap companies out there at which to look – a universe that has gotten even bigger over the past year.

DM: Here's a good example of the inefficiency you can find in small caps. Last fall, big insurance companies like MetLife, Prudential and Lincoln National sold off 50-70% over three weeks as investors got concerned about how those firms' declining investment portfolios might impact their solvency. As we saw that happening, we looked at smaller insurers to see how they were being priced relative to the risks. One we found, FBL Financial, looked to have at least as bad problems in its investment portfolio as well as a weak balance sheet, with most of its equity coming from low-quality intangible assets. Given that FBL's shares were down only 20% while the larger insurers were off maybe three times that, it turned out to make an attractive short.

Is that typical of how ideas crop up?

WH: It's fairly typical, but maybe a bit more thematic than is usually the case. More often ideas just come out some other work we're doing. In researching Pier One and Restoration Hardware in the past, for example, we spent a lot of time learning about the furniture industry, which has resulted in our taking positions – two short and one long – that are in the portfolio today.

We're looking for situations that are potentially misvalued, and then spend most of our time trying to understand why it is misvalued and whether we agree with this reason. If it just appears misvalued and we're not exactly sure why, the risk is higher that there's something out there we don't know that other people do. We'll likely pass on those.

ON TIME HORIZON:

If it will take two to three years for the mispricing to go away, we believe we can find better places to deploy capital.

Why are themes less likely to drive ideas?

DM: When I think of a theme, it's something like, "Water is the new scarce resource, so let's find the best water stocks to buy." A lot of people devote attention to those types of themes because if you make a conclusion, you can put a lot of capital to work.

Given our strategy, we're unlikely to be exposed to such general themes. For one, you tend to end up in pretty crowded trades. It also just exposes us to systemic risk that we don't want. We don't think the current price for natural gas is sustainable, for example, which is reflected in the futures curve and by common sense, when you see the supply response to low prices. While that might inform a specific position we have in an energy company, we don't ever want our performance to be driven by whether natural gas prices are up or down.

How long or short does your time horizon tend to be?

WH: We focus not only on something being mispriced, but also on return on capital – if we park our capital in something, will we earn returns that justify it being parked there? If there's a good chance it will take two or three years for the mispricing to go away, we generally believe we can find better places to deploy the capital in the meantime. As a result, catalysts are important to us.

DM: A lot of times the catalyst is just that we think future performance is going to be dramatically different from the past or what is expected – as with Meta Financial, for example – and the story is not well understood. In those cases we're often looking six to nine months out.

Related also to your question about ideas, we often find opportunity in companies that are restructuring, or facing liquidity problems, or selling off divisions. These types of situations are accompanied by uncertainty and often present a series of upcoming events upon which we can have an actionable opinion.

Can you give an example of that?

DM: Sure. Earlier this year we put on a relative-value trade that was short the equity of **Delta Petroleum** and long the bonds. In this case, the event we expected to unlock value was the reevaluation in March of the company's bank line of credit, based on the banks' assessment of the value of Delta's oil and gas assets. Given the sharp decline in natural gas prices and some company-specific investments that weren't panning out so well, we thought the banks might lower the borrowing base, forcing Delta to raise equity. If the banks did that, all creditors would benefit, at the expense of the equity holders.

What happened?

DM: The company raised $250 million in equity a couple weeks ago, and also won another $50 million in a litigation award from the U.S. government over drilling leases that were later rescinded. We've been surprised that the bonds haven't moved that much since, so we still hold them based on the expectation that they'll revalue.

Describe the bullish case for Delta's bonds today.

DM: After bringing in the new cash, if natural gas prices remain depressed, Delta has the liquidity to operate well into 2010. If gas prices fall off a cliff, the banks have required the company to hedge the majority of its production over the next few years, so additional downside for creditors would be limited. If gas prices rise, that's good news all around.

We estimate the total liquidation value of the company at around $450 million, which fully, though not lavishly, covers the current net debt of $350 million. There is also an additional $70 million claim against the government, which is likely to be resolved in the next year.

What bonds do you own and at what price do they trade?

DM: We own the 7% bonds maturing in 2015, which are priced today at around 40 cents on the dollar. That translates into a yield to maturity of around 30%, for a company that just raised $250 million in equity capital and has a liquidation value that we think covers the bonds at par.

The company has some covenant issues and weak cash flow, so we expect the bonds to trade at a high yield even though we ultimately think they pay off at par. But even at a 20% yield, that would give us a 15-point gain in the bond price, on top of the coupon.

Are you still short Delta stock?

DM: A little. In a liquidation, which we don't believe is going to happen, the residual value left over for equity holders after paying the bond holders would be significantly less than the current market value of $550 million.

Are fixed-income investments a major part of your portfolio?

WH: Bonds now are about 10% of the portfolio. If we're doing the work to value the equity in a company, it makes sense to evaluate all of the company's publicly traded securities – it's very little additional work and it's rare that they're all valued perfectly relative to each other.

In general, though, we want most of the portfolio in equities, because they're more liquid and the transaction costs are lower. When we invest in bonds, it's usually when we feel the risk/reward is substantially better than what we're finding in equities.

Given that, how about walking through another bond idea?

DM: We own the 5.902% bonds maturing in 2045 of **Stanley Works**, the tool maker, which currently trade around 58 cents on the dollar. That gives them a yield to maturity of just over 10%, versus the 4% or so yield at which other bonds in the company's capital structure trade.

ON PORTFOLIO SIZE:

If we got too big, we'd have to start ignoring great opportunities or we'd see our trading start to impact prices.

Clearly the market is saying there's something funny about this issue and there is. In particular, the coupon payments on the bonds can be deferred, optionally at the company's discretion, or in a mandatory way if certain cash-flow metrics are breached.

What's important here is that the company doesn't like these deferral features any more than the bondholders do. If a deferral were triggered, the company would also be required to discontinue its common-stock dividend and raise equity capital in order to pay the deferred bond interest. These are clearly not things a healthy investment-grade company is eager to do.

How big is the threat of deferral today?

DM: Not terribly high, but also not insignificant. If what is defined as "retained cash flow" falls to less than 15% of total debt on a trailing-12-month basis, or if it is less than 20% of debt for three consecutive quarters, they would have to defer. At this point, the economy would have to turn south again fairly sharply for cash flow to fall another 20-30%, which would put them in danger of having to defer.

If that becomes a real issue – and even if it doesn't – we think it's likely the company will try to retire this debt. They bought back $100 million of these bonds earlier this year – at around the current market price – and have cited the continued retirement of debt as a corporate objective. They have good access to capital markets to raise money, on more favorable terms, to retire these particular bonds.

What do you think the bonds are worth?

DM: The market is saying that other Stanley bonds without the deferral feature have little risk of defaulting over at least the next five years. With that as a starting point, we calculate that our bonds should more reasonably trade at a price well into the 90s. Discounting for the ugly structure and the volatile times, we still come to around 80 cents on the dollar.

For downside protection, we have the 10% yield, on a credit we believe is safe. We also own some out-of-the-money puts on Stanley stock, to hedge against the economy turning much worse. So if all goes well, company buying or natural buying in the market should drive significant price appreciation in these bonds. If things get worse, we're protected by our puts and we still think the company will be want to take us out at a price not far from today's.

Is your strategy difficult to execute with a large asset base?

DM: We've initially set a maximum portfolio size of $100 million, but believe we have enough liquidity in our positions to manage $250 million without running into problems. If we get too big, we'd have to start ignoring great opportunities or we'd see our trading start to

impact prices more than we'd want. We're not in this to maximize our assets under management or run a big organization, so we're happy with keeping things relatively small.

How many positions do you own?

WH: We typically have 25-30 longs and maybe 40 shorts. We size individual shorts smaller to help limit the risk from position sizes getting bigger as a short goes against you.

We also limit the maximum potential loss in any position, if it goes to our worst case for it, to 4%. Our strategy doesn't support too many eggs in one basket. When you're too large in a single name you expose yourself to more undiversifiable risk.

Tell us about a current long equity idea, Walter Investment [WAC].

DM: This is a recent spinoff, which started trading on its own only last month, of Walter Energy. It was actually spun off as a private company and merged into a public real estate investment trust shell, which was considered an easy way to convert to a REIT structure. One effect of doing it that way was that disclosure was limited – they didn't have to file the most-detailed form the SEC requires for public spinoffs.

The company is the former mortgage arm of Walter Industries' home-building subsidiary. It owns a portfolio of mortgage loans and non-recourse mortgage-backed debt backed by homes originally built by Walter Homes, primarily in the Southeast and Texas. The strategy was somewhat unique: They marketed homes to low- and middle-income buyers who, in lieu of a down payment, contributed the land the home was built on and agreed to pay for finishing touches like the driveway, sewer hookup and landscaping. Walter financed the loans internally and then sold them to what is now Walter Investment at 90 cents on the dollar, producing about a 10% yield before any credit losses.

What has the credit experience been?

DM: The credit performance has been very strong so far. Delinquencies are below 5% of the portfolio and credit losses have been running at less than 1% per year. That's largely a function of the underwriting model. The homeowner had to have real skin in the game, through the land contribution and property improvements. Walter also offered only fixed-rate mortgages, on homes typically costing less than $100,000, and actually emphasized verifying the borrower's income.

Another important attribute of the company's model is that its client service is all done in-house by a local network of agents, who essentially own a book of business that they are in charge of tracking and servicing. It's very much a personal-responsibility scheme, with each agent compensated based on the performance of his or her particular portfolio of loans. That helps keep delinquency rates low and, if houses go to foreclosure, the presence of the agents seems to have a significant impact on recovery rates. Walter is recovering over 80% of the loan value in repossessions, which is extremely high.

Is the company basically in run-off mode?

DM: No, they do have a growth strategy. Essentially, they want to take their servicing platform and use it for third-party loans. They say they have the capacity to service 30-50% more loans with their existing agents, so if they can sign up third parties that have loans worth putting this amount of effort into, the incremental margins from that would be very

INVESTMENT SNAPSHOT

Walter Investment
(Amex: WAC)

Business: Recently spun-off mortgage finance business of Walter Industries, now structured as a REIT, with some $1.9 billion of mostly subprime mortgage assets.

Share Information (@5/29/09):

Price	**13.50**
52-Week Range	5.54 – 14.42
Dividend Yield (Est.)	14.8%
Market Cap	$268.3 million

Financials (2008 Actual)

Revenue	$216.0 million
Pre-Tax Margin (Adj.)	18.8%
Net Profit Margin (Adj.)	18.8%

Valuation Metrics (@5/29/09):

	WAC	S&P 500
Forward P/E Est.	6.7	15.9

THE BOTTOM LINE

Due to strong underwriting and a unique servicing platform, the credit performance of the company's mortgage-loan portfolio has been excellent, says Dan Mack. He believes the quality of the company's earnings and balance sheet warrant a share price closer to $20, providing capital appreciation on top of a roughly 15% annual dividend yield.

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

high. This isn't going to turn Walter Investment into a growth stock, but as a modest strategy to offset the slow paydown of the mortgage portfolio, we think it has promise.

With the stock trading around $13.50, how are you looking at valuation?

DM: We estimate the company will earn roughly $40 million in net income this year. As a REIT it's required to pay out at least 90% of that, so given that and the fact that they'll have additional cash flow from principal repayments, we expect the dividend to be around $40 million as well, or $2 per share. The portfolio is well seasoned and the loans in it are going to pay down fairly slowly over time, so if they have any success at all with the growth plan, that $40 million annual dividend stream should be fairly stable. That's a 15% yield at today's price.

Mortgage-REIT comps are all over the place, but we believe it's reasonable to put a 10% discount rate on Walter's dividend stream, given the relative quality of its earnings and the fact that it has a clean balance sheet. When we do that we arrive at a share price around $20, slightly less than the $23-per-share book value.

Is the primary risk in credit quality?

DM: That's clearly one, that loan quality deteriorates as unemployment increases. Given Walter's model, though, we'd expect its experience to continue to outperform in a worsening economy.

Another risk is just that they can't produce any growth. If that happens, the fixed costs of the servicing platform will start to weigh heavily on cash flow as the loan portfolio gradually pays down.

Describe the full case for Meta Financial [CASH], which you mentioned earlier.

DM: Meta has two businesses, a commercial bank with branches in Iowa and South Dakota, and a payments-processing business focused on pre-paid cards. As I mentioned, the processing business is growing fast, benefiting from the continued trend away from cash toward the increased use of things like payroll cards (which are becoming popular for people who don't use bank accounts), gift cards and rebate cards.

The story here is all about the processing business, which we believe is hitting a pivot point. Most small banks spend money on marketing and opening new branches in order to attract deposits at a low rate that they can lend out at higher rates. They're profitable if their net interest income more than offsets their net non-interest expenses. In Meta's case what's happening is that after years of spending to build the processing business, it is now poised to earn not only positive net interest income – on the free float of around $400 million it generates today – but to also make money on a stand-alone basis. So they're not spending money gathering deposits, but making it.

We assume this hasn't shown up in the numbers yet.

DM: Not really. One reason is that the processing business is just now reaching a scale at which it can be very profitable. Another reason is that all that free float isn't generating much in income with short interest rates close to 0%. Finally,

INVESTMENT SNAPSHOT

Meta Financial
(Nasdaq: CASH)

Business: Bank holding company for two primary businesses: MetaBank and Meta Payment Systems, a provider of electronic-payment systems and services.

Share Information (@5/29/09):

Price	**15.63**
52-Week Range	5.72 – 28.60
Dividend Yield	3.5%
Market Cap	$40.7 million

Financials (TTM):

Revenue	$79.8 million
Operating Profit Margin	(-1.4%)
Net Profit Margin	(-0.5%)

Valuation Metrics (@5/29/09):

	CASH	Nasdaq
Trailing P/E	n/a	13.4
Forward P/E Est.	n/a	18.6

Largest Institutional Owners (@3/31/09):

Company	% Owned
Ashford Capital	9.7%
Dimensional Fund Adv	5.6%
Vanguard Group	2.5%
Royce & Assoc	1.4%
Northern Trust	0.5%

Short Interest (as of 5/12/09):

Shares Short/Float	n/a

CASH PRICE HISTORY

THE BOTTOM LINE

The company's payments-processing business focused on pre-paid cards is at a "pivot point" in terms of generating profits and interest-free float, says Dan Mack. At a 10x the $3 per share he estimates the company can earn over the next 12 months, the shares would double from their current price, with considerable upside beyond.

Sources: Company reports, other publicly available information

the bank side of the business hasn't been doing very well, not so much from credit problems, but due to some excessive costs and a good-sized fraud loss.

Our estimate is that on a forward 12-month basis, Meta overall will earn around $3 per share in earnings, almost entirely from the processing business. Given that earnings were modestly negative over the past 12 months, that's going to be a significant change and one we don't believe the market is expecting.

It wouldn't appear so with the shares at a recent $15.30. What upside do you see?

DM: If we're right, in the near term it certainly wouldn't be unreasonable for the shares to trade for at least 10x earnings, resulting in a share price closer to $30. There's also significant potential beyond that. If Meta earned on its free float 2.8% – what the markets are implying LIBOR will average over the next five years – that alone would add another $2.50 per share in earnings.

Do you have any concerns about the bank loan portfolio?

DM: The bank has been fairly conservative in underwriting, sticking only to their local markets, which have held up very well so far in the economic downturn.

The bigger medium-term risk is that increased competition slows growth and/or erodes margins in the processing business. So far they've done an exceptional job in attracting and retaining clients, but success typically breeds competition, so that's something to watch.

How did this tiny bank catch your eye?

WH: It is a bit smaller than we typically look at, but we first heard about it from a friend in venture capital who was looking at a company that was a client of Meta's.

Turning to a short idea, what's the bear case for Haverty Furniture [HVT]?

WH: Haverty is a furniture retailer in the Southeast with what we consider to be a pretty undifferentiated offer. It's like many other local furniture stores out there, except instead of having a few stores they have around 120.

The company's historical margins and returns on equity have never been particularly strong. During the height of the housing boom when furniture was selling quite nicely, its net income margin got as high as 3.5%, versus around 8% for best-in-class companies in the sector like Ethan Allen and Williams-Sonoma.

For the last four or five years the company produced strong negative comps, with sales per square foot falling from $200 to around $120 today. That's not good news for a retailer with relatively high fixed costs, and over the past 12 months Haverty had a $15 million operating loss. While other kinds of retail sales showed some signs of life in the first quarter, furniture sales were terrible and appear to be equally bad this quarter.

The primary reason we're short Haverty is not because it's a low-quality business, which it is, or that macro furniture sales are bad, which they are, but because the company today trades at 15x mid-cycle earnings when there are loads of retailers out there at less than 5x mid-cycle earnings. It makes no sense to us why it would be so highly valued.

INVESTMENT SNAPSHOT

Haverty Furniture
(NYSE: HVT)

Business: Full-service, mid-priced home furnishings retailer with over 120 stores located primarily in states in the Southeast and Midwest.

Share Information
(@5/29/09):

Price	**10.52**
52-Week Range	7.61 – 13.73
Dividend Yield	2.7%
Market Cap	$224.4 million

Financials (TTM):

Revenue	$651.9 million
Operating Profit Margin	(-2.4%)
Net Profit Margin	(-3.1%)

Valuation Metrics
(@5/29/09):

	HVT	S&P 500
Trailing P/E	n/a	15.2
Forward P/E Est.	29.2	15.9

Largest Institutional Owners
(@3/31/09):

Company	% Owned
Third Avenue Mgmt	23.2%
T. Rowe Price	12.4%
Donald Smith & Co	10.2%
Dimensional Fund Adv	8.5%
Franklin Resources	8.0%

Short Interest (as of 5/12/09):

Shares Short/Float	24.6%

THE BOTTOM LINE

Despite chronic declines in sales per square foot and profit margins, the company's shares trade for 15x mid-cycle earnings at a time when there are "loads of retailers out there" at less than 5x such earnings, says Wil Harkey. If the shares traded at a still-undeserved 7.5x mid-cycle earnings, he says, they'd fall 50% from today's level.

Sources: Company reports, other publicly available information

We thought you didn't like it when you didn't know why something was mispriced.

WH: One notion that has been out there for a long time is that the company owns a third of its store base, which puts a sort of a real estate floor on the stock. While that might have made some sense three years ago, the bid on real estate like this has fallen way off and their practical ability to realize any significant value is limited.

I guess people have also been somewhat pleased by the company's ability to cut costs and that its trailing 12-month EBITDA is still positive. But that hardly seems like a justification for the shares to trade at 15x mid-cycle earnings when a company like Williams-Sonoma trades at 3x mid-cycle earnings. The valuation premium may be even higher than that: Haverty's peak earnings early this decade were around $1 per share, so it's probably even generous to call 70 cents per share mid-cycle earnings.

What do you think the shares, now trading at $10.50, are worth?

WH: If the stock traded at 7.5x mid-cycle earnings – still a valuation premium we couldn't justify – the shares would be cut in half. Even though the numbers have already been bad, we expect lousy results in the next quarter or two to start to get noticed.

We've seen selling over the last two quarters by Haverty's largest shareholder, the Third Avenue Value mutual fund. If that continues, we don't expect much enthusiasm by people to step up and buy ahead of that.

Can you generalize about mistakes that you've made?

WH: Most of our mistakes so far have been of the one-off variety, where we just miss something or play down in importance something that turns out to be important. In some of our specialty finance positions, for example, we relied on a level of earnings from float that wasn't there when short-term interest rates went from 5% to less than 1% in a year. With Sears, which we were long, the financial crisis and economic downturn just sort of overwhelmed any upside we saw from Eddie Lampert's ability to cut costs or monetize real estate value. We sold the position as soon as it became clear the real estate floor was falling away.

DM: Sears is actually an excellent example of how our hedging strategy works.

ON THE CURRENT MARKET:

A good environment for us is when things are all over the place. Now is a pretty good time for that.

We were making a bet on the real estate value in Sears, so we hedged against that by shorting companies with large retail real estate holdings. It was also an example of how a mediocre business can look pretty interesting when times are good, but you don't want to be long a bunch of mediocre businesses whose multiples you expect to catch up with better ones. We want the long and short sides of our book to be well matched in terms of business quality as well.

In the end, we came out okay on Sears because our hedges paid off. But we certainly wouldn't say our insights to buy Sears at $140 were anything to be particularly proud of.

You've said the market environment of the past six months is particularly conducive to your strategy. Why?

WH: We're very much relative-value investors and the more uncertain the markets are, the more likely we are to find things that are mispriced relative to each other. One thing that was a little frustrating in late 2006 and early 2007 was the degree to which leverage and capital in hedge funds was driving relative-value discrepancies out of the market. That lack of inefficiency in relative value has thankfully abated. It also works in our favor that so many companies are going through big changes while at the same time there are fewer analysts and money managers paying attention.

DM: Another way of saying all that is that a good environment for us is when things are all over the place. Now is a pretty good time for that. VII

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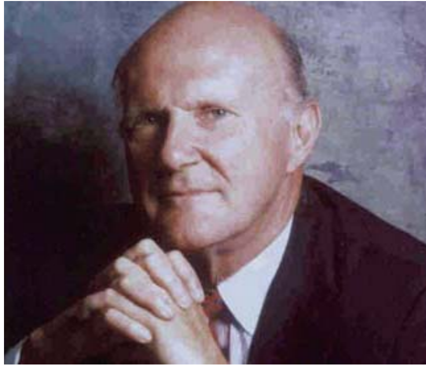
Double Jeopardy

Legendary hedge fund manager Julian Robertson warned us two and a half years ago of the calamity he saw coming from a bursting housing bubble. Unfortunately, his mood hasn't markedly improved.

INVESTOR INSIGHT



Julian Robertson
Tiger Management

Editors' Note: *No investor we have interviewed more pointedly warned against the dangers of a financial crisis than did Tiger Management's Julian Robertson two and a half years ago (VII, November 30, 2006). Non-saving, debt-laden consumers were unprepared to weather the "housing debacle," he said, concluding that, "the consequences of a housing bubble bursting could be enormously serious here. The market's not pricing that in at all." Now serving primarily as a coach and mentor to a thriving stable of some 40 hedge fund managers that he seeded with initial investments and houses at Tiger's Park Avenue offices in New York, the 76-year-old Robertson is still an active and passionate investor – with provocative, clear-minded points of view about the crisis, how it is likely to play out, and what investors can do to prepare.*

Has anything surprised you about how the financial crisis is playing out?

Julian Robertson: I have been shocked at the response to it. This is a crisis brought on by our collective profligacy, which manifested itself in too much spending, too much debt and no savings. The normal way to get out of a situation like that is to spend less, reduce borrowing and save more. I'm wondering why we haven't taken that approach – well, I know why, but I still question the response.

I'm amazed at the amount of money the government is throwing at this thing. You don't even react anymore unless somebody's talking about $1 trillion. I genuinely admire the administration's courage in doing what it's doing, but not the wisdom of it. I look at the TALF [Term Asset-Backed Securities Loan Facility] program, for example, and it's almost a bribe to get people to put on more leverage. When you can borrow money and the maximum you have to pay back is 90% of it, what do you think is going to happen?

When Margaret Thatcher took over in Great Britain at a very tough time in the early 1980s, she told people it was going to be a difficult period, that it would take years to get back on track, but that they would prevail. She gave them hope, but no quick promises. People here want instant gratification and an instant disposition of our financial problems, but it's just not that easy.

Everybody had good intentions in wanting people to have good homes and maybe even better homes than they could afford. Alan Greenspan had good intentions in not allowing the negative sides of the economy to affect people. But all that obviously didn't work. We'd be far better off if we just bit the bullet, paid down our debts and got on with it. We'll be a better people and a better country as a result.

What are the ramifications of the path we're taking so far?

JR: I ask anyone to give me an example of an economy beefed up by huge amounts of quantitative easing that did not inflate tremendously when or if the economy improved. I think what we're doing now will either fail, or it will result in unbelievably high inflation – and tragically, maybe both. That would mean a depression and explosive inflation, which is frightening.

What can investors faced with such bleak prospects do?

JR: There are a lot of things to do. The insurance policy I would buy is called a CMS [Constant Maturity Swap] Rate Cap, which is the equivalent of buying puts on long-term Treasuries. If inflation happens the way it could, long-term Treasuries are just going to explode.

[*Editors' Note*: Tiger trader Pat O'Meara explains that the CMS Rate Caps are options to bet on interest rates rising for 10-year or 30-year Treasuries. He provides a current example, in which one could buy for $50,000 a five-year option, betting that the yield on $10 million worth of 10-year Treasuries rises above 4.2% between now and expiration in 2014. Including the 0.5% cost of the option, the break-even yield level is 4.7%.]

JR: Less than 30 years ago, long-term interest rates got to 20%. I can envision that seeming like a very low interest rate compared to what might occur in the future.

Should you avoid equities under the scenario you envision?

JR: Equities are certainly better than cash. In particular, I'd expect the best things to buy to be natural resources stocks.

Any current examples from your portfolio today?

JR: We own an Indian zinc mining company called Hindustan Zinc [HZ:IN], which is probably selling for 4-5x earnings. Zinc is an important component in a wide variety of alloys, and has recently been selling for below its cash cost of production. You almost know that isn't going to last. Zinc would also seem to me to be a very good inflation hedge.

I love energy stocks. Without making any prognostication on oil prices, we think based just on cash flow that oil stocks are very attractive, and of course will be much more so if oil prices return to anywhere near where they were last summer. Some energy stocks we own are Occidental Petroleum, Talisman Energy, Ultra Petroleum and TriStar Oil & Gas. I really like some of the Canadian oil-sands plays, because there's probably more leverage to the price of oil there than anywhere else.

How about gold?

JR: I've never been particularly comfortable with gold as an investment. Once it's discovered none of it is used up, to the point where they take it out of cadavers' mouths. It's less a supply/demand situation and more a psychological one – better a psychiatrist to invest in gold than me.

Are there any non-natural-resource areas that are interesting?

JR: Two interesting European companies are Intertek Group [ITRK:LN] and Bureau Veritas [BVI:FP]. They're in the testing business, which involves a variety of inspections and certifications of products, materials, processes and machinery. We think these are recession-resistant businesses and they sell for only 11-12x what we consider to be normal earnings.

In the current environment, we also have an affinity for low-cost leaders. We own Ryanair [RYA:LN], which is the lowest-cost airline in the world and is run by a man I know, Michael O'Leary, who would kill for a nickel. The company is operating very well through a terrible time, which tells me it will do even better when times aren't quite as terrible.

A lot of people would say Wal-Mart [WMT] isn't that cheap, but I'd disagree given the quality of the business and the fact that it's right for this time. We're going into a period in which the have-nots are going to fare relatively better than the haves. That's going to be good for Wal-Mart, which caters to the have-nots and the smarter haves.

You're still very involved in identifying and mentoring great money managers. Can you generalize about the ones who turn out to be the most successful?

JR: We actually give a test to help determine all this, but they should be totally honest, very smart, and we think a competitive bent is very helpful.

Your own competitiveness was legendary. Was that a big driver for you?

JR: It was important, yes. I always said that when Tiger was going, that our employees would have taken a 15-20% pay cut if that would have somehow guaranteed us to be #1.

Does that fade over time?

JR: It definitely mellows out, but I still like winning, which is one reason I've done this same thing for a long time. You can get too much competitiveness, though, and then you're competitive with your subordinates and your superiors and you're kind of a horse's ass. That's why we have these tests, to try to measure the degree of all that.

What else motivates you to keep working?

JR: I really enjoy it. I did worry when I shut down the main hedge fund in 2000 that I didn't want my tombstone to say, "He died getting a quote on the yen," as if I had nothing better to do in the middle of night than that. I'm fortunate now that I don't have any direct responsibility, so I can spend the winter in New Zealand and play some golf.

I also get a tremendous amount of gratification from the charitable work we're doing. I was recently in Yosemite attending meetings of the National Park Service, which we support and which does such great work in places that mean so much to people. I have a trip planned to North Carolina, as part of a scholarship program we fund for 120 students at the University of North Carolina and Duke. Those are just wonderful things to be involved in.

What advice would you give to one of your scholarship students who wanted to go into investing?

JR: I'd advise them first to take one of those tests that measures their abilities against their interests. If it turned out investing looked like something they've do well in, they should go to the best investors they can find and try to get a spot. That's by far the best way to learn the business.

People are so critical of hedge funds these days, but that's where I'd look. I haven't quite understood why hedge funds get criticized for losing money last year, even though the average one did 50% better than the market. I think hedge funds are still going to attract the best people.

That brings something else to mind. A baseball player never really gets paid, no matter how many homeruns he hits or what his batting average is, unless he gets to the big leagues. Then he's guaranteed to make a lot of money. But in the hedge fund business you can find a minor league where you can hit for a better average, because that's what you're paid on.

I remember one of our guys taking us into Korea in the early 1990s, and the market was so inefficient that it was a gold mine if you knew what you were doing. One of our Tiger funds today focuses on gold – a league that is inhabited by some of the crazier investors out there – and it just has a phenomenal record. They know more about gold than anyone else in the world and just kill all the rest. My point is that to be successful in this business, you don't have to be better than everybody everywhere, just better than everybody in the league in which you play. It's getting more difficult to find those inefficient areas, but it's not impossible.

Last question: When we come back again to see you in two or three years, what do you think we'll talk about?

JR: You'll probably be asking how I could have been so wrong about inflation. Worse things could happen than that turning out to be the case. VII

Takeover Action

Given the activity last quarter in Wyeth shares, it appears that merger arbitrage remains very much in the investing arsenal of top investors. Why Joel Greenblatt counsels: "Don't try this at home."

In tracking the activity of superstar investors, *SuperInvestor Insight* highlights cases of collective action, stocks in which multiple managers are buying or selling at the same time. Worthy of note is when three or four of the 30 investors tracked appear to be making the same bets.

So it was a surprise when nine SuperInvestors in the first quarter increased their stakes in drug company Wyeth, eight of which were brand new positions. Had they brilliantly timed their investments in advance of Pfizer's announcement on January 26 that it was taking over Wyeth, in a deal valued on that date at $47.92 per share? Possibly. Far more likely, however, is that the managers bought in after the deal announcement, in a traditional merger-arbitrage bet on the deal closing.

Arbitrageurs look to profit from the closing of whatever gap (or "spread") that remains between a target company's share price and the price paid at deal close. Those spreads exist out of concern that the deal might fall through or be delayed – for any number of regulatory, financing or due-diligence reasons. The greater the uncertainty, the wider the spread – and the greater the potential arbitrage profit.

In the Pfizer/Wyeth case, Pfizer has agreed to pay for each Wyeth share $33 in cash and 0.985 of a Pfizer share. Given Pfizer's $15.15 closing share price on January 26, that translated into a price for Wyeth of $47.92. For illustrative purposes, had an investor bought Wyeth shares at their close of $43.39 that day and sold short the number of Pfizer shares he'd receive if the deal happens – erasing exposure to changes in Pfizer's share price in the interim – he would have "locked in" a profit of $4.53 per share upon deal closing. Assuming the deal takes six months to close – the companies have targeted the third quarter to complete the deal – the annualized gain would come out to 22%.

The uncertainty accompanying the financial meltdown has made today's market environment rife with opportunity – and risk – for arbitrage practitioners. John Paulson in his 2008 year-end letter to investors said "spreads in strategic deals widened to the highest rates of return over the past 20 years" last fall, citing a spread in October equating to a 90% annualized return for Anheuser-Busch shares, the target of InBev's $70 per share all-cash offer. He cited gains his funds made on A-B shares as "the largest profit we ever earned on a spread deal in our history."

High potential return, of course, does not come without risk. Deals fell apart regularly last year – strategic and financial alike – from BHP Billiton's attempt to buy Rio Tinto to Apollo's offer for Hunstman. And when things go wrong in merger arbitrage, they can go very wrong – often in an asymmetric way. Huntsman shares traded in the low-$20s for nearly a year after receiving Apollo's $28-per-share offer in June 2007. The deal started to unravel in June 2008, sending Huntsman shares from $20 to $10 in less than two weeks. They closed the year at just above $3.

Though the markets have significantly calmed since the Pfizer deal was originally announced, the spread on Wyeth shares as of May 29 was still nearly 7%, likely reflecting modest concerns over antitrust approval and the fact that Pfizer is relying on bank financing commitments of $22.5 billion to seal the deal. If the merger happens in the third quarter as planned, however, the current spread would still result in a hefty annualized return.

With an uptick in hostile corporate deals expected as acquirers look to take advantage of depressed market values of targets, there will likely be plenty for arbitrageurs to look at in coming months. For those looking to take advantage, consider this advice from legendary investor Joel Greenblatt, offered in his classic book, *You Can Be a Stock Market Genius*: "If you care to spend all day playing the averages, you should be able to earn a reasonable return on your investment. That's because, despite everything that *can* go wrong, most deals close. But there are easier, and safer, ways to make a buck." VII

INVESTMENT SNAPSHOT

Wyeth
(NYSE: WYE)

CLOSING THE GAP

Several superstar investors appear to have made a merger-arbitrage bet on Wyeth in the first quarter, following the January 26 announcement that Pfizer was buying it for the equivalent of $47.92 as of that date. While the spread between Wyeth's share price ($44.86) and the takeover price ($47.96) has narrowed, it remains nearly 7%.

WYE PRICE HISTORY

Inflated Expectations

The unprecedented monetary and fiscal stimulus being directed by government at the economic meltdown has almost certainly helped arrest the past winter's freefall in business activity, market levels and consumer confidence. Less certain, at least in the eyes of many investors, are the second-order effects such stimulus might have on things like interest rates and inflation.

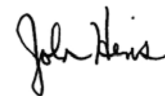
Investor thinking on that front seems to fall into a variety of camps. The less concerned respond that no one should be worrying about inflation when *de*flation from the economic crisis is more of an immediate concern. The more optimistic say things like, "We're hoping the government is able to drain liquidity from the system at the appropriate time to avoid inflationary pressures."

The more concerned, such as Tiger Management's Julian Robertson (*whose interview in this issue starts on p. 18*), feel potential inflation is an extremely serious threat: "I ask anyone to give me an example of an economy beefed up by huge amounts of quantitative easing that did not inflate tremendously when or if the economy improved," he says. More hyperbolic are commentators like Marc Faber, the well-known investor and publisher of the *Gloom Boom & Doom Report*, who argued recently that the U.S. is in danger of runaway inflation like that now seen in Zimbabwe.

Because it's been some 30 years since inflation was a scourge in the U.S., it's worth a brief look at what strongly rising price levels might mean, particularly for equity investors. In a classic article on the subject (*Fortune*, May 5, 1977), Warren Buffett went to great lengths to disabuse investors of the notion that unlike bondholders, shareholders could skate through inflationary times relatively unscathed. The crux of his argument was that, contrary to popular opinion, companies had very little leeway in improving returns on capital in inflationary times. With returns on capital more or less fixed, shareholder claims would be eaten away by inflation in much the same way as bondholders' fixed coupons would be. A brief glance at the less than awe-inspiring chart of the S&P 500 index between 1972 and 1982, when inflation rates in many years hit double digits, provides ample support for that argument.

We'll leave it to others who are far more qualified than us to address the likelihood that inflation will, in fact, rear its ugly head. But if that likelihood turns out to be high, what's an investor to do? Julian Robertson recommends buying into companies that produce consumable natural resources and suggests using options to short long-term Treasury bonds. Many top investors have turned to gold: At the end of this year's first quarter, the only stocks more widely held than the SPDR Gold Trust ETF by investors tracked by *SuperInvestor Insight* were Visa and SLM. Short-sellers, in both equities and bonds, will likely find much to keep them busy.

More preferable, of course, would be if the economy were able to restart and policymakers were adept at managing the nation's finances in a way that didn't ignite inflation. We'd argue the most prudent course is to be prepared for that not to go terribly smoothly. VII


John Heins
Co-Editor-in-Chief

Whitney Tilson
Co-Editor-in-Chief

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