MSN Money Articles

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By Michael Burry 2000/2001

Strategy

My strategy isn't very complex. I try to buy shares of unpopular companies when they look like road kill, and sell them when they've been polished up a bit. Management of my portfolio as a whole is just as important to me as stock picking, and if I can do both well, I know I'll be successful.

Weapon of choice: research

My weapon of choice as a stock picker is research; it's critical for me to understand a company's value before laying down a dime. I really had no choice in this matter, for when I first happened upon the writings of Benjamin Graham, I felt as if I was born to play the role of value investor. All my stock picking is 100% based on the concept of a margin of safety, as introduced to the world in the book "Security Analysis," which Graham co-authored with David Dodd. By now I have my own version of their techniques, but the net is that I want to protect my downside to prevent permanent loss of capital. Specific, known catalysts are not necessary. Sheer, outrageous value is enough.

I care little about the level of the general market and put few restrictions on potential investments. They can be large-cap stocks, small cap, mid cap, micro cap, tech or non-tech. It doesn't matter. If I can find value in it, it becomes a candidate for the portfolio. It strikes me as ridiculous to put limits on my possibilities. I have found, however, that in general the market delights in throwing babies out with the bathwater. So I find out-of-favor industries a particularly fertile ground for best-of-breed shares at steep discounts. MSN MoneyCentral's Stock Screener is a great tool for uncovering such bargains.

How do I determine the discount? I usually focus on free cash flow and enterprise value (market capitalization less cash plus debt). I will screen through large numbers of companies by looking at the enterprise value/EBITDA ratio, though the ratio I am willing to accept tends to vary with the industry and its position in the economic cycle. If a stock passes this loose screen, I'll then look harder to determine a more specific price and value for the company. When I do this I take into account off-balance sheet items and true free cash flow. I tend to ignore price-earnings ratios. Return on equity is deceptive and dangerous. I prefer minimal debt, and am careful to adjust book value to a realistic number.

I also invest in rare birds -- asset plays and, to a lesser extent, arbitrage opportunities and companies selling at less than two-thirds of net value (net working capital less liabilities). I'll happily mix in the types of companies favored by Warren Buffett -- those with a sustainable competitive advantage, as demonstrated by longstanding and stable high returns on invested capital -- if they become available at good prices. These can include technology companies, if I can understand them. But again, all of these sorts of investments are rare birds. When found, they are deserving of longer holding periods.

Beyond stock picking

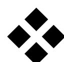
Successful portfolio management transcends stock picking and requires the answer to several essential questions: What is the optimum number of stocks to hold? When to buy? When to sell? Should one pay attention to diversification among industries and cyclicals vs. non-cyclicals? How much should one let tax implications affect investment decision-making? Is low turnover a goal? In large part this is a skill and personality issue, so there is no need to make excuses if one's choice differs from the general view of what is proper.

I like to hold 12 to 18 stocks diversified among various depressed industries, and tend to be fully invested. This number seems to provide enough room for my best ideas while smoothing out volatility, not that I feel volatility in any way is related to risk. But you see, I have this heartburn problem and don't need the extra stress.

Tax implications are not a primary concern of mine. I know my portfolio turnover will generally exceed 50% annually, and way back at 20% the long-term tax benefits of low-turnover pretty much disappear. Whether I'm at 50% or 100% or 200% matters little. So I am not afraid to sell when a stock has a quick 40% to 50% a pop.

As for when to buy, I mix some barebones technical analysis into my strategy -- a tool held over from my days as a commodities trader. Nothing fancy. But I prefer to buy within 10% to 15% of a 52-week low that has shown itself to offer some price support. That's the contrarian part of me. And if a stock -- other than the rare birds discussed above -- breaks to a new low, in most cases I cut the loss. That's the practical part. I balance the fact that I am fundamentally turning my back on potentially greater value with the fact that since implementing this rule I haven't had a single misfortune blow up my entire portfolio.

I do not view fundamental analysis as infallible. Rather, I see it as a way of putting the odds on my side. I am a firm believer that it is a dog eat dog world out there. And while I do not acknowledge market efficiency, I do not believe the market is perfectly inefficient either. Insiders leak information. Analysts distribute illegal tidbits to a select few. And the stock price can sometimes reflect the latest information before I, as a fundamental analyst, catch on. I might even make an error. Hey, I admit it. But I don't let it kill my returns. I'm just not that stubborn.
In the end, investing is neither science nor art -- it is a scientific art. Over time, the road of empiric discovery toward interesting stock ideas will lead to rewards and profits that go beyond mere money. I hope some of you will find resonance with my work -- and maybe make a few bucks from it.



Journal: August 1, 2000
• Buy 800 shares of Senior Housing Properties (SNH, news, msgs) at the market.

Why Senior Housing Properties looks so sexy
OK, time to get this thing started. What will a Value Doc portfolio look like? The answer won't come all at once. Depending on the complexity of the pick, I'll share one to three of them with each journal entry. I do expect to be fully invested in 15 or so stocks within two weeks.

My first pick is a bit complex. **Senior Housing Properties** (SNH, news, msgs), a real estate investment trust, or REIT, owns and leases four types of facilities: senior apartments, congregate communities, assisted living centers and nursing homes. Senior apartments and congregate communities tend to find private revenue streams, while assisted-living centers and nursing homes tend toward government payers, with the associated intense regulation.

As it happens, running intensely regulated businesses is tough. Within the last year, two major lessees accounting for 48% of Senior Housing's revenues filed for bankruptcy. With this news coming on the heels of Senior Housing's spin-off from troubled parent **HRPT Properties Trust** (HRP, news, msgs), it is not hard to understand why the stock bounces along its yearly lows.

But not all is bad. From here the shares offers potential capital appreciation paired to a fat dividend that weighs in at $1.20 per share.

First, the bankruptcies are not as bad as they seem. Senior Housing has retained most of the properties for its own operation, gained access to $24 million in restricted cash, and will gain three nursing home for its troubles. The key here is that the reason for the bankruptcies was not that the operations lacked cash flow, but rather that the now-bankrupt lessees had acquired crushing debt as they expanded their operations.

In fact, if we assume that rents approximate mortgage payments – which is not true but is ultra-conservative, then during the first quarter of 2000, the bankrupt operators generated $80 million in accessible cash flow before interest expense, depreciation and amortization. This is significantly more than the rents paid to Senior Housing. So while the general perception is that Senior Housing just took over money-losing operations, this is not so. It is true that while the bankruptcy proceedings go through approvals, Senior Housing will be lacking it usual level of cash flow. But this is temporary. Once resolved, cash flows will bounce back, possibly to new highs. The bankruptcy agreements provided for operating cash flows to replace rents starting July 1, 2000.

While we wait for the better operating results, the dividend appears covered. Marriott is a rock-solid lessee that derives its 94% of its revenue from private-pay sources and that accounts for over $31 million in annual rent, which approximates the annual dividend. The leases are good through 2013, and are of the favored triple net type. Income from the Brookdale leases -- 100% private pay and similarly rock solid -- provided another $11.2 million in annual rents. A few other properties kick in an additional several million.

Benefits of the Brookdale sale
Recent events provide more positive signs. Senior Housing agreed to sell its Brookdale properties for $123 million. While on the surface the company is selling its best properties and letting its best lessee off the hook, investors should realize the benefits.

One, the company has said it will use the proceeds to pay off debt. This will bring Senior Housing's total debt to under $60 million. Because of this, Senior Housing's cash funds from operations will dip only $1.5 million to $2 million, by my estimation, thanks to interest expense saved.

Two, Senior Housing stock lives under a common conflict of interest problem that afflicts REIT shares. Its management gets paid according to a percentage of assets under management. It is not generally in management's personal interests to sell assets and pay off debt. Rather, they may be incentivized to take on debt and acquire assets. With property assets more highly valued in private markets than public ones, that Senior Housing is selling assets is a very good thing, and tells us that management is quite possibly inclined to act according to shareholder interests.

Three, the Brookdale properties cost Senior Housing $101 million, and are being sold for $123 million. Yet the assumption in the public marketplace is that Senior Housing's properties are worth less than what was paid for them. After all, Senior Housing's costs for the properties, net of debt, stands at just over $500 million while the stock market capitalization of Senior Housing sits at $220 million. The Brookdale sale seems to fly in the face of this logic, as does a sale earlier this year of low-quality properties at cost. The Marriott properties approximate Brookdale in quality and cost over $325 million alone.

Combining the last two points, if management proves as shareholder-friendly as the most recent transaction, then the disparity in value between the stock price and the core asset value may in fact be realized, providing capital appreciation of over 100% from recent prices. In the meantime, there is a solid dividend yield of over 14%, an expected return of cash flows from the nursing home operations, another $24 million in cash becoming unrestricted, a massive unburdening of debt, and a very limited downside. When will the catalyst come? I'm not sure. But there are plenty of possibilities for the form it will take, and with that dividend, plenty of time to wait for it.

Watch reimbursements
A risk, as always, is reduced reimbursements. While the government is the big culprit here, and Marriott does not rely on the government, the trend in reimbursements is something to watch. A more immediate risk is the share overhang from former parent HRPT Properties, which has signaled -- no less publicly than in Barron's -- that it will be looking to dispose of its 49.3% stake in Senior Housing. Another pseudo-risk factor is the lack of significant insider ownership; the insiders are apparently preferring to hold HRPT stock.

All told, I still see a margin of safety. While the share performance over the next six months may be in doubt -- and we just missed the dividend date -- the risk for permanent loss of capital for longer-term holders appears extremely low. It's an especially good buy for tax-sheltered accounts. I'm buying 800 shares.

Journal: August 2, 2000
• Buy 150 shares of Paccar (PCAR, news, msgs) at the market.

Paccar is built for profit
Here's where it starts to become obvious that, despite the contest atmosphere of Strategy Lab, I do not regard my investments here or elsewhere as a contest. Over the long run, I aim to beat the S&P 500, but I will not take extraordinary risks to do it. On a risk-adjusted basis, I'll obtain the best returns possible. Whom or what I can beat over the next six months is less important to me than providing some insight into how I go about accomplishing my primary long-term goal.

With that said, I present a company that I've bought lower, but still feel is a value. **Paccar** (PCAR, news, msgs) is the world's third-largest maker of heavy trucks such as Peterbilt and Kenworth. We're possibly headed into another recession, and if Paccar is anything, it is cyclical. So what on this green earth am I doing buying the stock now? Simple. There is a huge misunderstanding of the business and its

valuation. And where there is misunderstanding, there is often value.

First, consider that the stock is no slug. A member of the S&P 500 Index ($INX), the stock has delivered a total return of about 140% over the last 5 years. And over the last 14 years, the stock has delivered a 384% gain, adjusted for dividends and splits. So it is a growth cyclical. One does not have to try to time the stock to reap benefits.

In fact, despite the high fixed costs endemic to its industry, Paccar has been profitable for sixty years running. With 40% of its sales coming from overseas, there is some geographic diversification. And there is a small, high-margin finance operation that accounts for about 10% of operating income and provides for a huge amount of the misunderstanding. The meat of the business is truck production.

The competitive advantage for Paccar is that the truck production is not vertically integrated. Paccar largely designs the trucks, and then assembles them from vendor-supplied parts. As Western Digital found out, this model does not work too well in an industry of rapid technological advancement. But Paccar's industry is about as stable as can be with respect to the basic technology. So Paccar becomes a more nimble player with an enviable string of decades with positive cash flow. **Navistar** (NAV, news, msgs), the more vertically integrated #2 truck maker, struggles mightily with its cash flow.

Let's look at debt

Over the last 14 years, encompassing two major downturns and one minor downturn, Paccar has averaged a 16.6% return on equity. Earnings per share have grown at a 13.2% annualized clip during that time, despite a dividend payout ratio generally ranging from 35% to 70%. Historically, it appears debt is generally kept at its current range of about 50% to 70% of equity.

But the debt is where a big part of the misunderstanding occurs. In fact, companies with large finance companies inside them tend to be misunderstood the same way. Let's examine the issue. Yahoo!'s quote provider tells us the debt/equity ratio is about 1.8. Media General tells us it is about 0.7. Will the real debt/equity ratio please stand up? With a cyclical, it matters.

So we open up the latest earnings release and find that Paccar neatly separates the balance sheet into truck operations and finance operations. It turns out that the truck operations really have only $203 million in long-term debt.

The finance operation is where the billions in debt lay. But should such debt be included when evaluating the margin of safety? After all, liabilities are a part of a finance company's ongoing operations. The appropriate ratio for a finance operation is the equity/asset ratio, not the debt/equity ratio. With $953 million in finance operations equity, the finance equity/asset ratio is 19.5%. Higher is safer. Savings and loans often live in the 5% range, and commercial banks live in the 7-8% range. As far as Paccar's finance operations go, they are pretty darn conservatively leveraged. And they still attain operating margins over 20%. I do not include the finance operation liabilities in my estimation of Paccar's current enterprise value.

Why can I do this? Think of it another way -- the interest paid on its debt (which funds its loans) is a cost of sales for a finance company. And yet another -- the operating margins of over 20% -- indicate that the company is being paid at least 20% more to lend money than it costs to borrow the money.

The leading data services therefore have it right, but wrong. Just a good example of how commonly available data can be very superficial and misleading as to underlying value.�Beware to those who rely on screens for stocks!

There is also $930 million in cash and equivalents, net of the finance operations cash. The cash therefore offsets the $203 million in truck company debt, leaving net cash and equivalents left over of $727 million. Subtract that amount from the market cap of $3.12 billion to give essentially a $2.4 billion enterprise value. So not only is there a whole lot less debt in this company than the major data services would have us believe, but the true price of the company -- the enterprise value -- is less than the advertised market capitalization.

Examining cash flow
Now come the ratios. Operating cash flow last year was $840 million. What is the free cash flow? Well, you need to subtract the maintenance capital expenditures. The company does not break this down. One can assume, however, that, of the annual property and capital equipment expenditures, a portion is going to maintenance and a portion is going to growth. Luckily, there is already a ballpark number for the amount going to maintenance -- it's called depreciation. For Paccar depreciation ran about $140 million in 1999. So in 1999, there was approximately $700 million in free cash flow.

Can it be that Paccar is going for less than 4 times free cash flow? Well, it is a cyclical, and Paccar is headed into a down cycle. So realize this is 4 times peak free cash flow.

In past downturns, cash flow has fallen off to varying degrees. In 1996, a minor cyclical turn, cash flow fell off only about 15%. In the steep downturn of 1990-92, cash flow fell a sharp 70% from peak to trough. Of course, it has rebounded, now up some 700% from that trough. The stock stumbled about 30% during the minor turn, and about 45% as it anticipated the 1990-91 difficulties.

The stock is some 35% off its highs and rumbling along a nine-month base. Historically, that seems like a good spot. The stock tends to bottom early in anticipation and rally strongly during a trough. The stock actually bottomed in 1990 and rallied 135% from 1990 to 1992, peaking at 474% in 1998. Now down significantly from there and with signs of a slowdown in full bloom, the stock pays a 7% dividend on the purchase price. Management policy is to pay out half of earnings, and makes up any deficiencies during the first quarter of the year. The stock is sitting above the price support it has held for about 2 years.

What makes the stock come back so strongly after downturns? Market share gains and solid strategy. In fact, during the current downturn, it has already gained 200 basis points of market share. And its new medium duty truck was ranked number one in customer satisfaction by J.D. Power -- this in a brand new, potentially huge category for Paccar.

And no, there is no catalyst that I foresee. Funny thing about catalysts -- the most meaningful ones are hardly ever expected. I'm buying 150 shares.

Journal: August 3, 2000
• Buy 200 shares of Caterpillar (CAT, news, msgs) at the open.

• Buy 400 shares of Healtheon/WebMD (HLTH, news, msgs) at the open.

This cool Cat is one hot stock
Today, let's go with two ideas, on the surface terribly divergent in character. The first is **Caterpillar** (CAT, news, msgs), which is bouncing along lows. Whenever the stock of a company this significant starts to reel, I take notice. Everyone knows that domestic construction is slowing down. I don't care.

Why? Let me explain. Let's pose that a hypothetical company will grow 15% for 10 years and 5% for the remaining life of the company. If the cost of capital for the company in the long term is higher than 5%, then the life of the company is finite and a present "intrinsic value" of the company may be approximated. But let's say the cost of capital averages 9% a year. Starting with trailing one-year earnings of $275, the sum present value of earnings over 10 years will be $3,731. If the cost of capital during the remainder of the company's life stays at 9%, then the present value of the rest of the company's earnings from 10 years until its demise is $12,324.

What should strike the intelligent investor is that 76.8% of the true intrinsic value of the company today is in the company's earnings **after** 10 years from now. To look at it another way, just 5.7% of the company's intrinsic value is represented by its earnings over the next three years. This of course implies that the company must continue to operate for a very long time, facing many obstacles as its industry matures.

Caterpillar can do this. Let's take a cue from the latest conference call. When people in the know think of quality electric power for the Internet, they think of Caterpillar. Huh? Yes, Caterpillar

makes electricity generators that generate so-called quality power. There are lots of uses for power that's uninterruptible, continuous, and free of noise, but some of the largest and fastest-growing are in telecommunications and the Internet.

Caterpillar is the No. 1 provider of this sort of power, and the market is growing explosively. In fact, Caterpillar's quality power generator sales had been growing at 20% compounded over the last five years, but are up a whopping 75% in the first six months of 2000 alone. Caterpillar expects revenue from this aspect of its business to triple to $6 billion, or 20% of sales, within 4 1/2 years. "This is our kind of game," the company says.

General sentiment around Caterpillar is heavily influenced by the status of the domestic construction industry. But while domestic homebuilding is indeed stumbling, we're talking about less than 10% of Caterpillar's sales. Caterpillar is quite diverse, and many product lines and geographic areas are not peaking at all. In particular, the outlook for oil, gas, and mining products is bright. In fact, Caterpillar's business peaked in late 1997/early 1998 and now appears to be on a road to recovery. The market has not digested this yet.

The balance sheet is also stronger than it appears. Caterpillar is another industrial cyclical with an internal finance company. I don't count the financial services debt, as I explained in my Aug. 1 journal entry. Hence, long-term debt dives from $11 billion to $3 billion, and the long-term debt/equity dives from 200% to just 55%.

The enterprise therefore goes for a rough 11 times free cash flow. Cash return on capital adjusted for the impact of the financial operations reaches above 15% over its past cycles, with return on equity averaging 27% over the last 10 years. Also, management is by nature conservative. Keep that in mind when evaluating its comments on the potential of the power generation business.

The main risk is that, in the short run, investors may take this Cat out back and shoot it if interest rates continue up. I'm buying 200 shares here along the lows.

Healtheon/WebMD

Remember when I said that my contrarian side leads me to the technology trough every once in a while? **Healtheon/WebMD** (HLTH, news, msgs) has no earnings, yet there is a margin of safety within my framework. The premier player within the e-health care space, the stock has been bashed due to impatience. So here sits a best-of-breed company bouncing along yearly lows, some 85% off its highs.

Healtheon/WebMD has the unenviable task of getting techno-phobic physicians to change their ways. Such things do not happen overnight. The fact remains that some $250 billion in administrative waste resides within the U.S. health care system, and patients and taxpayers suffer for it. Healtheon/WebMD is by far best positioned to provide a solution.

Recent acquisitions either completed or pending include Quintiles' Envoy EDI unit, CareInsite, OnHealth, MedE America, MedCast, Kinetra, and Medical Manager.

Assuming all these go through, there will be 170 million more shares outstanding than at the end of last quarter, bringing the total to 345 million. Medical Manager's cash will offset the $400 million paid for Envoy, leaving Healtheon/WebMD with more than $1.1 billion in cash and no debt. Quite a chunk, especially considering that many of the company's competitors are facing bankruptcy.

Challenges -- less than 40% of physicians use the Internet at all beyond e-mail -- seem outweighed by bright signs. WebMD Practice has 100,000 physician subscribers, up 47% sequentially. For reference, there are only roughly 500,000 practicing physicians in the United States. The company now offers online real-time information on 40 health plans covering about 20% of the U.S. population. The sequential growth rate in WebMD Practice use runs about 41%. Consumer use is rolling ahead at a 70% sequential clip. The company is not all Internet, either. The breakdown: 44% back-end transactions, growing 41% sequentially; 30% advertising, also seeing growth; 10% subscriptions, growing at 47% sequentially; and 16% products and services. All

told revenue was up 68% sequentially. This will decelerate, but it does not take a mathematical genius to figure out that even single digits can be significant when we're talking about sequential growth.

The acquisitions are putting other strategic revenue streams into play. OnHealth is the leading e-health destination. CareInsite is the company's only significant pure e-competitor and has the AOL in. Medical Manager will place Healtheon/WebMD by default into physicians' offices. A potential juggernaut in the making, but don't expect Healtheon/WebMD to tout this -- several acquisitions still need to past anti-trust muster.

Based on the company's current burn rate, it has about 4 1/2 years to straighten things out. There is no proven ability to turn a profit, and I am no fan of co-CEOs, either. Moreover, one must always be wary of the integration phase after a series of acquisitions -- the seller always knows the business better than the buyer. Recent insider buying by venture capital gurus John Doerr and Jim Clark is also not heartening, as it appears to be simply for show.

Still, the company appears to have the human and financial capital to build a successful organization in an industry there for the taking. With enough cash for 4 to 5 years, the post-acquisitions company will start with $900 million in annual revenues growing at a weighted compound average rate over 200%. The business economics are not Amazonian, either; margins will improve with higher sales. The price for this ticket? About $4 billion all told, or about half what the ticket cost to put together. I'm buying 400 shares, with a mental sell stop if it breaks to new lows.

Journal: August 4, 2000
• Buy 800 shares of Clayton Homes (CMH, news, msgs) at the open.

CMH: Best of an unpopular breed
Clayton Homes, a major player within the manufactured housing industry, is an excellent candidate for best-of-breed investing in an out-of-favor industry. But before investing in Clayton, one should make an effort to understand this fairly complex industry. Let's take a look how Clayton makes money.

Specifically, money can be made -- or lost -- at several levels of operation. A company can make the homes (producer), sell the homes (retail store), lend money to home buyers (finance company), and/or rent out the land on which the houses ultimately sit (landlord). Clayton is vertically integrated and does all these things.

When Clayton sells a home wholesale to a retailer; the sale is booked as manufacturing revenue. Clayton may or may not also own the retailer. The retailer then sells the home to a couple for a retail price; the sale is booked as retail revenue if Clayton owns the retailer. In Clayton's case, about half of its homes are sold through wholly owned retailers.

The couple may borrow a large portion of the purchase price from Clayton's finance arm. If so, that retail revenue is booked as equivalent to the down payment plus the present value of all future cash flows to Clayton resulting from loan repayments. The firm can be either aggressive (aiming for high current revenues) or conservative (minimizing current revenues) in booking this revenue, also known as the gain-on-sale. Since inherently this gain-on-sale method causes cash flow to lag far behind income, a conservative approach would be prudent.

Now that Clayton has loaned the money to the couple, the firm can sit on it and receive the steady stream of interest payments. Alternatively, Clayton can bundle, or securitize, the loans and re-sell them through an investment banker as mortgage-backed securities. Because the diversified security is less risky than a single loan, Clayton can realize a profit on the sale of the mortgage-backed security, especially if the firm was conservative in estimating the loan's value in the first place. Moreover, Clayton's finance arm can act as the servicing agent for the security and earn high-margin service fees.

Finally, through Clayton's ownership of land and some 76 communities, the company can sell or rent land to the couple for the placement of their new manufactured home.

During Clayton's fiscal 2000 third quarter, 25% of net income came from manufacturing, 20% came from retail, and 8% came from rental/community income. The key to the valuation, however, is that Clayton has a large finance and insurance operation – coming in at 52% of operating income in the most recent quarter. All told, 44% of operating income is recurring -- community rents, insurance, and loan payments. Clayton has over 140,000 people making monthly loan payments.

Clean record in troubled industry
Obviously, there is the potential for abuse. Many other companies in the manufactured housing industry, such as **Oakwood Homes** (OH, news, msgs) and **Champion Enterprises** (CHB, news, msgs), have indeed exploited that potential. One way was to originate poor-quality loans in the first place. This "lend to anyone" approach goosed retail sales in the short-run, but led to uncollectible receivables. Worse, in recent years, companies would borrow money themselves to pay up to 20 times earnings for retail operations, only to loan money much too freely to customers. They would then aggressively book gains-on-sale only to have to take charges later as these loans proved bad. This simply cannot be done in a cyclical industry. Indeed, it was the aggressive over-expansion by many players that caused the recent inventory glut and cyclical downturn.

Clayton never participated in these excesses. In fact, despite the sub-prime category into which the industry's loans fall, loans originated by Clayton have a delinquency rate of only 1.65%. And while other manufacturers struggle, Clayton still runs every single one of its plants profitably. The last quarterly report made 65 of 66 quarters as a public company that Clayton has recorded record results. Now, amidst bankruptcies and general industry malaise, Clayton can take its efficient, Internet-enabled operations and strong balance sheet and go shopping.

Shopping? Clayton has expertise in "scrubbing" manufactured home-loan portfolios. The company has shown itself to be not only a terribly efficient manufacturer (building plants for 25% of the price others pay to buy, and achieving profitability within two months), but also a keen underwriter and evaluator of risk. For instance, in a recent transaction, Clayton purchased $95 million in loans. It will scrub these loans, stratifying them for risk, shaking them down for near-term repossessions, and re-issuing them at a profit within a year. Clayton will insure the loans, as well as service the loans, for recurring income.

Conservative company
Clayton strives to be conservative in its revenue recognition and acquisition strategy. It imposes the barest of office spaces on its executives, and provides all its employees direct and indirect motivation to improve company-wide efficiency and performance. For instance, it matches 401(k) contributions only with company stock, and plants are rewarded on individual profitability measures rather than volume of production.

Over the last two years, the company has used about 75% of its cash flow to buy back stock. And now, as management says we are at the very bottom of an industry downturn, Clayton stands as one of the best-positioned players, with a pristine goodwill-free balance sheet and the best management in the industry. Others are still stuck in the mud of their own excesses. As it happens, the industry is self-cleaning -- Clayton simply gains share during downturns.

The shares are at risk for a near-term catharsis with the potential bankruptcy of Oakwood Homes. Nevertheless, with Clayton's shares trading at less than 8 times earnings despite an unleveraged and consistent return on equity greater than 15%, I'm buying 800 shares.

Journal: August 7, 2000
• Buy 350 shares of Carnival (CCL, news, msgs) at the market.

You've got more time than you think
Before I get to today's pick, let me take a moment to respond to the recent suggestion that as a 29-year-old, I simply possess long-term investment horizons. Hmmm. Living in Silicon Valley proper, I could write volumes in response. Suffice it to say that the twentysomethings I meet are not often interested in my 10-to-20-year analysis horizons. Although you may trade frequently, the wind should be at your back. If all else fails, a long-term hold should pull you through. And the only consistent, prevailing wind in the investment

world is that of the present value of future cash flows.

As a practical matter, professional investors are absolutely handcuffed by short-term quarterly expectations. That's why I don't run a mutual fund -- I need control over what sort of investor becomes a client. Of course, financial planners often impose the same quarterly bugaboo on their private money managers. I stay away from those as well. Focusing on quarterly targets is not a method for removing undue risk. On the contrary, it throws the portfolio manager in with the cattle call that is modern investment marketing -- even though increasing firm assets is of little direct benefit to an individual client -- and by default places the portfolio manager's operations in the "risk equals reward" paradigm. The competitive advantage therefore rests with those investors who can go where inefficiency reigns and risk is uncoupled from reward -- beyond the quarterly and/or yearly performance mandate.

Health care will continue to improve, and many people should live a lot longer than they or their financial planners think. As a result, it hardly seems imprudent for people older than me to consider the longer, safer road to investment success. Twentysomethings and thirtysomethings have no unique claim on this path, and often ignore it anyway. It is a complex subject, but without issuing too broad a generalization, there is often time to accept longer-term rewards regardless of age.

Cruising with Carnival
Now let's get back to picking a few good stocks. Given the space left, I'll go with one -- **Carnival** (CCL, news, msgs). As the No. 1 cruise operator in the world, Carnival Corp. has five cruise lines – Carnival, Holland America, Cunard, Seabourn and Windstar -- spanning 36 wholly-owned ships with capacity for more than 45,000 passengers. Carnival also markets sightseeing tours and through subsidiary Holland America, it operates 14 hotels, 280 motor coaches, 13 private domed rail cars, and two luxury "dayboats."

Carnival also owns 26% of Airtours, which operates more than 1,000 retail travel shops, 46 resorts, 42 aircraft and four cruise ships. Carnival and Airtours co-own a majority interest in Italian cruise operator Costa Crociere, operator of six Mediterranean luxury cruise ships with capacity for 7,103 passengers.

During the 1990s, the world was Carnival's oyster. Return on assets marched steadily upward from 8.4% to 13.3%, and return on equity was similarly stable, ranging between 20.1% and 22.5% over the 10-year period. And this is not leveraged -- debt as a percentage of capital fell from 51% to under 13% over the same period. This, of course, implies that return on invested capital steadily rose, and indeed it did, from 9.8% to a bit over 15%.

Recently, however, fuel costs skyrocketed and interest rates rose just as the supply of ships caught up with softening demand, resulting in pricing pressure. Return on equity slipped under 19%, and the stock fell 60% off its highs and now touches the bottom it hit during the October, 1998 currency crisis. After the initial hit, it was hit some more with news of a soft second half of 2000 amid several cruise cancellations.

Carnival still best of breed
The basic demographics still favor the industry -- affluent baby boomers will live longer and become a more-significant part of the passenger mix. And Carnival remains the best of its breed, with the highest margins and best management. Moreover, it has historically been difficult to predict the demand fluctuations in the cruise industry. Soft and strong periods alternate without a lot of reason at times. There are reasons now for softer demand and the pricing difficulties, but it is just as possible that with the U.S. economy still fundamentally strong, demand will fluctuate back to the strong side sooner than most think.

In the meantime, here's a stock trading at just 11 times earnings despite a long record of 20% growth. With the company maturing and growth slowing a bit, momentum players have abandoned the stock completely, and few are willing to be patient for the hiccups to stop. The recovery could take the stock up three-fold in the next three to five years. The company is currently a little over 60% through a $1 billion stock buyback it announced last February. In the

process, about 10% of the stock has been retired. The company has also been working to broaden its product reach into the baby boomer segment. A recent alliance with Fairfield, a large timeshare operator, is the most tangible evidence of this to date, but other distribution channel initiatives are forthcoming.

The downside risk is low, as simply replacing the ships and other critical operating assets of Carnival would cost more than the current market capitalization, which prices the brand equity as a negative number. And for those investors wanting to stick it to the IRS, here's a chance to do it. While headquartered in Miami, Carnival is a Panama-chartered corporation and does not pay U.S. income taxes -- the overall tax rate is less than 1%. Ironically, the biggest real threat is this thumb in the eye of the IRS. Will the IRS find a way to tax Carnival? It is an open question, but one that Carnival feels is answered in its favor.

Perceptions of the company and the industry are profoundly negative on Wall Street. At an enterprise value less than 11 times EBITDA and with the shares trading at replacement value, I'm buying 350 shares.

Journal: August 8, 2000
• Buy 1,000 shares of Huttig Building Products (HBP, news, msgs) at the market.

Off to a slow start
Relative to the indices, it appears that I've gotten off to quite a slow start in this Strategy Lab session. A minor reason might be that I, as with all Strategy Lab participants, was able to execute my first trade on Aug. 1, but the indices' tally started on July 28th. The market did rally a bit during that time. It's tough to beat the S&P, but especially so when there's a handicap.

Even accounting for the handicap, however, I am still lagging the S&P. This is largely because, while my general theory involves being fully invested, I've been adding only a stock or two per day as the markets rally. Why did I not just throw a batch of stocks out there all at once? Because my view of the purpose of Strategy Lab is to give you insight into how I operate. As it is, I'm editing my 2,500+ word analyses down to 1,000 words to fit in this medium. To shorten them much more would give short shrift to the thrust of Strategy Lab.

Another factor to consider is that I write here about stocks that I personally would buy now. I have plenty of stocks in my portfolios that are extended 40% or more. Those are stocks I would not necessarily buy for the first time now. So they do not get into my Strategy Lab journal. Within a six-month time frame, start-up costs and untimely decisions seem magnified in importance. Nevertheless, I hope you're getting what you came for.

Building a portfolio with Huttig
Today, I'm buying an ugly stock in an unglamorous business. Surprise, right? **Huttig Building Products** (HBP, news, msgs), spun off from **Crane** (CR, news, msgs) last year, is a leading distributor of building products such as doors, windows and trim. Revenues topping $1.2 billion are accompanied by razor-thin margins that contribute to misunderstanding and to the sub-$100 million market capitalization. Actually, including debt, the enterprise value attached to Huttig is about $218 million.

I first obtained this stock during the spinoff, as I was a Crane shareholder. I soon rid myself of it. From the 10K and the proxy, I could not find much to love. Then I read the annual report, made available within the last few months. A call to the company confirmed and enhanced the discovery, and now I'm a fan. Let's look at why.

Synergistic savings
At the time of the spinoff, Huttig acquired Rugby USA and increased revenues over 60% in one swoop. Rugby USA had been owned by the Rugby Group, a British maker of cement and lime. The U.S. business has been an inefficient operator in much the same industry as Huttig, the industry's most efficient operator. So efficient that in a thin margin, cyclical industry like distributing building products, Huttig has been profitable since the Civil War.

Huttig confirms that they are ahead of plan to save $15 million through synergies with Rugby. Taking into account these synergistic savings, Rugby's $15 million in EBITDA (earnings before

interest, taxes, depreciation, and amortization), and additional volume discounts, Huttig should realize at least $30 million in additional EBITDA as a result of the acquisition. Moreover, Huttig expects to whip Rugby's substantial but inefficient operations into Huttig-like shape. By doing so, Huttig should squeeze another one-time gain of $20 million out of working capital. This $20 million can be subtracted from the purchase price. Adjusted, Huttig acquired Rugby and $30 million in additional EBITDA for only $40 million. Smart management.

Going forward, Huttig will have tremendous free cash flow. Free cash flow averaged $21 million per year for the three years before the acquisition of Rugby. Now, EBITDA jumps to at least $60 million, and free cash flow jumps to at least $35 million. Plus, in the short term, the $20 million or so that comes out of Rugby's working capital. As a result of this, during calendar 2000 Huttig is well on track to bring its $122 million in debt down to $82 million. Reasons? Reduced interest expense and expanded ability to pursue acquisitions in this fragmented industry -- an industry where Huttig as the leader only has an 8% share. So what we are looking at is an enterprise trading at just 3.1 times EBITDA, and only about 5.1 times free cash flow. Keep that in mind when you think of the 130 years of profitability Huttig has achieved.

Despite the stated intent to acquire more firms, we do not have to worry about a willy-nilly acquisition policy. As the Rugby acquisition suggests, Huttig's executives are shrewd and aligned with shareholder interests. In fact, while I have a few problems with EVA -- Economic Value-Added -- theory, it is a useful and shareholder-friendly tool for evaluating executive decisions. Huttig is a pioneer in its industry as far as using this theory to evaluate and reward executives for their choices. Huttig is also a fan of GE's "Six Sigma" quality-improvement program. These executives appear to be committed to doing right by shareholders. That's a rare and valuable find today.

Odds and ends

There are some other odds and ends that make Huttig interesting. Seth Klarman, known for his intellectual and strict value discipline, has accumulated a large chunk of the float. Consider that portion of the float locked up. Also, recently, a large distributor of wholesale doors left the business. Huttig is expanding to meet the demand. Because of this, sales may rise over the next year or two even if, as seems probable, the homebuilding market turns south.

The big price risk near-term is that the Rugby Group -- the company that sold Rugby USA to Huttig -- now holds some 32% of Huttig's shares. This firm may be a price-insensitive seller in the open market, and has the ability to sell 20% of its position without restriction. This is a price risk and not a business risk. As such, I am not terribly worried about it. Neither are the insiders.

Huttig should be attractive to acquirers. A firm or group of investors with the means and the interest would find Huttig a no-brainer, especially once the savings and cash flow become apparent over the next few quarterly reports. With a shareholder advocate as chairman, it is unlikely that a takeover would be unfriendly to shareholders. Recent transactions in the industry suggest a private market value at least $10/share. With the shares trading at less than $5, I'm happy to buy 1,000 shares.

Journal: August 9, 2000

- **Buy 200 shares of Axent Technologies (AXNT, news, msgs) at the market.**

My 'buy' rules

With the market rallying since just prior to the start of the Strategy Lab, I must admit that many of the stocks I wanted to write about have already appreciated some. This is problematic because even if I like a stock fundamentally, I am rarely willing to buy more than 15% above technical support.

I also generally use broken support as an exit point. "Sell on new lows" might be another way to put it. If I buy a stock 50% above support, then I must watch a gargantuan loss develop before I eat it. At 15%, I'm looking at only a 13% loss before support is broken. Combining these guidelines allows me to put the odds a bit more on my side. I look at it as an extra kick to help out my fundamental analysis. This is not how most value investors operate, but it is something that

has contributed to my success. Of course, my rules are not absolute, and I do make exceptions.

A worthy exception

Today I'm buying an exception. **Axent Technologies** (AXNT, news, msgs), a provider of e-security solutions to businesses, will be acquired by **Symantec** (SYMC, news, msgs) for one-half share of Symantec stock per share of Axent. There is no collar, and Axent now trades way up off its lows, with no immediate support. But Symantec is bouncing along at about 8 months of support in the high $40s, and I'm listening to the arbitrageurs. Now, in general, arbitrageurs are very shrewd. As in options and futures, arbitrage is a game played successfully only by the very smart or very advantaged. Information is digested with extreme speed and immediately reflected in the arbitrage "spread," the difference between the price Axent now trades and the price where it will be taken out.

At the time of this writing, the spread is only 2.3%. Of late, spreads in the technology sector have been much, much larger. So this tiny spread tells me a few things. When evaluating the spread in a stock transaction without a collar, we are really looking at, first, the chances the deal will go through, and second, the value of the acquiring company's stock after the deal executes.

With about five months until the close of the deal, a 2.3% spread gives an annualized return on par with Treasury bills. In other words, the market has decided this deal will go through. Deal closure is rarely a 100% safe assumption, but it can approach 100% if the deal seems to make sense strategically and is structured in a way that financing and anti-trust clearance are non-issues. That seems to be the case with Symantec's acquisition of Axent.

The tiny spread also indicates that the new post-acquisition Symantec will be worth at least the current share price of Symantec. I agree, but feel this is conservative. Symantec should be worth more. Assuming today's prices, the market capitalization of the new Symantec will approach $4.05 billion. This, for $1 billion in revenues growing 27% for at least several years. Accretion to cash flow should begin by the end of fiscal 2001. Intuitively, there's value here, but let's explore it some more.

The real deal

The deal gives Symantec's Chief Executive Officer John Thompson a potent arsenal in his quest to make Symantec a one-stop e-security shop. A former IBM executive, he has infused an awareness of the company mission throughout his workforce and made cost controls a priority. The new company will benefit from Thompson's management as it offers products covering the gamut of the current e-security field. Axent provides a head start as it brings on a host of gold-plated customer wins, including 45 of the Fortune 50 and a recent long-term contract -- the industry's largest ever in terms of revenue -- to provide managed-security solutions to Xerox Europe.

In response to the deal, a **Network Associates** (NETA, news, msgs) representative criticized Symantec's strategy of "being everything to everyone." Yet a Visa e-security expert tells me that a one-stop shop is what everyone has been waiting for. I must admit that the same expert is taking a wait-and-see approach to Symantec, as he is not used to thinking of Symantec as an enterprise-level company. He also criticizes Axent's products as a bit rough and lacking in support, and notes that Symantec still will not offer a product implementing Public Key Infrastructure (PKI) technology. E-security experts have touted the benefits of PKI, but developing a PKI product is a difficult task involving cross-platform incompatibilities. It is uncertain whether Symantec needs one at this point. With a solid balance sheet, it is likely it can acquire its way into the market if the need arises. I am also counting on Symantec bringing some order to Axent's support operations.

Symantec's free cash flow runs higher than its net income, as does Axent's. Both are accumulating cash on the balance sheet; combined, the companies have nearly $650 million in cash and no debt. Accounting for lower overall gross margins thanks to increased service revenue and taking management's guidance for operating expenses, we can expect about $200 million in free cash flow for the year ending March 31, 2001. Hence, today's stock prices imply an enterprise trading at about 17 times free cash

flow. With Symantec upgrading its revenue guidance and both Axent and Symantec beating estimates significantly, Symantec appears to trade at nearly a 50% discount from where its growing intrinsic value now sits.

One may wonder whether Symantec could have developed products like Axent's for less than the cost of acquiring Axent itself. This would have been a poor choice in an exploding industry. In addition to products, Axent brings human capital, which may as well be renamed "vital capital" in the technology space, and it is the first mover in providing comprehensive intrusion-detection solutions. The evidence is in the customer wins. Symantec just bought a foot in the door of 45 of the Fortune 50. That's a pretty big off-balance-sheet asset in Thompson's hands. I am choosing to buy Symantec through Axent. I have confidence the deal will go through, and hence I'd like to claim the spread. I am buying 200 shares of Axent at the market.

Journal: August 11, 2000

• Buy 500 shares of Huttig Building Products (HBP, news, msgs) at a limit of 4 5/8.

• Buy 100 shares of Healtheon/WebMD (HLTH, news, msgs) at a limit of 11 5/8.

• Buy 50 shares of Axent Technologies (AXNT, news, msgs) at a limit of 24.

Loading up on favorites

Today's trades are a near repeat of yesterday. I'll try to buy 500 shares of **Huttig Building Products** (HBP, news, msgs) at a limit of 4 5/8, and I'll go with another 50 shares of **Axent Technologies** (AXNT, news, msgs) at a limit of 24. Also, I'll add another 100 shares of **Healtheon / WebMD** (HLTH, news, msgs) at a limit of 11 5/8. No new picks, but let's review the events of the week.

Did you see whom **Active Power** (ACPW, news, msgs), the week's high-flying IPO in the power generation sector, touted as a technology partner? **Caterpillar** (CAT, news, msgs). It's a pretty good partnership -- Caterpillar is the brand stamped on the partnership's end product. Who's the man here? Caterpillar.

No bombs on the earnings front

Healtheon/WebMD reported a great quarter. There are a lot of metrics to consider, but the bottom line is losses are shrinking as revenues grow -- that's a very important point, as it goes to the viability of the business model. With $1 billion in cash and no debt, this business is not just viable -- it's a gorilla. New information for me includes management's claim to have already identified $75 million in synergistic cost savings to be had over the next few quarters. The 30% growth in physician registrants on WebMD Practice provides a bit of an upside surprise as well. That's a difficult market to crack, but WebMD Practice already has 26% of it. I'm watching the new lows warily.

Clayton Homes (CMH, news, msgs) reported numbers in line with estimates, giving the company its second-best results ever as its competitors report losses. Clayton will emerge from this downturn in fine condition.

Senior Housing Properties (SNH, news, msgs) also reported earnings, which should turn out to be the worst-case quarter for the company, as the bankrupt lessees are no longer making minimal payments. Starting at the beginning of the current quarter, Senior Housing began realizing direct operating cash flows from the properties vacated by the bankrupt lessees. What the latest results do show is that funds from operations clearly cover the dividend.

Three earnings reports from companies under stress and no total bombs. I'll take that.
I'll have new picks on Monday.

Journal: August 14, 2000

• Buy 200 shares of Pixar Animation Studios (PIXR, news, msgs) at a limit of 33 3/4.

To infinity and beyond with Pixar

Pixar Animation Studios (PIXR, news, msgs) is a stock sitting where no one can get it. Even if analysts or portfolio managers like the long-term story, the Wall Street Marketing Machine will not allow them to buy it

The problem? Pixar's next feature film will not be released until November 2001 -- a full two years after the last, "Toy Story 2." No matter that the first three releases -- "A Bug's Life," "Toy Story,"

and "Toy Story 2" -- establish Pixar as a 1.000 batter later in the season than any other major studio before it. No matter that Pixar promises at least one theatrical release per year from 2001 on, and has beefed up its talent pool with the likes of animation guru Brad Bird. For Wall Street, this is a timeliness issue.

Not for me. As I discussed back in my Aug. 3 entry, even for a growth company, only a tiny fraction of the intrinsic value of a company results from the next three years. Heck only a fraction of today's intrinsic value depends on the next 10 years. The key is longevity -- will Pixar be around and making money 10 years from now . . . and beyond? Certainly.

In part, I get this confidence from CFO Ann Mather and CEO Steve Jobs, as well as the talent that Pixar seems to attract. The teams that created the first three hits are still around for the next four that are already in production. During the most recent conference call, Steve Jobs prefaced his remarks with the declaration, "I am a forward looking statement." No doubt, Steve.

Animated cash flows

But I would never invest in this company if I couldn't see the financial kingdom behind the magical one. And I do. Pixar is generating cash at such a rate that it is building its new Emeryville digs out of cash flow-- with no financing -- and still laying down cash on the balance sheet. At present, cash on hand tops $214 million. Jobs is a fan of cash flow and cash strength because he thinks it helps him negotiate with Disney. "Hey, if you don't want a piece, we'll just finance it ourselves..." Whatever the reason, I like cash too.

The next year and a half will include the driest quarters Pixar will ever see. Still, Pixar sees the coming pay-per-view release of "A Bug's Life" generating gross revenues of 15-20% of worldwide box office receipts before Disney takes a cut. And "Toy Story 2" will go into home video release this October, generating about 35 million in unit sales over its lifetime at a higher average selling price than originally forecast. Helping to generate enthusiasm for this release -- and to help cement the evergreen nature of the "Toy Story" characters -- will be a new "Buzz Lightyear of Star Command" television show, which debuts this fall as part of Disney's 1 Saturday Morning program.

These are additional revenue phases for established assets. To believe in Pixar as an investment, one has to believe in the evergreen nature of its creations. Pixar's full product life cycle, managed correctly, can be extremely long. And as Pixar releases more films, more life cycles are put into play, overlapping and creating smoother and larger earnings streams.

Pixar is guiding us to earnings of $1.30 this year, but it is likely we'll see earnings exceeding $1.35. History tells us Pixar's free cash flow runs quite a bit higher than its net income. That's how cash on the balance sheet jumps $17 million in one quarter despite net income less than half that. As an enterprise less its cash, the price of Pixar is currently trading at about 21 times accounting earnings, but only about 14 times free cash flow. Earnings will fall next year, and the stock is heavily shorted in anticipation. It's not like me to say this, but getting into the quarterly accounting minutiae here is a bit counterproductive. The business plan is intact and there is a working program for creating brand equity.

For instance, every one of those 35 million copies of "Toy Story 2" home video product will feature a trailer for next year's "Monsters, Inc." Kids will be watching this over and over again. And when "Monsters, Inc." comes out on video, will it have a trailer for another upcoming release? Of course. And will these products ultimately end up on pay-per-view? Of course. Pixar's catalogue itself creates lead-ins to new product success.

Concessions from Disney?

In 2004, Pixar will release its final film under the distribution agreement with Disney. This agreement is an onerous one that Pixar agreed to when it had much less success under its belt. Currently Pixar only gets 50% of the gross revenues of its product after Disney deducts the costs of its distribution and marketing. Disney's claim on distribution and marketing fees is such that the entire domestic box office for a film can mean no profits for Pixar. Already Pixar is of sufficient strength to extract a much more lucrative deal from Disney. After a few more blockbusters, Pixar will be in a position to

restructure a new agreement with tremendous implications for Pixar's bottom line.

The key is that any additional concessions from Disney should flow nearly untouched to the bottom line. An additional concession of 20% of profits after distribution costs should result in roughly a 40% boost to Pixar's operating income from a given film. Knowing this, we can estimate that in 2005, we should see a big boost to Pixar's income and at the minimum rejuvenation of its growth rate. Pixar's cash earnings over the next 10 years alone could approximate $30-$40/share in present value. And the profits should not fizzle too much even after 10 years. Of course, this is very rough because we do not know what the new Disney contract will bring. But I like it when my margin of safety does not require a calculator.

The risk is that the films flop. If this were Fox, I'd worry. I'll try to buy 200 shares at a limit of 33 3/4.

Journal: August 15, 2000

- **Place order to buy 400 shares Deswell Industries (DSWL, news, msgs) at a limit of 13.75.**

Deswell Industries -- solid gold

Deswell Industries (DSWL, news, msgs) is a contract manufacturer of metal and plastic products as well as electronics. Traded on the Nasdaq but based in Hong Kong, Deswell runs an efficient operation that employs such techniques as on-site dormitories for its workers -- tactics that are profitable but not generally practical in the United States. One might consider this as a competitive advantage, but as a small company based in China, the firm's shares are met with distrust and general avoidance. While the stock trades daily, the volumes are miniscule

Common products made by Deswell include printed circuit boards, telephones, computer peripherals, and electronic toys which are sold to original equipment manufacturers that brand the end product. Hence, Deswell is behind the scenes -- **Vtech Holdings** (VTKHY, news, msgs) and Epson are major customers. Deswell has a reputation for timely, efficient operations and has been winning larger and more numerous contracts over the years. Business with Epson is expected to triple over the next year, and business with Vtech is experiencing solid growth as well.

Deswell is a growth company but pays a generous dividend. Its officers own the majority of the stock, and rely on dividends as a partial salary replacement. Why? Dividends are not taxed locally. What this means is that in the long term, Deswell shareholders receive a quite generous payout every year -- often approaching double digits. And we can count on the dividend being preserved.

But excellent working capital management -- the latest quarter's 47% increase in sales came with less than 20% increases in inventory and accounts receivable -- keeps cash flow so strong as to continue funding quite significant growth. This is not often seen in companies with high dividend payouts.

Show me the business

You can see where this is heading. CEO Richard Lau pays little attention to the stock price, preferring to focus on the business. Investor relations is farmed out, and institutions generally ignore the company. What all this adds up to after backing out the $5.33 per share in cash is a stock trading at about $8.50/share after earning $2.01/share over the trailing four quarters -- and quite a bit more than that in free cash flow. This despite recent revenue growth in the 40% range and additional growth expected for the foreseeable future. By the way, the cash on the balance sheet is held in U.S. dollars.

The malaise in the stock over the last few years has been linked to difficulties in its electronics operation, but the latest quarter saw an 80% revenue jump in that division. Mr. Lau expects continued strength there as the market for portable communications devices heats up. Moreover, Deswell is attaining a critical mass in terms of capacity -- the company is increasingly seen as a realistic option as a contractor on even very large jobs. The expected 250% growth in Deswell's Epson contract over the next year is evidence of this. Expansion is being funded out of cash flows.

Another concern hovering over Deswell has been the effect of the rise in petroleum prices on its

plastics business, which depends on resin as major input. But management hedged its supply such that there was no material effect on the business despite the parabolic rise in oil prices. This is a smart move, indicative of management's savvy in its field.

Contract manufacturers as stocks are split into quite disparate valuation categories based on size. Deswell trades at an enterprise value/EBITDA ratio of 2.7. **Solectron** (SLR, news, msgs), with sales 200 times Deswell's, trades at an enterprise value/EBITDA ratio of 30. **Plexus** (PLXS, news, msgs), with sales ten times Deswell's, trades at an enterprise value/EBITDA ratio of 40. And Deswell's return on capital and equity are quite a bit better than these other firms. The potential for multiple expansion with growth in revenues is hence quite significant.

I am looking to buy 400 shares at a limit price of $13.75.

Journal: March 9, 2001

- **Buy 500 shares of DiamondCluster International (DTPI, news, msgs) at 14 3/4 limit, order good until cancelled.**

- **Buy 1,400 shares of GTSI Corp. (GTSI, news, msgs) at 4 3/4 limit, good until cancelled.**

- **Buy 10,000 shares of Criimi Mae (CMM, news, msgs) at a 75-cents limit, good until cancelled.**

- **Buy 800 shares of Senior Housing Properties Trust (SNH, news, msgs) at a 10 limit, good until cancelled.**

- **Buy 1,000 shares of London Pacific Group (LDP, news, msgs) at $6.65 limit, good until cancelled.**

A diamond in the value rough

As a value investor, one of my favorite places to look for value is among the most out-of-favor sectors in the market. In order to obtain maximum margin of safety, one must buy when irrational selling is at a peak. Ideally, illiquidity and disgust will pair up in tandem pugilism. Ben Graham suggested bear markets offer such an opportunity. Right now, technology is in a bear market. One of the key themes is that business customers are putting off purchase decisions today in order to minimize expense in the near term -- and hence protect near-term earnings guidance. In the long run, this is a bad management decision, and in the long run the purchases that need to be made will be made.

The major software makers have been hit, as has nearly any company selling high-ticket items to big business. The market has visited particular scorn on the e-consulting companies, which have been lumped into one basket and simply heaved overboard. Within this sector, there are a variety of companies, however, and the stronger ones cater nearly entirely to blue-chip businesses. The ones that catered to dot-coms in particular are suffering quite severely, and rightly so. The stronger ones, however, have big cash balances and dot com exposure in the low single digits -- they have also demonstrated a capability of managing a business for positive returns on investment, and hence come off more credible l to intelligent executives of top corporations.

Based on an analysis of accounts receivable quality as well as cash conversion cycles, two e-business integrators stand out as among the best. One is **Proxicom** (PXCM, news, msgs); the other is **DiamondCluster** (DTPI, news, msgs). Both have demonstrated the ability to produce positive cash flow while growing significantly, but more importantly, both have extremely minimal exposure to questionable clients such as dot-coms. Their clients -- Fortune 500 companies -- will indeed eventually return to the prudent path of spending on high return on investment projects.

Of these two, my favorite is DiamondCluster. DiamondCluster has the best margins and working capital management in the business, despite working with blue chip clients that often demand favorable credit terms. The management team is quite strong, and in the coming quarters nearly half their business will come from overseas -- primarily from Europe and Latin America and away from the North American meltdown. Dot-com exposure is less than 2%. Moreover, their developing expertise in wireless, from working with **Ericsson** (ERICY, news, msgs) in Europe, will prove quite handy when wireless eventually takes off here in the United States.

Wireless is one area of telecom that continues to hold promise. Many of the biggest carriers worldwide have already spent billions on licenses that have not been developed. These carriers will not be able to delay long purchasing the consulting services needed to realize a return on such a large investment. DiamondCluster is very well-positioned in that area.

The balance sheet is pristine, with more than $150 million cash (over $5/share) and no debt. In fact, the stock has some history, having been punished severely during the October 1998 meltdown, only to rebound twenty-fold before crashing once again. This is a stock that is fundamentally illiquid and tends to provide opportunities within its tremendous price ranges.

Management continues to maintain a no-layoffs policy, and tends to promote from within. These features are unique in the industry and foster stability within the company that can only benefit it in relation to its peers. The competitive landscape includes **IBM** (IBM, news, msgs), a formidable e-services competitor. However, DiamondCluster has demonstrated an ability to win many of the biggest clients and is in the process of developing a branded reputation as well. Success with big clients is the biggest selling point when speaking with other big clients. The human-relations culture fostered at DiamondCluster (industry-low turnover is just 11%), the blue-chip client base, and the fundamental cash return on investment mindset that management constantly evokes all set it far apart from many of its weaker, struggling competitors. Unlike commodity staffing, high-level business consulting is very susceptible to branding, and DiamondCluster has been making the right moves to create an effective brand.

In any consultancy, human resources management is key. By not laying off consultants, management is signaling to the highest quality candidates out there that DiamondCluster offers stability and financial strength. This lowers turnover as well as costs, and helps DiamondCluster to the best margins in the industry. This also allows DiamondCluster to be most ready when the economy revs up once again and competitors are once again scrambling for talent.

Backing out the excess cash, DiamondCluster trades for around 10-times newly lowered estimates. It reached cash profitability at a lower revenue threshold than any of its competitors, and it will remain solidly profitable despite the current downturn. As a value investor, I am quite used to buying cyclicals as the downturn looks most dire -- but before the actual bottom is hit. Traditionally, cyclical stocks begin their bull rally well in advance of the actual business bottom. I believe that DiamondCluster is poised for such a rally.

There is some price risk here. Other high-tech consultancy stocks have plummeted to levels approximating their cash holdings, and DiamondCluster may in fact do that too. To date, the quality of the business has actually provided DiamondCluster stock some price protection relative to its lesser peers. But what I believe we are seeing is a short-term catharsis from the lack of visibility for recovery. The illiquidity of the stock as well as the momentum shareholder base simply aggravates the fall. Most value investors would not touch something called DiamondCluster, and hence price support is vanishing. I have seen the stock fall as much as 5% on a few hundred shares, only to see others follow and dump thousands of shares because the stock fell 5%.

The stock is hence something of a falling knife rapidly accelerating its descent. Technically speaking, the only support flows from the bottom of a channel uptrend extending back to early 1997 and a recent bounce off $14 1/2.

Fundamentally, the metrics look good. The company has been able to maintain revenues per billable of about $350,000 -- over 50% higher than several prominent comparables. Expect a cyclical lull in this figure as the company refuses to cut headcount during the downturn, but as mentioned before long-term investors should welcome this attitude.

However, the intrinsic value of this company is double current levels even using conservative long-term growth estimates well below those provided by the company. A key factor in these

sorts of companies is management, and in this case management is reacting exactly how I would like them to -- as owners interested in the long-term prosperity of the business. The stock is now priced as if earnings will grow only 10% annually for the next 10 years, before falling to about 6% growth. A share buyback is underway, as it should be. Whenever a company has an opportunity to purchase $1 dollar of intrinsic value for 50 cents, it should do so. The company has ample cash to amplify the buyback, and ought to do so when the current allotment is completed.

For the record, management continues to target annual 30% revenue growth long-term, and earnings per share growth approximating 25%. They are looking across the valley. Intelligent investors would never take these growth rates, extrapolate a value from them, and call out "margin of safety." But intelligent investors should be able to also look across the valley and see an opportunity for capital appreciation in a long-term hold from these levels.

The industry may see some consolidation. Anecdotal reports are that foreign firms looking to snap up American technology expertise are already scouting out various targets among the e-business consulting walking dead and wounded. Proxicom seems particularly susceptible here. I am not expecting DiamondCluster to sell out, but depressed shares composed 1/3 of cash are generally attractive targets. Buy 500 shares at 14 3/4 limit, good until cancelled.

Other buys
Also, buy 1,400 shares of **GTSI** (GTSI, news, msgs) at 4 3/4 limit, good until cancelled. This stock is a holdover from last round. A supplier of technology equipment to the government, it remains a net net (selling at a discount to net working capital less all liabilities) despite a tremendous change in the business for the better, with expected earnings in excess of $1 per share.

Buy 800 shares of **Senior Housing Properties Trust** (SNH, news, msgs) at 10 limit, good until cancelled. This is another holdover from last round. A high dividend payout on this health-care REIT and an improving regulatory and financial climate due to recent budget changes continue to make the stock attractive. Warren Buffett bought stock in **HRPT Properties** (HRP, news, msgs), which has the same management as Senior Housing and which is also Senior Housing's largest shareholder.

Buy 10,000 shares of **Criimi Mae** (CMM, news, msgs) at a 75-cents limit, good until cancelled. This is a stock of a finance company coming out of bankruptcy soon and worth at least $1.25/share and with only slightly different assumptions a little over $2/share. This is one of the slightly innocent bystanders forced into bankruptcy by the Long Term Capital Management crisis of 1998. This one's complicated and has recently been under selling pressure from a convertible preferred issue that has been converting. Penny stock is a pejorative term that happily makes people not want to look deeper, but the market cap is greater than GTSI, which trades above $5 regularly, and the enterprise value is much greater still.

Buy 1,000 shares of **London Pacific Group** (LDP, news, msgs) at $6.65 limit, good until cancelled. This is an ADR representing an ownership stake in a London insurance company and asset manager that uses its float in part for venture capital activities. The company has had a tremendous track record, and many of its companies not taken public have been acquired, resulting in large stakes in companies like **Siebel Systems** (SEBL, news, msgs). The extensive list of companies it has helped fund include **LSI Logic** (LSI, news, msgs), **Atmel** (ATML, news, msgs), **Linear Technology** (LLTC, news, msgs), **Oracle** (ORCL, news, msgs), **AOL Time Warner** (AOL, news, msgs) and **Altera** (ALTR, news, msgs), among others. Currently trading at a substantial discount to the net asset value, the stock should in fact mirror the value of its public and private holdings plus the value of its $5 billion asset management operations. It is also important to realize that a soft IPO market does not result in losses -- the company simply must keep its private companies private a little longer. Similarly, mark-to-market losses on public securities are simply paper losses until realized.

Journal: March 16, 2001

- **Change the outstanding limit order on GTSI Corp. (GTSI, news, msgs) to buy 1,500 at 4 7/8**

limit, good until canceled.

- **Change the outstanding limit order on Criimi Mae (CMM, news, msgs) to buy 10,000 at an 80-cent limit, good until canceled.**

- **Change the outstanding limit order on Senior Housing Properties Trust (SNH, news, msgs) to buy 700 shares at $10.10 limit, good until canceled.**

- **Buy 1,500 shares of Grubb & Ellis (GBE, news, msgs) at 5 limit, good until canceled.**

- **Buy 2,000 shares of Huttig Building Products (HBP, news, msgs) at $4.10 limit, good until canceled.**

- **Buy 2,000 shares of ValueClick (VCLK, news, msgs) at 3 5/8 limit, good until canceled.**

Two out-of-favor choices
First, let's adjust a few unexecuted trades. Change the outstanding limit order on **GTSI Corp.** (GTSI, news, msgs) to buy 1500 at 4 7/8 limit, good until canceled. Change the outstanding limit order on **Criimi Mae** (CMM, news, msgs) to buy 10,000 at an 80-cent limit, good until canceled. Change the outstanding limit order on **Senior Housing Properties Trust** (SNH, news, msgs) to buy 700 shares at $10.10 limit, good until canceled.

Now, today's new names:

I'll buy 1,500 shares of **Grubb & Ellis** (GBE, news, msgs) at 5 limit, good until canceled. A real-estate services firm, one would imagine that this company would be out of favor right now. It sure is. **CB Richard Ellis** (CBG, news, msgs), a competitor, is being taken private by management at an enterprise value/ EBITDA multiple of 6.2. Currently, Grubb & Ellis trades at a multiple of about 3. Warburg Pincus and **Goldman Sachs Group** (GS, news, msgs) are the majority owners of the firm. The stock has been languishing, and Warburg is looking for a way out. They've been shopping the firm around, but found no takers for uncertain reasons – possibly the price was too high. GE Capital and Insignia Financial Group have taken a peek.

The firm recently completed a fully subscribed self-tender for about 35% of the outstanding shares at a price of $7 -- undoubtedly a way for Warburg and Goldman to liquidate a portion of their position in light of the fact that there is no ready buyer. The company released the CEO last May and neglected to search for a new one. This company is, quite simply, on the block and as yet there are no takers.

In the meantime, it is very cheap. Cash on hand at the end of the year is inflated by deferred commission expense, and this is a cyclical industry headed into a downturn. But if CB Richard Ellis is worth a 6 multiple on peak EBITDA, surely the Grubb & Ellis share price is awfully low. Other comparables trade at a 6 multiple on EBITDA as well.

I'll add in a buy 2,000 shares of **Huttig Building Products** (HBP, news, msgs) at $4.10 limit, good until canceled. A holdover from last round, this building-products distributor with a nifty value-added door manufacturing operation trades at low valuation and has been out of favor since its spin-off from **Crane** (CR, news, msgs) in late 1999. It recently pre-announced this quarter, seasonally its most difficult. Over the decades, however, this firm has managed to stay profitable through thick and thin. It is executing a plan to de-leverage its balance sheet and has found cost synergies in a major acquisition last year that will bloom this year. A comparable company, Cameron Ashley, was taken private by management last year at a valuation multiple that implies Huttig deserves a share price in the $10-$15 range. The largest outside shareholder wants out and may find the easiest way is to instigate for a buyout. The second largest shareholder is the Crane Fund, an affiliate of Crane, and Crane's CEO is Huttig's Chairman. Without a takeout, the company trades at low multiple of free cash flow, has management focused on return on capital hurdles, and makes a good hold.

Buy 2,000 shares of **ValueClick** (VCLK, news, msgs) at 3 5/8 limit, good until canceled. ValueClick is a pay-for-performance (or cost-per-click) Internet advertiser. Again, tremendously out of favor right now. What this company has going for it is a hefty cash load as well as shares in an overseas subsidiary, ValueClick Japan, that

together are worth significantly more than the current share price. Operations have been roughly cash-flow neutral, and certainly things are not getting worse. Because of pooling transactions rules, ValueClick's management claims it cannot institute a share buyback of any size.

Intuitively, one would expect that the cost-per-click or pay-per-conversion model would start to make sense to more and more advertisers as traditional revenue models requiring payment simply for the presentation of a banner prove futile. Financial companies such as credit card vendors are starting to see the light here. Japan remains a stronger market for ValueClick, which got into the market earlier and hence is participating more fully in the de facto advertising standards that developed there. ValueClick has also acquired assets in areas such as opt-in e-mail campaigns and software measuring return on investment.

DoubleClick (DCLK, news, msgs) owns a stake in ValueClick and has representation on the board. If nothing else, this company seems a takeout waiting to happen. Most downside is priced in at this point – after all, the business has a negative valuation – and there is a decent upside.

Journal: March 28, 2001

- **Place order to buy 1,000 shares of Spherion (SFN, news, msgs) at 7.85 limit, day order only.**

- **Place order to short 300 shares of Standard Pacific (SPF, news, msgs) at 22 or higher, good until canceled.**

- **Place order to short 100 shares of Adobe (ADBE, news, msgs) at 36.50 or higher, day order only.**

The recovery mirage
A prominent newspaper recently published one of the least informed articles I've ever seen. I believe it speaks volumes about where the stock market might be headed. The title was "Why High Tech Can Weather the Slowdown." The newspaper, unfortunately, was the San Jose Mercury news. Hometown shame.

Here's some choice wisdom:

- (caption for photo of Yahoo's new headquarters): "Yahoo's new headquarters in Moffett Park is an ironic lesson in the New Economy: Silicon Valley can avoid a recession like the one 10 years ago because it has diversified beyond defense contracts, chips, and hardware." My comment: Internet advertising is a tool for diversification against an economic slowdown? Quick, someone tell **The Washington Post** (WPO, news, msgs)...
- "A broad spectrum of tech companies hedges against slumps in any particular sector at a given moment. Although all the tech companies are linked in a food chain, some will probably suffer less during the IT spending slowdown, the economists say. "They're holding hands, but they're cartoon characters, and their arms can stretch," said Mike Palma, principal IT analyst at Gartner Dataquest." My comment: Oh, they're cartoon characters all right ...
- "I don't think there's anything out there that would lead us to anything even approaching the early-1990's experience," said Ted Gibson, chief economist at the state Department of Finance. Silicon Valley economics guru Stephen Levy, co-founder of the Center for the Continuing Study of the California Economy agreed. "Everyone knows that it's temporary," he said of the tech slump. My comment: "The Silly Putty guru levied a temporary study of the continuing"... Wait, no... "The joint economy of a continuing center of Sili. Valley gurus and government intelligence"... wait, no... "We're from the government-and he's an economist-and we are all known for being very very right most of the time"... ah, much better ...
- This time it will be different because "California is slowing from an extraordinarily red-hot economy" and "In 1990, California was coming off a building binge" and "Monetary policy is different" and, wait, this is great-"Venture capital has matured as an industry, fueling business innovations in a broader way than before." My comment: Yeah, those VC's

really refined that "dump it on the gullible public" strategy. Thank God the VC's will be there with their newfound expertise to help us pull through these rough times.

But the market has already fallen so far. Could it really fall further? Sure. As long as everyone is asking, “Is this the bottom?", I doubt that it is. When people truly capitulate, no one will be asking if there’s capitulation. Capitulation will be defined by a loss of interest in capitulation.

I’m not trying to divine market direction from popular behaviors. In fact, I really am not proclaiming anything about market direction. But the valuations justify a bottom about as much as the behavioral indicators do, which is to say not at all. So here goes my essay, titled “Why High Tech Stocks Cannot Weather the Slowdown.”

The stock-options shell game

I’m going to outline a problem that a lot of tech companies face -- and that makes their stocks in general overvalued. Unlike nearly every other industry, tech companies compensate their employees in a manner that hides much of the expense of the compensation from the income statement. Of course, I’m talking about options.

With the most prevalent type of option -- called “nonqualified stock options” -- the difference between the price of the stock and the price of the options when exercised accrues to the employee as income that must be taxed because it is considered compensation. Not according to Generally Accepted Accounting Principles (GAAP), but according to the IRS. So the IRS gives companies a break and allows them, for tax purposes, to deduct this options expense that employees receive as income. The net result is an income-tax benefit to the company of roughly 35% of the sum total difference between the exercise price of the company’s nonqualified options during a given year and the market price of the stock at the time of exercise.

Since GAAP does not recognize this in the income statement -- for whatever reason, I’m not sure -- the cash flow statements record this “net income tax benefit from employee stock compensation” in operating cash flow as a positive adjustment to net income. After all, the company included neither the cost of the options nor the income tax benefit on the income statement. Hence, the correction to cash flow.

Great, right? So net income is understated, right? Wrong. When evaluating U.S. companies, investors ought to assume that if the IRS can tax something, then it is a real profit. And if they allow one to deduct something, then it is a real cost. For instance, goodwill amortization cannot be deducted for taxes, but that’s another topic for another day.

For many tech companies, options compensation is a big issue. In a rising market, the net income tax benefit can be quite large -- but it only reflects 35% of the actual cost of paying employees with options. How does it cost the company? Because the company must either issue new stock or buy back stock for issuance to employees in order for the employees to obtain this stock at a discount. The cost is borne by shareholders. The per share numbers worsen, while the absolute numbers improve (after all, issuing stock at any price is a positive event for cash flow if not shareholders).

Adobe (ADBE, news, msgs), for instance, is widely regarded as a good company with a franchise. A bit cyclical maybe, but a member of the Nasdaq 100 ($OEX) and the S&P 500 ($INX). It’s been around the block. And its shareholders have been taken for a ride.

Looking at its recently filed form 10K for 2000, one sees that the income-tax benefit for options supplied $125 million, or roughly 28% of operating cash flow. Fair enough. Let’s move to the income statement. Based on a corporate tax rate of around 35%, that $125 million represents $357 million in employee compensation that the IRS recognizes Adobe paid, but that does not appear on the income statement.

Plugging it into the income statement drops the operating income -- less investment gains and interest -- from $408 million to $51 million. Tax that and you get net income somewhere around $33 million -- and an abnormally small tax payment to the IRS. That $33 million is roughly the amount of net income that public shareholders get after the company’s senior management and employees feed at the trough.

For this $33 million – roughly a tenth of the reported EPS-shareholders are paying $8.7 billion. Adjusting the price/earnings ratio (PE) for what I just described jumps the PE well into the triple digits.

This is why I call a lot of technology companies private companies in the public domain -- existing for themselves, not for their shareholder owners. Of course, it is a shell game. A prolonged depressed stock price -- for whatever reason, including a bear market -- would cause a lot of options to become worthless, and would likely require the company to either start paying more in salary or often worse, to start repricing options at lower prices.

In a coldly calculating market rather than a speculative one, the stocks of companies that have been doing this to shareholders will suffer. It is not limited to Adobe. **Cisco** (CSCO, news, msgs), **Intel** (INTC, news, msgs), **Microsoft** (MSFT, news, msgs) and many of the greatest tech "wealth creators" of the last decade are in the same boat. When shares are bought back in massive amounts and the share count keeps rising, that's a clue. And in a true bear market, even cold calculations are barely worth the screens they're punched up on. As much as this market overshot to the upside, expect an overshoot to the downside.

And now for the trades
We're in the midst of a bear market rally, so I'm not anxious to buy much yet -- I like to buy when things are more gloomy. I will resurrect a short from last round, though. Short 300 shares of **Standard Pacific** (SPF, news, msgs) at 22 or higher, good until canceled. A homebuilder heavily exposed to California's difficulties, with insider selling. Sentiment surrounding the homebuilders remains wrong-headedly perky. I wrote about this last round and will update my analysis soon.

Here goes one buy now because a catalyst is in the offering: **Spherion** (SFN, news, msgs) is a human resources/temporary services firm now floating a subsidiary on the London exchange for more cash than the entire market capitalization of Spherion. The proceeds will be used to pay off debt and buy back shares. The upside could be variable, especially in the near-term, but using very conservative assumptions, it appears the downside to the valuation is still about 18% above the current price. And to the extent the share price remains depressed as Spherion starts buying back stock, intrinsic value per share will rise. Buy 1,000 shares at 7.85 limit, day order only.

Journal: March 29, 2001

- **Place order to sell position in London Pacific Group (LDP, news, msgs) at the market.**

- **Place order to sell position in Spherion (SFN, news, msgs) at the market.**

- **Place order to buy 500 shares of GTSI Corp. (GTSI, news, msgs) at 4 7/8 limit, good until canceled.**

Real stocks, real profit, real value
My short of **Adobe** (ADBE, news, msgs) was not triggered. But I do recommend rereading my argument for doing so. I am not short Adobe in real life either, but the same logic applies to many, many of the tech stocks out there. I do not believe we are near a bottom yet because in the cold light of a bear market these types of things -- such as dilutive options compensation and hiding mistakes with charge-offs --matter. The greater fool theory no longer rules. What a relief

Now, maybe, finally, we have a time for rational stock picking. If the market begins the first multi-decade sideways run of the new century (there were two such runs last century – both times after extreme valuation bubbles), then the surest way to profit will be to buy stocks of incontrovertible value. Stocks of profitable companies that can be bought for their level of earnings per share five to 10 years out meet this criterion. In this vein, buy 500 more shares of **GTSI Corp.** (GTSI, news, msgs). This is one of the cheapest stocks in my universe, with the best story. They distribute technology products to the military, the IRS and others. Over $650 million in sales and a $35 million market cap. No debt. Net net value (net working capital less all liabilities) is north of $6. And they will earn over a buck a share this year. They earned a buck a share last year, but that was with a tax loss shelter from the era before new management took over. They

have seen steady gross margin improvement, and even with full taxation this year, they expect earnings to beat last year's untaxed income. Because of the contractual nature of the business, there is some visibility, and yes, there's growth.

The company just won a dispute over a large contract to supply products and services to the government. While awards within the contract are still open to competition between the company and **IBM** (IBM, news, msgs), GTSI should do well. This is a relationships business, and GTSI competes well because they have the relationships with the government decision makers and the willingness to get into all the government paperwork. It is a low, low margin business in which the largest portion of capital is usually tied up in working capital. To the extent that new technologies help them squeeze working capital, cash will be freed up for other uses. The company is looking to do its first-ever road trip and broadcast the better business practices that now hold sway over all that revenue.

Insiders were buying at lower levels, as was I. For a few years it was a lock of a trade from 2 5/8 to about 4. Lacy Linwood, the largest shareholder, has been buying in the open market and was one of the founders of **Ingram Micro** (IM, news, msgs). Having a large, non-management shareholder with a large, illiquid stake is catalyst waiting to happen, though without guarantees. His background confirms that Ingram and its ilk are not the competitive threats here, as one might think.

Undoing some mistakes

Investment managers are bound to be wrong many, many times in their lives. This is a business of managing emotion as much as managing money, and taking one's lumps is the surest path to a more erudite view. So it is time to own up to a few mistakes. In my last entry, I outlined my pessimistic outlook for technology shares based on the devious, unfriendly manner in which many tech managers try to hide the truth from shareholders. Two of my holdings do not reflect that pessimism.

DiamondCluster (DTPI, news, msgs) and **London Pacific Group** (LDP, news, msgs) were very big timing mistakes. The same mistakes I made at the beginning of the last round -- being overly optimistic as a new round gets under way, and under some self-imposed pressure to make some moves. Optimism in such cases is rarely warranted. Nearly without fail, egg will befall one's face. With stocks in freefall, I thought, "Well, these two are interesting situations and we have at least six months." Unfortunately, every time I think like that I become cavalier in my timing. The fact of the matter is I should always wait for my rules to kick in – and that includes waiting for falling knives to lay motionless on the floor before trying to pick them up. I violated these rules, and now I've lost two fingers to a couple of very sharp blades. There is value in these companies at current levels, however, and I'll hold DiamondCluster for now.

I am selling London Pacific Group at the market open because of something I call the "5 to 3" effect. Illiquid stocks falling beneath 5 often fall much further because of margin calls that kick in in the 3-5 price range. Forced selling in illiquid stocks is a recipe for price risk, so I have found it prudent to get out of stocks as they cross below 5. It is a very rare case that I pay attention to absolute share prices, but this is one of them.

I should note that DiamondCluster is about to lose significant European business because of **Ericsson's** (ERICY, news, msgs) cost-cutting and the European slowdown. This non-U.S. business had shielded DiamondCluster from some of the rampant devaluation in the e-consultancy sector. Not anymore. Nevertheless, I expect both layoffs and quite significant cash drain over the coming quarters at DiamondCluster. At current prices, however, this pessimism is largely discounted. Whether DiamondCluster will recover before the end of the Strategy Lab round is a matter in serious doubt. Moreover, DiamondCluster has a big options compensation problem, much as I described with Adobe. Nevertheless, the value five years or so out should be greater than it is now, and the company has become an attractive acquisition target with a load of cash on the balance sheet. The earnings power in good times is roughly about 33% of the current share price net of cash, with no debt and a resilient business

model.

An event play, sans the event
Sell **Spherion** (SFN, news, msgs) at the market open. This was an event-driven value play, and the event occurred after I submitted the story. In this case, the event did not look like I thought it would look. Too late to cancel the story, so the order went through and I bought a position. One more reason I say learn what you can from me, but don't imitate me. Now I'm selling it because in event-driven investment if the event does not turn out as predicted, the only prudent thing to do is to exit the position. Spherion is likely to announce horrendous numbers, and there is price risk in the stock. A good argument can be made that it is only fairly valued in the 7's, not undervalued. To justify a sell I must only be able to make such an argument.

What happened? As this was an event-driven value trade, for the investment to work we had to have the event go off nearly as planned. In this case, the event -- a float of subsidiary Michael Page in London -- did not go off nearly as planned. Actually, the pricing still hit the bottom of my model, so there was some safety in the price I paid given the information I had.

The circumstantial evidence points to some skullduggery, however. Michael Page's officers had some incentive to have the offering priced low. Now any options that they get -- and that they can use to incentivize employees -- will be priced low. Moreover, they had incentive to do an offering rather than to sell to others in a private transaction worth as much as 25% more. The incentive involved the fact that Page management was getting 6% of the company and there was a large 12% overallotment for the underwriters. Unfortunately, there was every incentive, except fiduciary responsibility to the shareholders, to price this offering low. Michael Page is a good buy now over on the London exchange. I doubt that it will stay under 200p long.

Also, it appears that Ray Marcy, the CEO of Spherion, now wishes to use the proceeds to pay off some debt and then hold cash for the downturn. This is opposed to the previous statement "pay down all debt and buy back stock." The two statements imply drastically different levels of confidence in the business. One potential catalyst -- again, this was an event-driven trade/special situation -- was that the company would at least support its stock in the market. That would be relatively easy to do given the stock's illiquidity. A buyback of 30% to 40% of the capital stock could even push the moderately higher, and with some more optimistic projections, build more intrinsic value per share. It is not to be.

A board member who was selling large chunks of stock in Spherion during the months leading up to the offering could be a target of shareholder scorn. The prevalent idea was that this was distressed selling for him because of personal financial difficulties. Even if true, he engaged in massive dumping of large blocks in the months leading up to some very bad news. Spherion has never been the best-managed company, but the degree of funny business here is illuminating as to what management will do with future cash flows.

Event-driven trades occasionally don't work out in the short-term, but what you want is a fundamental floor to your valuation in the worst possible case. I think we have that here, and it is around the mid 7's. But I'm not hanging around for the questionable appreciation potential and sure-fire bad news that management will announce regarding earnings within the next two or three weeks.

Also, before Michael Page, the company had significant difficulties producing free cash flow. If they just sold off all their free cash flow production, the situation could deteriorate, and we can't know this for certain yet. This situation would have been mitigated if they had received $300 million more in the offering, as we were recently told to expect. Instead, we are left with the image of a desperate seller in need of much more shareholder-friendly management and a better economic outlook.

Journal: April 2, 2001

- **Place order to buy 1,000 shares of ValueClick (VCLK, news, msgs) at a 3 1/32 limit, good until canceled.**

What price repricing?
Where's the insider buying?

Cisco (CSCO, news, msgs), **Intel** (INTC, news, msgs), **Microsoft** (MSFT, news, msgs), **Sun** (SUNW, news, msgs)? Of course, I could probably count off hundreds, and it is a little unfair to single out these companies. Only a little. It is not that management is not prescient. In most cases, they knew to sell heavily at the top -- or at least as heavy as they could without seeming improper. These are individuals who have made millions if not billions, and yet they are not buying back their company stock in this time of need. In fact, many chose opportune times during the January bear market rally to give gifts of stock -- thereby maximizing the tax benefit while the going was good. Good thing they didn't wait. (Microsoft is the parent of MSN MoneyCentral)

Another controversial aspect of all this is that many of these companies have been executing massive share buybacks with funds from corporate coffers as these executives and founding shareholders have sold off their shares. Shareholder cash providing liquidity for their officers to dump stock? Sure. Happens all the time, especially in the tech industry, where the phenomenon of private companies existing in the public domain in order to take advantage of the public is rampant. This is not a new problem, but the venture capitalist mindset of the last decade has exacerbated it.

Shareholders ought not expect insider buys to start anytime soon. Aside from the general lack of value, most corporate officers and employees have just had options repriced, and others are considering it. Why pay for something you can just take? Options repricing is one of the most blatant forms of theft from shareholders that corporate officers have at their disposal. The larger the company, the greater the degree of theft. If Cisco reprices -- as has been rumored -- it very well may be the greatest single theft from shareholders in history.

Moreover, portfolio manager James Clarke of Brandywine Asset Management suggests that options that can be repriced are worth a whole heck of a lot more than Black-Scholes or the company's annual report would have you to believe. I know Clarke, a good friend of mine, to have at least thrice-daily original thoughts, and this one was an excellent one.

Here's how it works. Be aware that this part, however, is my extrapolation of his insight. If an employee has been given a call option to buy stock at certain price, one can potentially calculate the value of the option because there is risk if the stock price falls and there is gain if the stock price increases. If the option can be reissued or repriced so as to eliminate or mitigate risk if the stock price falls, how does one value the option? Well, you are basically putting something akin to zero in the denominator of the reward/risk tradeoff, which uncaps the value of the option. If a company were to pay cash in lieu of such options of such high value, what would the cash amount be? Would it be infinity? No, but it would be very high, and that's not good for stockowners, most of whom are OPMIs (Outside Passive Minority Investors), in the parlance of Third Avenue's Marty Whitman.

So let's recap.

- Per my journal entry last Tuesday, many tech companies are drastically overreporting cash earnings per share -- by a factor of 10 or more -- by relying on options compensation that does not appear on the profit/loss statement. Example:**Siebel** (SEBL, news, msgs), which would have massively negative per share cash earnings if it paid in salary what it paid its employees in options last year.
- With few exceptions, insiders are not stepping up to buy shares yet, even though they are fat with profits from selling the same shares at much higher prices, possibly aided by massive share buybacks using shareholder money. Example:**Exodus** (EXDS, news, msgs), which saw its executive officers sell down their holdings to near-nil last summer. There is still selling occurring. And dare I mention Microsoft? Witness VPs galore locking in

their fortunes and now holding only token amounts of shares.

- The rampant practice of repricing and reissuing options after a stock price fall in effect is like paying employees with items of near-limitless value, which raises the question of whether we should deduct near-limitless expense from the income statement. Examples: Too many. One or two examples wouldn't do this justice. But watch for Cisco to reprice its options. They've shelved the plans for now but are considering it.

Which brings me to my original thesis. When these stocks were going up, greater fools worldwide made millions. Many kudos to those non-insiders who were able to take advantage of it without rolling the money into yet another foolish idea. Now the zero-sum nature of growing companies that consistently dilute out and take advantage of their status is crystallizing in the nation's pocketbooks. Yet I cannot begin to tell you how common a question "So, has Cisco bottomed?" is whenever people discover my occupation. So whether any of these issues are crystallizing in anyone's mind is another matter.

Now that the bubble is pricked, tech stocks will face scrutiny they never faced before. It is a good time to start picking prices based on a solid understanding of the fundamentals behind these companies. Whether we have a bear rally or not, greater bargains are sure to come, and some "wish list" prices may come into view on the truly great, shareholder-friendly companies with permanent competitive advantages. For now, I remain unexcited by the prices I see in general in the market, and I'm happy to keep some powder dry for better values later.

ValueClick (VCLK, news, msgs), a current holding in the portfolio, was knocked down no doubt by some window-dressing at the end of the quarter. Who or what would want to show ValueClick, an Internet advertising firm, as quarter-end holding? Hopefully this will draw in more sellers. The company has north of $5 a share in cash and securities and is trading at $3 and small change. I should be clear, however, that management are acting foolish. They've been buying companies with their 60-cent dollars, i.e., their shares, and that is just nonsensical and wasteful. A buyback would work wonders for investor confidence and maybe even allow people to think that $5 in their hands is worth at least $5.

Journal: April 12, 2001

- **Sell entire position in DiamondCluster International (DTPI, news, msgs) at the open.**

- **Sell entire position in Criimi Mae (CMM, news, msgs) at the open.**

- **Sell short 75 shares of Kohl's (KSS, news, msgs) at the market.**

Preparing for more bad news
I'm selling my entire **Criimi Mae** (CMM, news, msgs) and **DiamondCluster International** (DTPI, news, msgs) positions at the market open.

A significant worsening in the commercial real estate market could undo the former, and on the latter, I am just taking advantage of a mindless bear-market rally in tech.

Also, I expect that DiamondCluster stock will not hold up well in the face of as-yet unannounced news of significant weakening in Europe. Its largest client there is **Ericsson** (ERICY, news, msgs), which is of course having some trouble. Word is that Ericsson's consultants are getting the ax, and DiamondCluster would be in that group.

I'll also short 75 shares of **Kohl's** (KSS, news, msgs) at the market. Same-store sales growth is cited widely as far and above the best in the industry. OK. But this growth overstates true organic growth. Sales per square foot has been tracking in the very low single digits. The company is turning to debt to finance the expansion, and Kohl's has been priced much too high for a while now.

Also, Kohl's has the same options-compensation problem that I have discussed previously with regard to technology stocks. Last year, nearly $270 million in options compensation was handed to employees, which largely dilutes much of last year's income.

Journal: April 13, 2001

- **Sell short 100 shares of General Electric (GE, news, msgs) at a limit of 44.**

- **Sell short 100 shares of Krispy Kreme (KREM, news, msgs) at a limit of 36.**

- **Buy 600 shares of Delphi Automotive (DPH, news, msgs) at a limit of 11.**

GE: bringing good things to earnings?
First, let me just re-emphasize that my trades here in fake-money land should not be followed verbatim. Yesterday I sold some shares of **Criimi Mae** (CMM, news, msgs) at the market open. The stock gapped down nearly 20% before rallying nearly 30%. Illiquid, low-priced stocks are subject to extreme swings. Because I often invest in such securities, I always use limit orders, and I never enter trades the night before in real life. I like to get a look at the market before I start maneuvering for a best-price execution. Here in Strategy Lab, I tend to be a little flippant with my trades – since they are often not securities in which I really have positions. Also, to write something up and never get executed – well, that has happened to me too much here, so I entered market orders

Similarly, I'd been meaning to put "short Kohl's" up here for at least a week or so. I finally got around to it -- and the timing was both fortuitous and unfortunate. The stock fell significantly at the open on an announcement that fits my thesis quite perfectly. Yet because I entered a market at open order, the trade executed on the gap down. Again, not something I would do in real life, but this isn't real life and market orders are often the best way not to waste words. Given the unfortunate results of my market orders in this forum, I will go back to potentially wasting words (and using limit orders).

Short 100 shares **General Electric** (GE, news, msgs) at 44 limit, good until cancelled. GE has been bringing good things to earnings for a long time now. Unfortunately, those earnings aren't what they are cracked up to be. Everybody knows this, but everybody lets it slide because those earnings are so danged consistent. What happens to these kinds of stocks when those earnings show any sign of strain? GE will bring every ounce of its substantial resources to manage earnings such that GE does not miss while Jack Welch is still in power. Yet the economy will hit GE, despite Jack Welch's claims to the contrary. The stock should be at least 50% cheaper. They overpaid for Honeywell, an acquisition which will prove to be quite unfortunate. And the fact that they have a retiring legend in the CEO spot, well, fairy tales are no good without the handsome prince.

Short 100 shares of **Krispy Kreme** (KREM, news, msgs) at 36 limit, good until cancelled. This is not Starbucks. No one is really addicted to these confections. Donuts are an expendable item coming out of at least semi-discretionary spending. But that's almost beside the point, and the point is not that Starbucks has had some difficulty creating shareholder value even with an addictive product and cool concept. No, the point is that Krispy Kreme's $17 million in net income pales next to its nearly $1 billion valuation. The net income also stopped navigating the cash flow statement during the last nine months. Free cash flow is in the single digits. And stock is being issued in abundance. There is a lock-up expiration to deal with. Oh, the list goes on and on.

And, to finish off the trades, buy **Delphi Automotive** (DPH, news, msgs) at 11 limit, good until cancelled. If this executes, I'll give reasons why.

Journal: April 17, 2001
Don't be distracted. Cisco is in far worse shape than even the dismal forecast it presents.

Hidden in Cisco's bad news, more bad news
Cisco Systems (CSCO, news, msgs) is writing off well over 60% of its inventory! They are trying to use the one-time write-off sneak-a-roo to great effect here. That is, "Hey, we've got bad news on the earnings front, so let's take billions in charges to write off all the parts of the business we know we managed poorly. And then let's say we'll actually be profitable this quarter before the charges!"

Do you buy it? I don't. This is a company that suffers from a tremendous lack of shareholder-orientation. A private company in the public domain, existing to take advantage of shareholders, not to benefit shareholders. While

John Chambers, the CEO, states that the hardest thing he has had to do is lay off these thousands of workers, well, that's only because he and his IR crew let only trusted "friendly" analysts in on the quarterly conference calls.

Let's look at what Cisco is doing:

- **Workforce reduction charge.** Cisco is taking at least a $300 million charge to lay off more than 8,500 people. That approaches one-quarter of the work force and tells us that this is not by any means a temporary lull in business. In fact, this tells us that Cisco really does not know whether or not the long-term growth rate can even approach 30%-50%, despite its assertions to the contrary. If Cisco really believed this, they would plan for it. And a 25% work-force reduction isn't planning for it.
- **Consolidation of excess facilities.** Here's another $500 million out the door and another sign that 30%-50% growth "long-term" is a pipedream. Cisco was to build a brand-spanking new campus about a mile and a half from my house here in south San Jose. Portions of it were supposed to be modeled after snooty Palo Alto's downtown area. Plans on hold indefinitely, now. Poor Cisco. They couldn't even build their very own trophy campus like all the other flash-in-the-pan never-can-fail growth stories got to do before they went bust. How unfair!
- **Asset impairment charges.** Bye-bye to $300 million or so. This is a goodwill write-off, which means, "We overpaid at least $300 million for acquisitions over the last few years." Honestly, this number seems low. Expect more where this came from -- only tremendous mind-over-matter denial is keeping Cisco from puking yet again and in greater volumes.

Oops, did I almost forget the $2.5 billion charge for inventory write-offs? Cisco would like me to, but Cisco's dreaming again. Read the press release: "Cisco expects to take a restructuring charge of $800 million to $1.2 billion" -- and then lists out the three components of the charge, as I did above. And then it puts an "also" in there. As in, "Oh, by the way, there's another $2.5 billion coming out of inventory, but don't pay too much attention to that."

That is over 60% of inventory vaporized with a simple charge. That is very real money out the door -- costs that Cisco experienced but will never recoup.

To put in more real terms, remember those $3.7 billion in profits Cisco said it earned over 1995-1998? Well, Cisco has gotten so big that it can now take a one-time charge to eliminate 1995-1998 from the record books. Impressive, huh?

Actually, it gets more impressive. If one accounts for the shareholder dilution from massive options compensation abuses, you could potentially add total income from 1991-1994 to the write-off.

Oh, numbers to warm a shareholder's heart...Now, we await the repricing of options, or shall I say, "sheer ecstasy waiting in the wings."

Journal: April 18, 2001
- **Hold all positions. Intel is much more difficult to tear apart than Cisco Systems, but I'll try.**

Deciphering Intel's news
Now it's Intel's turn. First thing one notices is that the press release is not structured to hide much. That's because **Intel** (INTC, news, msgs) beat its lowered guidance, and is indicating its microprocessor business has stabilized. No need to hide good news

And to be perfectly honest, Intel is much more difficult to tear apart than **Cisco Systems** (CSCO, news, msgs). The abuses are simply not as egregious. I'll give it a college try, however.

One big number that stands out is the $23.2 billion that Intel has spent since 1990 buying back shares. Pretty impressive. Unfortunately, there is roughly the same number of shares, adjusted for splits, outstanding now as back then. In fact, there may be even a few tens of millions more shares. Was that entire $23.2 billion diluted out of existence by options programs and stock issuances for employees and management under the GAAP table? Almost.

When the employee executes a $2 option and

turns around to sell the stock at $30, the company gets that $2 plus a tax benefit, both of which are offset by dilution of the common shareholder. Over the last decade, Intel has realized about $8 billion in cash inflows from these options exercises and from the associated tax benefits. So if the share count stays about even over the decade, the absolute dollar amount of dilution to shareholders is roughly $23 billion minus $8 billion, which equals $15 billion.

That $15 billion is only roughly one-third of the $46 billion in net income Intel reported from 1991-2000. Over the long-term, this is how much Intel's options compensation and stock compensation policies dilute shareholders, and hence a rule of thumb might be to dock Intel's reported earnings numbers by a about one-third when trying to figure out value. If Intel demonstrates a penchant for re-pricing -- a practice that is just sheer theft from shareholders, in my opinion -- then earnings get docked a lot more.

Another aspect of Intel's earnings reports is that it reports earnings before goodwill write-offs, amortization and in-process R&D charges. If you are going to add back goodwill charges to earnings, then you have to add back the goodwill amortization and charge-offs to the balance sheet. Intel charged off $660 million this past quarter, $1.7 billion in 2000, and $803 million in 1999. These are significant amounts of cash out the door. So while they are non-cash charges now, it is important to remember that all these charges are only money spent by Intel in the past finally making its way through the income statement.

I am a big fan of the proposal to eliminate the amortization of goodwill. Let the goodwill stay on the balance sheet for all to see. This way we can tell exactly how much money the company has wasted in the past by simply looking at what the company is earning now and looking at what the company has invested to get to the now. Goodwill amortization hides mistakes. When the goodwill amortization doesn't hide mistakes fast enough, you see extra charge-offs, as we saw with Cisco earlier this week. Shareholders should not want mistakes hidden.

As for inventory concerns, nowhere did you see in Intel's report anything close to the horrendous wipeout of 60%+ of inventory that Cisco reported the day before. Cisco wrote that inventory off and then said they expect to increase inventory turnover. I would hope so! All in all, that sort of big bath accounting/funny business is not in Intel's quarterly statement. It is clues like these that lead me to have much more trust in what Intel is telling me than what Cisco is telling me.

Not all is rosy in inventory-land at Intel, though. I see inventories jumped over 29% during the quarter even as revenues fell 23% sequentially. When you are in a business that sets the gold standard for planned obsolescence, such an inventory bloat is not generally good. It also hits operating cash flow. In fact, the $411 million jump in inventory nearly obliterates the $485 million in first quarter net income.

Last year, with business picking up, inventories jumped only 5.7%. Could there be an inventory writeoff in the future? Sure. In fact, we should expect it. But I don't expect Intel to claim anything about improving inventory turns when they do.

By the way, it was reported in the Bay Area that Intel would not build any more plants here due to the high costs of doing business. Smart. Cisco, meanwhile, was plowing ahead with plans for the new campus in my neighborhood. Not smart.

By and large, I don't think success went to the head of Intel as much as it did Cisco. And so it is not surprising that scathing commentary on Intel is not so easy to write as it was for Cisco. Companies that manage themselves to please some Wall Street bogey are bound to say and do stupid things when they can no longer please Wall Street.

But just because Intel is relatively better doesn't mean it is absolutely good. For the reasons given above, I do not believe that Intel's current valuation is justified, the after-hours 10% pop in the share price notwithstanding.

Journal: April 25, 2001

- **Cover short position in Standard Pacific (SPF,**

news, msgs) at 16.25 limit.

- **Place order to buy 1,000 shares of American Physicians Capital (ACAP, news, msgs) at 16.50 limit.**

- **Place order to buy 400 shares of IBP Inc . (IBP, news, msgs) at 15.25 limit.**

Two buys with upside to spare
Cover the entire **Standard Pacific** (SPF, news, msgs) short position at 16.25 limit, good until canceled. Earnings will be released after the close, and I cannot ask for much more from this short. If you remember, I started this short last round with an initial short around 30. I re-entered the short this round substantially in the low 20's. Now with the price flirting around book value, the stock no longer violates one of my most successful rules of thumb: Public homebuilders should not trade much above book value. Presently, Standard Pacific doesn't.

This is not a buy recommendation, though. I anticipate that Standard Pacific will warn going forward and that it may have to write down some of its book value. But certainly the easy money has been made on the short side, and hence it is time to cover.

Buy 1,000 shares of **American Physicians Capital** (ACAP, news, msgs) at 16.50 limit, good until canceled. A mutual insurance company that demutualized in an IPO this past December, American Physicians is a terribly cheap stock. Book value is north of 30 a share, and a share buyback will only increase the per share book value. The company underwrites low-limit medical malpractice policies as well as some workers compensation insurance. The ratios are headed in the right direction, and the company is quite profitable as well as tremendously overcapitalized. At the very least, this stock should be trading at a more modest discount to book value.

Buy 400 shares of **IBP Inc.** (IBP, news, msgs) at the 15.25 limit, good until canceled. IBP is the gargantuan $17 billion sales beef and pork processor. After a bidding war that involved a management group and **Smithfield Foods** (SFD, news, msgs), Tyson won the right to buy IBP for 30 a share. Tyson Foods got heat from its shareholders over straying so drastically from chicken. After all, many portfolio managers had bought Tyson as one to benefit from the mad cow scare, not as one to suffer from it. In any case Tyson found a reason to back out and did. So IBP has fallen all the way down to 15 -- half the winning buyout offer and at about 65% of the initial buyout offer from the management group. IBP is no great shakes in terms of its business economics, but it is worth substantially more than 15 a share. In time, I expect Smithfield to make a substantially reduced offer at a substantial premium to the current price. The downside here is fairly limited.

Journal: April 27, 2001

- **Place a buy stop on previous position in Krispy Kreme (KREM, news, msgs) at 46, good until canceled.**

- **Place a buy stop on previous position in Standard Pacific (SPF, news, msgs) at 22, good until canceled.**

- **Place a buy stop on previous position in Kohl's (KSS, news, msgs) at 62, good until canceled.**

- **Place a buy stop on the previous position in General Electric (GE, news, msgs) at 51, good until canceled.**

- **Place order to sell 1,500 shares of ValueClick (VCLK, news, msgs) at 4 limit, good until canceled.**

When things go wrong
Considering I've had four shorts go the wrong way lately, I can't be too upset with my position in the Strategy Lab. Shorting things like **GE** (GE, news, msgs), **Krispy Kreme** (KREM, news, msgs) and **Kohl's** (KSS, news, msgs) in the face of one of the fiercest bear market rallies in history could have left me in much worse shape

As it is, I tried to get out of my **Standard Pacific** (SPF, news, msgs) short before they released results. I anticipated a typically promotional press release, and got it. Earnings, revenue, backlog all up. Unfortunately, so are inventories -- well in excess of sales -- and debt, and cash is way down.

No cash flow statement provided. And just as unfortunately, no sooner did I enter my order than it rallied 21% in two days on short covering – gapping its way out of reach of my limit order. An example of a limit order working out the wrong way. I would much rather have covered earlier, but with no opportunity to alter the order in the wake of the new housing numbers -- we're on a 24 hour delay here -- it wasn't possible. I'll put in a buy stop at 22, good until canceled.

The Kohl's short, a position I entered on a market order that went off quite badly, has been similarly unfortunate. My thesis remains intact there. I will put a buy stop at 62, good until canceled, however. No need to lose my shirt if the market goes haywire to the upside. Kohl's is a great short at 62, but it's also a better short at 70. No need to lose 8 on the way to the better short.

General Electric is a stock I am convinced will trade substantially lower in the wake of Jack Welch's retirement and the Honeywell acquisition. Its collective powers to manage earnings are considerable, but a slowing economy will showcase GE's weaknesses. Notably, absent the 110% surge in profit at GE Power, GE would have shown a 25% decline in operating profit this past quarter. Those kinds of surges will not be an ongoing event at GE Power. At this point, given its recent strength and tendency to rally hard with the market, I will place a buy stop on the position at 51, good until canceled.

Krispy Kreme trades in a manner decoupled from any reasonable fundamental valuation, much like the internet stocks of 1999-2000. In such cases, the stock floats on sentiment alone. My thesis remains intact -- the stock is worth at best 1/3 current levels, and eventually sentiment will correct its error. Actually, I'm being generous – 1/3 current levels approximates the IPO price, which was surely a bit high. In the interim, there can certainly be wild swings to the upside as shorts rush to cover on any change in general market sentiment, as has happened recently. Hence the stock has tremendous short-term upside risk. Given that Strategy Lab is a short-term activity and the current trend seems to be higher, I'll place a buy stop at 46, good until canceled.

In real life, I never enter market orders, nor do I enter limit orders with good until canceled features. I look at stocks I want to buy and short, set target prices, and watch the market action -- along with my trader -- for the best price in light of market conditions and recent news. When I attack, I attack with intraday limit orders. But such orders are not practical here. I've had a few fits and starts here in Strategy Lab trying to find the optimum mix of market orders and limit orders, and I'm not sure I've found a satisfactory method yet in light of the delay. As a practical matter, the amount of control I have in real life will never be attainable here in Strategy Lab, so I must make do. Attempting to cover a housing short with a limit order the night before national new homes data is released is not a good way to go about things. Noted.

ValueClick is a good example. Today **ValueClick** (VCLK, news, msgs) releases earnings, and a good part of my decision on what to do with that position will depend on what the earnings release reveals – and especially how the balance sheet looks, since this is to a large degree an asset play. I figure the stock is worth at least 4.30 as a stand-alone entity accounting for recent share dilution. To a strategic buyer like **DoubleClick** (DCLK, news, msgs), ValueClick could be worth much more. But without knowing what today's news will reveal, I'll make a conservative move that will likely result in a non-event. Sell 1,500 shares of ValueClick at 4 limit, good until canceled.

I had previously bought stock in **DiamondCluster** (DTPI, news, msgs) this round at 14 per share or so (and subsequently offloaded it at 10 or so, thinking I could buy it back cheaper later). My thesis was that DiamondCluster was worth about twice the price I paid and would make a nice acquisition. In that same entry, I brought up **Proxicom** (PXCM, news, msgs) as an alternative to DiamondCluster. Yesterday, **Compaq Computer** (CPQ, news, msgs) announced it was buying Proxicom for 5.75 per share cash. Normalizing various multiples over to DiamondCluster based on this new standard for valuing e-business consultants, and adjusting for the higher margins and better cash production at DiamondCluster, one finds DiamondCluster to be worth about 21.50.

This is a bit lower than my original estimate of value, and no doubt reflects the distressed future facing many of these firms as stand-alone entities. DiamondCluster had the best shot, in my opinion, of remaining profitably independent, and because of this it might deserve a higher valuation. As for the opportunity to buy DiamondCluster back cheaper later, I doubt that opportunity will occur now. No investor has a 1.000 batting average, but every mistake deserves scrutiny and this one will get it.

I will note that it seems likely that there was a leak in the Proxicom deal with Compaq. Proxicom stock has been leaping in a manner out of proportion to its brethren in the industry-over two days late last week the stock jumped 158%. That was about the time this deal was probably starting to come together. Hence, someone knew something -- and many people traded on that knowledge, since volume was up to five times higher than normal. Security regulators will probably never investigate, but investors should be outraged at this transfer of wealth based on what looks on the surface to be inside information.

Journal: May 23, 2001

- **Place order to buy 700 shares of Wellsford Real Properties (WRP, news, msgs) at 16.40 limit, order good until canceled.**

A cheap piece of real estate

I waited a few days to post this here, and so this stock has run up a bit. The phrase "cheapest piece of real estate on the stock exchange" is bandied about quite frequently, so I won't use that hyperbole here. Nevertheless, I can make a good case for net real asset value here over $30/share, and it has been basing around $16 for the last four years

What has changed is that **Wellsford Real Properties** (WRP, news, msgs) is liquidating its most visible investment -- a joint venture with Goldman Sachs. This joint venture specialized in rehabilitating office buildings -- turnarounds. So the book value underestimates true asset value. A recent sale went for a 25% premium to book value.

The chairman of this New York real estate investment trust is dedicated to buying back stock, and the company has retired 20% of its shares in the past two years. Wellsford invests in commercial real estate mostly around the Northeast.

But at this point, I've let others do the waiting for me long enough. Time to take a position.

Journal: May 30, 2001

- **Sell the entire ValueClick (VCLK, news, msgs) position at a limit of 3.20.**

- **Increase the limit buy price on Wellsford Real Properties (WRP, news, msgs) to 16.45.**

Watch for return to April lows and lower

The last few trading days notwithstanding, chances are that you feel as if every stock you look at has moved up recently. You would be correct in that feeling. The recent rally has been incredibly broad, with over 80% of NYSE stocks participating almost regardless of market cap or sector. The problem is, very few people actually bought the April lows. Hence, chances are you have also watched several of your favorite or most wanted stocks creep (or leap) steadily upward without you. It's a fateful and frustrating experience, no doubt. But it does give some insight into what professional managers are feeling

Yes, the phenomenon is no different for professional investors -- they missed the early April lows en masse and have had to deal with tremendous lags in performance ever since. The difference? Professionals by and large were not fully invested when the turn came, while the indices by definition were. You have seen the results of this phenomenon here in the Strategy Lab, where all the players received $100,000 as the market entered one of the steepest four-week dives in history only to rebound within two and a half weeks of hitting its lows.

Of course, with each passing day of the rally, a few (hundred) more institutional holdouts crossed the line and started buying. After all, mutual fund investors never did pull money out of mutual funds altogether. It went to the money market funds, not to the mattresses. That money

came rushing back with the ease of a click or a phone call, compounding the cash-on-hand problem. Hence, we got a "can't miss" rally, as in "can't miss the next bull market." Yet, the indices inched achingly ahead of the institutions' performance nonetheless. Which of course begets even fiercer buying. The aggressive ones are using leverage, if they are able, to catch up.

I can only conclude that it is quite possible we have not yet seen the bottom. Speculative booms like the 1920s and the 1960s were followed not only by steep stock declines, but also by stocks falling to absurd values. The aftermath of the speculative boom of the 1990s has seen ostensibly severe stock declines, but never during the April lows did I find stocks, generally speaking, go on sale. There was no sale in tech, but neither was there a sale in the financials, consumer products companies, cyclicals, etc. Gilt-edged brand names like **Coca-Cola** (KO, news, msgs) and **Gillette** (G, news, msgs) have seen their valuations reduced slightly, but they remain quite highly priced.

Indeed, by my calculations -- taking into account the massive corporate governance abuses borne of the bull market -- many of the biggest tech names and some of the biggest non-tech names that did fall fell only to fair value at worst. No fire sale in a fundamental sense at all. What is fair value? I use an annual 10% return to shareholders after dilution, slings and arrows.

Conventional wisdom says that either we've seen the bottom, or that there will be one more leg down, creating a W-shaped bottom. It is possible, even likely, that conventional wisdom will be proven wrong, and that the only alternative to these two options will instead occur. That is, the April lows will not only be tested, but pierced.

Bull markets: gifts that keep on giving
This is not a common viewpoint, but you shouldn't expect it to be. Such a viewpoint would imply we don't know where or when the bottom will be hit. But surely, "I don't know" does not sell. It doesn't sell advertising, generate commissions, generate deals or attract investors.

Thus, everyone from CNBC to any broker, sell-side analyst, market maven or personal finance magazine has a vested interest in advancing confident-sounding market prognostication. And the bias, of course, is for a bull market, not a bear. Bull markets are simply the gifts that keep on giving.

Meanwhile, several if not most CEOs of our greatest corporations are by and large blowing the proverbial sunshine...well, you get the idea. To the degree they can attempt to talk consumer confidence and capital spending up, they will all do their darndest. After all, when Jack Welch speaks, people listen. No matter that he's simply cheerleading his own exit. Think of management as a car salesman desperate to please. It's an overreaching metaphor, but it puts one in the correct defensive mind frame when listening to such charismatic characters. It is quite likely that the glimmers of hope we are hearing from such sources are simply just that -- glimmers, easily explained away in the future as never having been certain in the past.

So, I will go on record right now as saying that this is a time of tremendous uncertainty about market direction -- but no more so than at any time in the past. I continue to believe the prudent view is no market view. Rather, I will remain content in the certainty that popular predictions are less likely to come to pass than is believed and that absurd individual stock values will come along every once in a while regardless of what the market does.

Trade updates
I'm moving the limit price on my outstanding order to sell the **ValueClick** (VCLK, news, msgs) position down to 3.20. This stock was a case of good assets, bad business, bad management. The result was certainly predictable, and hence this was a mistake on my part. By and large I was looking for a fluctuation upward to net asset value. Looking at this conservatively, that's where we are now. The target came down to meet us, and hence it is time to minimize the impact of this trade to a small loss.

I will also raise the limit a nickel on the **Wellsford Real Properties** (WRP, news, msgs) buy. The limit buy price should now be 16.45.

Journal: June 13, 2001
- **Place order to sell 500 shares of American**

Physicians Capital (ACAP, news, msgs) at a limit of 20.40.

• Place order to buy 900 shares of Cascade Corp. (CAE, news, msgs) at 9.00 limit.

• Increase the limit buy price on Wellsford Real Properties (WRP, news, msgs) to 16.45; change order to 600 shares.

A nickel between me and break-even
Still pushing to get back to break-even. I'd have achieved that goal by now if I had been a nickel more generous with my limit buy on **Wellsford Real Properties** (WRP, news, msgs). Wellsford just bought back 24% of its shares at a huge discount to intrinsic value. Hence, intrinsic value per share just jumped at least $3 per share. The shares moved up to reflect this accretive action by management, but now they're soft again. It's not often that I'll raise my initial buy price on a stock (usually, I let missed opportunities be), but in this case 18.50 now is cheaper than 16.45 was back before the buyback. Increase the limit buy price on Wellsford to 18.50, but reduce the number of shares to 600.

Also, sell 500 shares of the **American Physicians Capital** (ACAP, news, msgs) position at 20.40 limit, good until canceled. I took advantage of a no-brainer price when I took such a large position, but at this price I'll scale it back to a still large but more average-sized position. I continue to be quite bullish on American Physicians, with the biggest risk being a dumb acquisition by management.

Back to basics
With only a couple of months until the end of Strategy Lab, I have to say I'm quite disappointed with my performance thus far. As I did during my first Strategy Lab last round, I kicked off the round buying several stocks that possessed a lot of short-term price risk. Optimism (associated with the beginning of a new round) and a wad of cash (fake, granted by MSN MoneyCentral) make for toxic twins in the world of investing. I should have been smarter, even if it is only fake money. And once having bought such securities with near-term price risk, I should never have sold them simply because they fell in the near term. Had I simply held all the stocks I bought this round rather than selling some of them, I'd be much better off. This was largely true last round as well. Ok, two strikes. Will MoneyCentral give me a third chance?

It is not in my nature to scramble for excess short-term return by taking on extra risk. Hence, you will not see me take massive stock positions or leveraged options positions simply to try to shoot the lights out in these last few months. As I did last round, I'll try to recover by going back to basics.

Start off with a new order to buy 900 shares of **Cascade Corp.** (CAE, news, msgs) at 9.00 limit, good until canceled. Cascade, a maker of forklift parts with significant branding and market share, was the subject of a management-led buyout offer earlier this spring. The offer put Cascade in play, and after a well-run bidding process that included more than 10 parties, an outside group offered to buy the company out for 17.25. Management came back with a late 17.50 offer that was properly rejected by the board.

The buyout fell through when the outside group encountered some skittishness on the part of lenders. Not surprising; several deals have been scuttled because of weak debt markets. What is surprising is that there was a final offer from the group -- $15.75 a share -- that was rejected by the board as well. In other words, a leveraged buyout can be done at prices 50% to 100% greater than the current price, and sharks are circling.

Recently **CB Richard Ellis'** (CBG, news, msgs) going-private transaction got a shot in the arm when it successfully placed junk debt in an oversubscribed offering. This is a good sign that with lower interest rates offsetting the economic risk, the junk markets are attempting a comeback. I expect Cascade to be taken out in a reasonable time frame. This illiquid stock, which was transferred from the hands of long-term owners to arbitrageurs during the bidding process, was unceremoniously dumped by those arbitrageurs when the deal fell apart. Now approaching half the price bid just a few months ago, the shares of this old economy diehard appear a bargain at 4.3 times trailing nonpeak EBITDA (earnings before interest, taxes, depreciation and amortization) with significant free cash production. The stock is

at about three times peak EBITDA. No doubt the company faces rougher economic times ahead, but with a trio of bidders willing to pay over $16 a share just a few months ago, there is a margin of safety here.

Journal: June 20, 2001

- **Sell the entire position in IBP Inc. (IBP, news, msgs) at the market.**

Taking the easy trade

Buy stocks cheap enough and the news is bound to be good. As the deal for **Tyson Foods** (TSN, news, msgs) to buy **IBP Inc.** (IBP, news, msgs) blew up in late April and went to the courts, IBP stock fell to around $15, despite the fact that competitive bidding for the company less than six months earlier had priced the company at $30 to $32 a share. Moreover, $15 represented a 50% gain back to the $22.50 price at which a management-led group had offered to buy the company. And finally, $15 meant that if the deal went through as planned -- roughly 50% stock, 50% cash -- then you were getting Tyson stock for free. If the deal did not go through, one was getting a significant cash-generating business at less than book value. In short, at $15, one could argue that any news was going to be good news

IBP won its fight to have the merger agreement stand, and so now I sit on appreciated shares of IBP. If Tyson's current share price holds and the previously negotiated merger agreement stands, then IBP will be bought for a sum total of about $25.40 per share. IBP closed at $23.52 Tuesday.

So the natural question is, "What now?"

Risk arbitrageurs would now buy IBP stock and short a pro rata amount of Tyson stock in an effort to obtain the difference between that $25.40 and the $23.52. That's an 8% spread, which, if realized in a reasonable time frame, represents a good return. Risks for these arbitrageurs include that the deal price is reduced or that the deal does not pass antitrust muster. In such a case, Tyson's stock would rise and IBP's would fall. On the arbitrageurs' side is a court order mandating Tyson do the deal and Tyson's statement that it would not likely appeal.

I am not a risk arbitrageur. I believe that risk arbitrage is a quite overcapitalized field and, by and large, not currently a very profitable endeavor unless one has significant access to borderline inside information. Because there are only a few months left in this round of Strategy Lab, the only logical option for me is to sell IBP now and take the gain.

Those with a longer-term horizon could make a good argument for holding onto IBP and taking delivery of the $15 per share plus Tyson stock when the deal closes. Indeed, selling IBP now is equivalent to selling the Tyson stock at $7.16 per share before even receiving it. The key to remember is that the value of the deal is not the same thing as the short-term compensation to be received by IBP shareholders. That is, the value of Tyson stock is not necessarily that which the market is now quoting, as the stock is under intense short pressure from risk arbitrageurs. Longer-term holders who feel they can correctly judge the underlying value of Tyson stock as possibly $11 or greater would find the implied price of the Tyson shares embedded in their current IBP stock to be quite a bargain.

With respect to IBP, I'm a bit late here in Strategy Lab -- the news was announced Friday after the deadline for submissions for Monday trades. Making myself even more late, I did not submit an entry on Monday. Hence, my "automatic sell" of IBP is on time-delay and it has cost me a buck or so. Two days late and maybe a buck and a half short.

Journal: June 22, 2001

- **Sell the entire Grubb & Ellis (GBE, news, msgs) position at a 6.25 limit, good until cancelled.**

How to get even

An outsider might think find investors' thinking odd. Presented with new money to invest, most set goals of growing that money. They set targets of 20%, 30% or sometimes much more. And they set off fully intending to do so. Not so odd, yet.

However, once having lost money, investors tend to set a seemingly conservative new goal: breakeven. The irony is that breakeven math is one of life's crueler realities. That is, breakeven requires a percentage gain in excess of the percentage loss incurred. Not so conservative.

Moreover, losses are the ultimate slippery slope. If one has lost 20%, then one requires a 25% gain to break even. If one has lost 50%, one requires a 100% gain to break even.

As a result, the goal of breakeven is often much more aggressive than one's initial investment assumption. In an attempt to get back to breakeven, most investors simply ratchet up the risks they take. Of course this usually just ratchets up the losses – and increases the required return back to even. Talk about a death spiral.

My experience is that when one has losses that look other than temporary, there is usually a reason. The appropriate corrective action is to investigate the reason for the loss. More often than not, I find that I have strayed from the consistent method of investment that has served me so well for so long. Indeed, this finding often needs no investigation – I knew at the onset of the investment operation that I was straying, yet foolishly plowed ahead anyway.

All investors stumble. Usually some stubborn insistence plays a role. But fools will not be suffered lightly in a bear market. The risk of ruin is real. As investors, we must continually guard against the missteps that might lead to losses – and react rationally if we find ourselves down. Acting like a fool after the fact will only compound the error.

Portfolio updates
Senior Housing (SNH, news, msgs) is acting beautifully and pays a nice dividend. I would not be a buyer here, and I do not expect fireworks for the remainder of the round. The stock was a steal at 10 or below, and fair value is between 15 and 17. The upper end of that range may be reached as the payment situation in senior living improves even more. The dividend certainly enhances the return for long-term holders.

Huttig Building Products (HBP, news, msgs) remains significantly undervalued. I value this stock north of 10. $30 million could be squeezed out of the real estate acquired from Rugby (and on the books for nearly zero) by just rearranging some properties. I continue to anticipate a buyout or some other value-realizing activity, as this is a company that does not need to be public.

American Physicians (ACAP, news, msgs) was a no-brainer at 13.50, which is the price at which it demutualized last fall. Below 17, I'm a buyer. This company is overcapitalized with tons of excess cash and hence I view the move from 17 to 20 as more of a move from 5 to 8. That's why I'm willing to reduce the size of this hefty position in the 20.50 range. The biggest risk is that management carries out a dumb acquisition. Tremendous value could be created by just buying back the shares, which carry an intrinsic value north of 26.

Grubb & Ellis (GBE, news, msgs) under 5 is a decent buy, but there are structural ownership issues that limit the upside. Meanwhile, a new CEO has taken over and will want to make a mark even as the commercial real estate industry is entering a funk. I continue to believe that my long-term downside risk is that the company gets bought at a 40% premium to what I paid. In the near-term, this illiquid stock can bounce quite low. But I won't worry about that. Last quarter, some big institutional investors dressed up the stock at the end of the quarter in order to enhance their returns. That may happen again. In anticipation, I'll enter an order to sell the entire position at 6.25 limit, good until cancelled.

GTSI (GTSI, news, msgs) is prepping a blowout for last half of the year. Operational changes and a couple of contract wins have boosted business at this government technology products distributor, which sells at a multiple of around 5 on this year's earnings. The business is much less cyclical than the stock price, which bounces around a lot. The stock is finding its way into stronger hands, however. I believe the stock is worth at least 8 and probably more.

So that's it. With my previous sale of **IBP** (IBP, news, msgs), I have only five positions left. When I sell half of the American Physicians position, another slot will be open. I am being patient for the end-of-quarter selling that often occurs in downtrodden names as institutions rush to window dress their portfolios. In the meantime, my standing order to buy **Wellsford Real Properties** (WRP, news, msgs) at $18.50 might execute.

Journal: August 10, 2001

• Buy 1000 shares of Mesaba Holdings (MAIR, news, msgs) at 8.80 limit, good until canceled.

To own or not to own Cisco

Cisco Systems, market capitalization $141 billion, reported combined earnings for the last two years of $1.66 billion, and it is uncertain how or when Cisco will grow again. Moreover, it is possible and maybe probable that Cisco will write off $1.66 billion as a one-time charge sometime in the next few years. As usual, details regarding Cisco's options compensation programs are scarce.

So, which is the bigger risk: owning Cisco or not owning Cisco? One need not be short Cisco to experience the risk of not owning Cisco. For professionals, performance is benchmarked. That is, performance is relative. In the relative performance game, one is effectively short every stock not in one's portfolio that is nevertheless a part of the benchmark. To illustrate, a 100% cash position benchmarked against the S&P 500 Index is 100% short the index in the relative performance game. If the S&P 500 rises 10%, then in the relative performance arena the cash portfolio is down 10%. This is how Wall Street works.

So who in their right mind would short Cisco now? Virtually no one. Despite mustering every ounce of confidence possible, most analysts, portfolio managers, economists and corporate executives have no clue as to when either the economy or Cisco will again rebound. And on the off chance that the rebound occurs next month, well, better not be short Cisco.

What we have here is greed overruling fear, despite the fact that for a financial buyer -- a buyer that does not think strategically but rather thinks in terms of pure proven cash flows -- the public stock market offers precious few opportunities. And almost none of them are in big caps. Cisco does not qualify. I have given some reasons why in previous journal entries.

This lack of value should be troubling to thoughtful investors. Tremendous liquidity continues to grace the stock market. Hence, when investors flee from growth, they rush to value. Any big publicly traded company with a low price/earnings ratio or low price/book ratio and without obvious warts has seen its stock have a big run recently. Indeed, the bull run for value that started last fall has continued right up into the present. Now, however, most stocks are at least fairly valued. I would argue most remain overvalued.

Given the current valuation scenario across the market -- and evident in my daily reviews of anything and everything that looks either undervalued or overvalued -- investors would do well to start replacing fear of missing a rally with fear of further capital loss. Before the bear goes back into hibernation, the time will come when fear overrules greed. We are not there yet. Though we may soon be.

With little doubt, this round has been a disappointment. Now that I'm a short-timer, it seems hazardous to enter a position now, knowing that it is only a guess where the price will be in a few weeks when the totals are recorded for eternity. Nevertheless, the spirit of the Strategy Lab is not to remain idle. So here goes.

Hoping for a Mesaba takeoff

Buy 1000 shares of **Mesaba Holdings** (MAIR, news, msgs) at 8.80 limit, good until cancelled. Mesaba is a regional airline that was recently dumped at the altar by Northwest, which is also minority shareholder in Mesaba. Mesaba's primary business is to be an operator in the Northwest Airlink system.

Mesaba is the cheapest domestic airline. It gets paid by the capacity it makes available rather than the number of passengers it carries. It also has a favorable long-term fuel contract that buffers it from fuel cost fluctuations. Currently, one of its largest cost centers is the training of pilots. That will become less of an issue when Mesaba opens its new domestic pilot training center inside of a year from now.

The other potential catalyst is the winning of additional routes and jets from Northwest. Mesaba primarily competes with Express Air, a wholly owned subsidiary of Northwest. Therefore it follows that Mesaba will not get the majority of the new business from the recently announced

large purchase of regional jets by Northwest. It is this lack of near-term growth that really turns off most analysts.

Mesaba will get some of those routes, however, and growth isn't terribly necessary given the valuation. With approximately $5 a share in cash, no debt and $2.31 a share in trailing EBITDA, $9 seems a cheap price for the stock. And it is. Book value per share checks in at around $8, and it is growing at a nice clip. A rational valuation is probably in the mid-teens, all aspects of this investment considered. Northwest turned away from buying Mesaba at $13 after an industry pilot strike resolution made the deal unfavorable for Northwest. Nevertheless, Northwest was not the only company interested in buying Mesaba. Last fall, another airline group made an inquiry to the board regarding purchasing the company and was rebuffed in favor of the Northwest deal.

If one looks at the valuations accorded peers such as **Mesa Air** (MESA, news, msgs), **SkyWest** (SKYW, news, msgs), and **Atlantic Coast Airlines** (ACAI, news, msgs) and adjusts for the lease structure at each, one would find Mesaba worth $16 a share or more. For now, it is just an illiquid stock knocked down by arbitrageurs rushing for the exits after the Northwest deal blew up. It has yet to recover, and it probably won't recover within the next month. Near-term downside may be as much as 12% to 15%, but such downside would be far from permanent.

Journal: Dec. 3, 2001

- **Don't worry about indexes. Worry about your stocks.**

Brace for yet another new paradigm
Welcome to Round 7 of Strategy Lab. The strategy entry pieces together outtakes from the quarterly letters I write to Scion Capital's investors

The cumulative return of my picks over the previous two discontinuous rounds has been just over 23%. Over the same 14-month span, the S&P 500 ($INX) returned a cumulative -22%, and the Nasdaq ($COMPX) returned a cumulative -58%. While the relative performance looks respectable, I am not happy with the absolute performance. It is not generally true that my portfolios correlate with the various indices anyway, and I know I could have done better with my stock picking here within Strategy Lab. Last round's performance was particularly harmed by my special situation airline and hotel holdings. I will attempt to do better here this round.

A good friend and portfolio manager recently related a conversation he had with a sell-side analyst. "Never in history have we seen interest rate cuts like this," the analyst waxed, surely prophetic in his own mind, "and not seen the economy and the stock market recover quickly."

My friend's response? "Unless you're Japanese."

You never see a bubble until it pops
The standard argument against a Japan 2000 scenario here in the United States is that we never had the real estate bubble like Japan did. For us it was just stocks. Or so the story goes. Of course, most people don't recognize bubbles until they've burst, while precious few seem quite capable of recognizing asset bubbles even while they are still intact. Good portfolio managers -- of which there are precious few, by no small coincidence -- belong to the latter camp. And good portfolio managers ought realize that the U.S. real estate bubble is simply not yet popped.

Another standard argument against a prolonged recession or depression is that the U.S. markets are freer, allowing quicker adjustments. However, if by adjustments, such pundits mean hurricane-force layoffs, greased-lightning monetary policy and the great disappearing act that is the federal budget surplus, I am at a loss. After all, none of this will change the fact that the economy is mired in a sea of stranded costs -- courtesy of about five years of moronic capital investment strategies. The country simply neither wants nor needs much more of what additional capital investment might produce. After all, when was the last time a new computer actually seemed faster than the old computer?

Moreover, there is a downside to a low interest rate policy in a nation of ever-expanding seniors. That is, lower rates mean lower income for the growing fixed-income population. Which means less spending if not crisis in certain quarters. Unlike stimulation of capital investment, this

consequence of lower interest rates is both certain to occur and generally ignored. I have already had several of my own investors inquire as to sources of higher yield.

The yield chase

The need for yield has been apparent in the new issue bond markets of late. The **Ford** (F, news, msgs) deal was doubled in size even as Ford made it clear that the company would be lending out at 0% that which it borrows. Stocks don't pay dividends anymore, savings and money market accounts yield too little. The remaining option is bonds. To the degree the need for yield results in a mass panic for yield, however, the consequences will be dire. While earnings yields on equities are commonly mispriced, bond yields are much less commonly mispriced. So what is my recommendation to those who approach me in search of higher yields? Caveat emptor. In other words, work hard not to be seduced when a too-good-to-be-true higher yield investment comes along.

Moreover, should deflation become a factor, the tremendous debt burden under which many U.S. companies and consumers operate will become much more of a burden, even as consumers hold off on consumption as they wait for lower prices.

Paradigms are continually turned upon their heads. This how the United States as a country progresses. We ought brace for yet another new paradigm -- one that few if any pundits including me -- can predict. Regardless of what the future holds, intelligent investment in common stocks offer a solid route for a reasonable return on investment going forward. When I say this, I do not mean that the S&P 500, the Nasdaq Composite or the market broadly defined will necessarily do well. In fact, I leave the dogma on market direction to others. What I rather expect is that the out-of-favor and sometimes obscure common stock situations in which I choose to invest ought to do well. They will not generally track the market, but I view this as a favorable characteristic.

Journal: Dec. 14, 2001

- **Don't worry about missing a rally. Worry about losing your money.**

Why I'm all cash – for now

Cash seems quite conservative, quite boring. Yet the typical professional investor finds cash a little too hot to handle, and therefore high cash balances become the too-frequent prelude to forced investments and poor results. As this round started, the market roared ahead before most of us Strategy Lab players had acquainted ourselves. Indeed, the market was just continuing a massive rally from September lows. And then there we were, each with $100,000 cash. Absent the ability to short or use options, I chose, as a strategic decision, not to invest the cash, and I continue to choose not to invest the cash. This is by no means a permanent decision.

continue to avoid forecasting either market or economic direction. Rather, I simply attempt to keep both eyes and mind open to the inputs that influence the prevailing market environment. I use any resulting insights to help target areas of potentially lucrative investment. Currently, I am finding most opportunity in investments that would not be appropriate for posting here in Strategy Lab. Below, I describe my view of the current investing environment.

The equity ethic continues to circumscribe American investment philosophy. That is, America's taste for stocks is not yet diminished, and tremendous cash liquidity exists, ready to race to the next hot or quality or safe sector. Yet some basics of investing go unhindered, not the least of which is valuation.

When I speak of overvaluation, I do not refer to aggregate price-to-earnings ratios. Rather, I survey common stocks across all market capitalization ranges and find that the market continues to find ignorance bliss. That is, off-balance sheet and off-income statement items are ignored even as complex pro forma accounting obscures on-balance sheet and on-income statement items. Insider related-party dealings, despicable corporate governance and other such issues continue to take a back seat to an intense focus on expected growth rates. Greed continues to conquer fear.

Don't try to dig your way out

A key phenomenon driving the recent stock

market advance is the need for so many fund managers to catch up. Having had discouraging years through the end of September, many professional investors took on increased risk in order to dig themselves out of a hole. I warned against this tendency during the last Strategy Lab round. The math of investing requires a 50% gain to wipe out a 33% loss, and the only catch-up tool most professional investors have at their disposal is to take on increased risk.

Moreover, the year-end represents a nail-biting finish to a very grand one-year performance derby. The winners of the derby reap massive rewards. For most, missing a year-end rally would be fatal to such aspirations. Hence, just as happened twice earlier this year, Wall Street has climbed the wrong wall of fear; the common fear has been of missing the next bull market, not of further stock market losses. Fundamental valuations have been cast aside in the scramble. And once again, in the short run, mob rules.

One argument that has been used to sell and to sustain this rally as the real thing is the idea that the stock market rallies 25% or so 4-6 months in advance of an economic recovery. Therefore, as a rally reaches those proportions, predictions of a recovery 4-6 months out become ever more confident and full of bluster. Yet, to borrow a phrasing, the market has predicted two of the last zero economic recoveries in 2001 alone! Circular logic remains an oxymoron.

Of course, even if we have economic stabilization or recovery, it would be wrong to assume that this would be a boon for stocks in general. Indeed, for most investors, it would be better to watch interest rates. Interest rate changes become more significant in stock valuation when valuations are very high. That is, investment in a stock with a price/cash earnings multiple of 25 will be much more sensitive to interest rates than investment in a stock with a price/cash earnings multiple of 5. Rising rates paired to a richly valued stock market ought not result in a significant new bull market, despite an expanding economy. To put this in other terms, most widely held stocks have already (over)priced in a substantial economic and earnings recovery – even as they sit far below their highs of yesteryear.

Contrary to the somewhat absurd notion that all we have to really fear is missing a rally, I truly only fear permanent and absolute capital loss. Over the course of this round, I will place my investments as very good opportunities arise.

Journal: Dec. 28, 2001

- **Short 100 shares of Magma Design Automation (LAVA, news, msgs) at $29.50 or higher.**

Magma is one of a handful of companies that supply the semiconductor industry with the software to design semiconductor chips. Two other 2001 IPOs in this industry have performed decently.

Magma also has the meteoric price rise, up over 120% from its offering price. The stock has broken free from any rational valuation and now seems to go up simply because it is going up. And the offering price of $13 was a heck of a stretch in the first place.

True to its heritage, Magma’s appeal suffers when one peeks under the hood. Here are the basics, culled from the company’s own prospectus, news coverage and my own due diligence, including conversations with top management and insiders in the industry.

The company is not profitable. In fact, it has been losing tens of millions of dollars a year. Earlier this year, Magma laid off a significant portion of its workforce even as several of its competitors were doing very good, even record, business.

Also earlier this year, after filing in May for a public offering, the company found itself the subject of intense criticism as industry pundits noted that the filing revealed Magma’s precarious financial position. The filing also helped heave doubt on the veracity of Magma’s prior claims as to the size of its backlog and market share. This followed reports that Magma had been actively shopping itself to its four biggest competitors in the electronic design automation industry and that all had said no

quite quickly. The IPO was thus delayed.

The delay created stress on the cash-hungry business, and in August Magma required a bridge loan of $25 million for working capital. The interesting terms of this loan included giving the creditor the right to convert the loan into stock at 67% of the IPO offering price. Indeed, this is what ended up happening, as Magma went public amid renewed investor appetite for risk on Nov. 20.

Primping for the public

What did Magma itself do to spruce up for its debut? Plenty, its filings show, and it is not pretty. First, starting in April, Magma imposed on its sales staff new rules: Commissions would no longer be paid upon the initial sale, but rather would be paid in installments over time. By spreading out the commissions expense, Magma delays cash outflows as well as near-term expenses.

While Magma acted to make expenses appear less than they really are, it also acted to make revenues appear greater than they really are. During the quarter ending Sept. 30, the company changed its sales model to emphasize perpetual sales over subscription sales. This has the effect of allowing greater revenue recognition in the near term at expense of revenue recognition down the road.

The net result of these two actions was to delay short-run expenses while boosting short-run revenue. The company also acted to beautify the cash-flow statement, reducing the capital expenditure run-rate to less than 50% of historical levels.

All this should give investors pause. Clearly, the last thing investors need is yet another management team with tendencies toward aggressive accounting. And investors ought keep in mind the reason for all these maneuvers was to look good enough to pawn the company off on the public at an IPO price that values the company at roughly $375 million. Magma discloses that the small portion of this that goes to company coffers allows only about 12 months of operations at current levels.

Over the next 12 months, other issues will arise. Magma specializes in an area of electronic design automation that has historically been the lair of embattled **Avant!** (AVNT, news, msgs). In fact, Magma has benefited from Avant!'s legal troubles with industry leader **Cadence Design Systems** (CDN, news, msgs) and from the associated marketing headwind that Avant! faces. After Magma's IPO, it was announced that the widely respected **Synopsys** (SNPS, news, msgs) is acquiring Avant!. The resultant Synopsys/Avant! combination is going to be a powerful one for several reasons that I will not detail here. The net effect on Magma, however, is that one of Magma's reasons for being has been severely weakened even as the resources of its largest competitors just doubled at minimum.

An exit for early investors

As well, of the nearly 30 million shares outstanding, some 24 million or so will come out of lock-up during the first half of 2002. The high percentage of shares in the hands of pre-IPO investors is reflective of the tremendous venture capital support this company required, and without a doubt one key reason for this IPO was to provide an exit for early investors. In time, this will bring selling pressure even as it multiplies the float available to buyers. Engineering tiny floats was a key tool in achieving rapid run-ups of IPOs during 1999.

In the short run, I also expect that the effective float has been made temporarily even smaller, as purchasers over the last month nearly all have gains, and a good portion may be unwilling to realize those taxable gains before year-end. It is possible that early January could see some of those buyers move to lock in these gains.

The three main underwriters of Magma's IPO have had their research arms come out with thoroughly unimpressive 'Buy' ratings on the stock. Other aspects to consider include that short covering may be driving a good part of the recent rally. There is also speculation that Cadence might be forced to acquire Magma in response to the Synopsys/Avant! combination. This is hard to imagine at Magma's current valuation, however.

I saved the valuation for last. It will be hard to nail the price of this security one day in advance. In

the last half hour or so, the stock has risen another 7% or so and appears ready to crack $30 a share.

Valuation is out of whack

Valuation is a bit difficult for other reasons. After all, it has the requisite 1999-era quality of massive cash losses paired to no reasonable expectation for actual profit in the foreseeable future. Still, I'll take a shot. At $30 a share, Magma approaches a $900 million market capitalization. That represents about 36 times its (inflated) trailing revenues, although I'm being a bit overprecise here in assigning more than one significant digit to either this volatile stock or the uncertain business underlying it. Its strongest comparables across all market caps trade for between 3 and 6 times revenue – and are generally plenty profitable.

We also can look to a recent deal to help clarify valuation. Synopsys is paying an all-things-considered price of about 3 times revenues for Avant!, which generates tremendous free cash flow and has the best margins in the business.

Realize that this IPO occurred for two main reasons: to provide an exit for venture investors and to provide cash to allow Magma to survive a bit longer. My feeling is that insiders would sell like mad at $30 a share if they could. As Strategy Lab just loosened the rules to allow shorting, I will short 100 shares of Magma at $29.50 limit, good until canceled

Journal: Feb. 8, 2002

- **Buy 800 shares of Elan (ELN, news, msgs) at $12.70 or lower.**

- **Buy 200 shares of Kindred Healthcare (KIND, news, msgs) at $36.25 or lower.**

- **Buy 1,000 shares of Industrias Bachoco (IBA, news, msgs) at $8.50 or lower.**

- **Short 400 shares of Magma Design Automation (LAVA, news, msgs) at $25.00 or higher.**

Amid 'Enronitis' scare, three Buys and one Short

Those of you that have been reading my journal entries here for a while know that I've been a fairly vehement critic of accounting shenanigans. In the past, I've whacked **Cisco Systems** (CSCO, news, msgs) over the head, dissed **WorldCom** (WCOM, news, msgs), and I've had a few choice words in general for the way the professional stock market works to take advantage of the amateur stock market

I of course still believe that companies, in the long run, will not be able to fool anyone. Either value is created, or it is not, and the share price ultimately reflects this. Sometimes, and maybe even most of the time, a company that has been involved in scandal will be overly punished in the marketplace. What's more, as long as the company has the cash flow and the balance sheet such that it does not need access to capital markets, and as long as its customers don't care about the stock price, a company can have a very decent shot at long-term redemption.

The real Elan

Take **Elan** (ELN, news, msgs). This is a real company. Real shenanigans. Real debt. Real cash and real cash flow. Real drugs. Real pipeline. Real customers. Real value. Drug companies don't generally trade to 9-10% free cash flow yields. Remember folks, this is the pharmaceutical industry.

There are plenty of strategic buyers for Elan, and now it has fallen to a financial buyer's price range. Such circumstances usually don't last long. Ethically-tainted, scandal-plagued companies trading at real financial buyer multiples in an industry full of potential strategic buyers -- well, such situations usually deserve another look.

Kindred's spirit

Kindred Healthcare (KIND, news, msgs), a nursing home and long-term acute care operator, emerged from bankruptcy early last year. Very few are watching this as it drifts lower over worries that two key pieces of legislation benefiting Medicare revenues will essentially be reversed. I won't get into the specifics, but only half of what is feared might actually come true. The other half is 50-50, but for once I'm rooting for Tom Daschle.

This too is trading down at a roughly double-digit free cash flow yield, and has a net cash position. The downside in the event of a bad legislative outcome is maybe a 20% fall from current levels, and maybe even just stabilization at current levels. The upside to a good legislative outcome is a near doubling of the share price from here.

Poultry profits
Industrias Bachoco (IBA, news, msgs) is a Mexican chicken products producer. No. 1 in the country, trading at about a 20% free cash flow yield and at half book value. Enterprise value/EBITDA multiple is just over 2.5X. Economic trends vary, but this company has been around for the last 50 years, and in the last several years it paid off, out of free cash flow, an acquisition of the No. 4 player in the industry.

Nos. 2 and 3 in the industry are associated with **Pilgrim's Pride** (CHX, news, msgs) and**Tyson** (TSN, news, msgs). I admit -- this is not a great business. Maybe just worth book value. OK, double the share price and give me book for my shares.

Unlocking short value
Finally, if **Magma Design Automation** (LAVA, news, msgs) ever gets near 25 again, short the heck out of it. I believe I've already provided my rationale. In light of their earnings announcement reporting a one penny per share profit, investors should just realize that the company booked a fairly significant perpetual license order late in the quarter. They disclosed this on the conference call. Perpetual orders allow for significant revenue recognition up front, as opposed to revenue from time-based licenses, which are recognized ratably over time.

Also, we should realize that during the conference call management did not describe the non-cash stock compensation charges as non-recurring, but excludes them from its pro-forma profit calculation anyway. Management did say it was "hopeful" that these charges would eventually decline.

Lock-up expiration is just a few short months away, and then we find out what all the insiders really feel the stock is worth

Journal: Feb. 15, 2002

- **Place order to buy 200 shares of Reuters Group (RTRSY, news, msgs) at $46 or lower.**

- **Place order to buy 1,000 shares of National Service Industries (NSI, news, msgs) at $6.75 or lower.**

- **Buy an additional 200 shares of Elan (ELN, news, msgs) at $13.25 or lower.**

- **Change previous order to short Magma Design Automation (LAVA, news, msgs) to 300 shares at $22.50 or higher.**

Two stocks that look cheap
Coming up on the deadline, so I'll make this quick. **Reuters Group** (RTRSY, news, msgs) looks cheap. A cash-flow machine with significant brand equity and a solid balance sheet, the business is in the midst of a turnaround at the hands of a new American-for-the-first-time CEO. The company owns sizable stakes in **Instinet** (INET, news, msgs) and **Tibco** (TIBX, news, msgs), and it has a significant venture portfolio. It recently bought Bridge Information Systems assets out of bankruptcy. Buy 200 shares at $46 or lower

National Service Industries (NSI, news, msgs) is a cigar butt trading at a deep discount to tangible book. The reason: asbestos. The company has also been the subject of a recent restructuring and reverse stock split. None of this looks very appetizing to nearly any institution, and so the shares have been getting dumped lately. It takes some work to understand the true earnings power of the business, not to mention the asbestos liability. After doing this work, I've concluded the stock should be trading at levels at least twice the current level based on a variety of measures. Buy 1,000 shares at $6.75 or lower.

Also, reviewing prior picks, buy another 200 shares of **Elan** (ELN, news, msgs) at $13.25 or lower, and change my order on **Magma Design Automation** (LAVA, news, msgs) to short 300 shares at $22.50 or higher.

Journal: Feb. 18, 2002

• Sell position in Elan (ELN, news, msgs) at the market and cancel all outstanding trades.

• Change previous order to short Magma Design Automation (LAVA, news, msgs) to 400 shares at $22 or higher.

• Change previous order to buy National Service Industries (NSI, news, msgs) to 1,500 shares at $6.85 or lower.

Whoops. Elan doesn't look so hot
Time for a mea culpa. I am selling the entire **Elan** (ELN, news, msgs) position at market and will cancel all outstanding orders regarding this security. The accounting here is pretty tricky, as the world knows, and it takes some creativity on the analyst's side to interpret the numbers presented. I believe I made several errors in judging the safety of this common stock investment, and so I will unload the position.

After further review of historical filings and after discussing my concerns with the company, I feel the net issue here is that the company has put itself in a more precarious financial position than was prudent. It has leveraged itself in order to ramp its pipeline as fast as possible, and has been capitalizing much of the expense of doing so. I find it very difficult to foot the valuation from a financial buyer's perspective. In my world, it is primarily the financial buyer's perspective that is meaningful, even if the strategic value to a corporate buyer might be somewhat higher.

With that lead-in, I'll emphasize that common stock is the most precarious portion of the various layers of capital structure. In a bankruptcy preceding, it is most likely that the common stock is canceled altogether. Therefore when assessing the safety of a common stock investment, one must also evaluate the probability of bankruptcy at some point in the future.

The simplest way to look this is to examine capital flows. If a company does not earn its cost of capital, then it will have to access capital markets periodically. If the hope of earning its cost of capital is perceived to be fading, the capital markets will become less accessible for the company. In such cases, bankruptcy will ensue, with the associated destruction of stockholders' equity.

In the interest of not wasting some previous picks, I'll change some trades so that they are more likely to get executed fairly soon here in Strategy Lab. **National Service Industries** (NSI, news, msgs) -- change the order to buy 1,500 shares at 6.85 or lower. **Magma Design Automation** (LAVA, news, msgs) -- change the order to short 400 shares at 22 or higher.

Journal: Feb. 21, 2002

• Place order to buy 100 shares of Reuters (RTRSY, news, msgs) at $42, good until canceled.

• Place order to buy 100 shares of Reuters (RTRSY, news, msgs) at $40, good until canceled.

• Place order to buy 100 shares of Reuters (RTRSY, news, msgs) at $38, good until canceled.

• Change my order for National Service Industries (NSI, news, msgs) to buy 1,000 shares at $7 or lower, good until canceled.

• Place order to buy 200 shares of Canadian Natural Resources (CED, news, msgs) at $26.75 limit, good until canceled.

Magma still has room to fall
Since I shorted **Magma Design Automation** (LAVA, news, msgs) common, the stock is down considerably. I do not feel the need to cover the position at recent prices. The company recently filed its form 10 with the SEC. This filing reveals, as I suspected, that the company is not showing a cash profit in line with its pro forma profit claim. Rather, the company continues to produce negative operating cash flow. The filing also reveals an interesting relationship with a large customer that received 100,000 Magma options in November in exchange for 'advisory services.' I am attempting to clarify that relationship, as well as several stock repurchase agreements Magma has with its founders. These, too, were disclosed in the 10Q. Any individual who is long or short the stock ought to be looking at these things -- all the disclosure in the world will not help those who do not read the filings. In any event, the

stock is not worth even double digits, so I will not cover here in the high teens. I expect another 50% gain or so from recent levels, possibly even during this Strategy Lab round

Reuters (RTRSY, news, msgs) stock has been in a free fall. The value is higher than the current price by a large degree, however, and therefore falling prices are beneficial. The company produces a prodigious amount of free cash flow -- my estimates are that the recent share price will reflect less 10% free cash flow yields during 2002 and less than 12% in 2003. For these estimates, I assume top-line growth will be flat in the face of a sluggish world economy. The shareholder base is likely turning over as we speak – overanxious growth investors selling to patient value-oriented investors. Several other factors are contributing to the depressed share price, but none contributes more to the low valuation than the myopic views of investors in general. I should note that this is a very volatile stock, so I have no illusion that I've found the near-term bottom here. In the event that I'm not watching closely when it happens, place an order to buy another 100 shares at $42, an order to buy another 100 shares at $40, and an order to buy another 100 shares at $38, all good until canceled. I do not necessarily expect that this position will recover before the end of the round.

National Service Industries (NSI, news, msgs) keeps squirting higher. I won't pay more than $7 per share, and I will change my order to just that: buy 1,000 shares at 7 or lower, good until canceled. Maybe one of these days I'll get some in the portfolio here. I'm expecting a horrible quarterly report, so maybe that will do it.

Canadian Natural Resources (CED, news, msgs) is a boring favorite of mine. One of the largest Canadian exploration and production companies, with among the best returns on invested capital in the sector, Canadian Natural has thus far missed out on the mergers and acquisitions binge involving North American exploration and production companies. The recent acquisition of Canada's Alberta Energy gives another decent comp for valuation purposes. All signs point to Canadian Natural being worth over $35 share, although it might be as much predator as prey. It is relatively illiquid for such a big market capitalization, so I'll set a low limit price in hopes of taking advantage of the volatility. Buy 200 shares at $26.75 limit, good until canceled.

Journal: Feb. 25, 2002

• Place order to buy an additional 250 shares of Industrias Bachoco (IBA, news, msgs) at 9 or lower.

• Cover short position in Magma Design Automation (LAVA, news, msgs) at 9 or lower.

• Cancel outstanding orders in Reuters (RTRSY, news, msgs).

Playing chicken

Industrias Bachoco (IBA, news, msgs), a current portfolio holding, took a hit Friday as it released earnings. However, the valuation remains very compelling.

The market capitalization of the stock is $450 million as I write this. The company has just $33 million in debt paired to $128 million in cash, for an enterprise value of $355 million. Earnings before interest, taxes, depreciation and amortization (EBITDA) was $145 million during 2001. Free cash flow was $100 million. The trailing enterprise value: EBITDA ratio is therefore 2.45, and the free cash flow yield is 22%. The company continues to trade at just over half book value, and it paid a dividend during 2001 amounting to 7.7%. The price/earnings ratio is just under 4. All these numbers are not so bad at all, especially when one considers that 2001 was a difficult year for the industry, as the economy softened along with pricing. In all probability, the sell-off occurred because of the recent run-up -- a sell-on-the-news phenomenon.

As I noted before, the company is the leading producer of poultry products in Mexico, where chicken is the No. 1 meat. **Pilgrim's Pride** (CHX, news, msgs) and **Tyson Foods** (TSN, news, msgs) lag Bachoco in Mexico, where fresh chicken products are much more broadly accepted than processed chicken products. Bachoco, having been in the Mexican chicken business for decades, has a natural advantage that can be exploited if the company is run well, and it does seem to be run well. Regardless of the recent run-up in the share price, I continue to target a

$15 or greater share price for Bachoco. As time goes by, shareholders equity will continue to grow and dividends will be paid. This should be a solid total return investment. I'm not asking for an extravagant valuation; 8-9 times earnings and par with book value would provide tremendous price appreciation from the current level, especially when paired with the dividend. If it falls to 9 or lower, buy another 250 shares.

Regarding **Magma Design Automation** (LAVA, news, msgs), the position is working out pretty well – a roughly 50% gain on this too-small short position. Just in case it has a midday meltdown followed by some short-covering, I'll enter an order to cover the entire position at 9 or lower. Sounds ridiculous to enter such an order, but while I did not expect the stock to fall as fast as it did, I do not see any reason that the stock doesn't crash the $10 level soon as well. Any rallies in this stock are likely to be short-covering rallies as shorts lock in their quick gains.

GTSI Corp(GTSI) - $5.00 on Mar 28, 2001

A debt-free net net stock, now showing earnings growth and consistency for the first time. Known for its trading range, with the highs in the range usually produced by some bit of good news paired to low float, but there are some changes afoot that should set it free to the upside.

GTSI distributes technology products to the military, the IRS and others. Bsically, a B2G distributor. Market Cap at 40 mill, sales over $650 mill. Low margin stuff. As like any distributor, they have to have hot hands, and by and large they do. Located just outside D.C. New management arrived 4 years ago and has started turning around a money-losing operation. Now, working capital is not overly bloated, they turn inventory well (12 turns/year), and AR increases match AP increases well. They were profitable for the third straight full year new management has been in place, and GTSI is starting to see gross margin enhancement from hawkish working capital management, cost controls, more favorable contracts, and increased sales. The result: $1.15 in diluted earnings last year, but that was with residual tax losses creating a tailwind.

Management has given guidance, however, that they will beat last year's earnings per share even after full taxes are paid this year. So right off the bat we have an honest PE less than 5, no debt, and an improving business with capable management and increasing contract wins.

Management has bought the stock aggressively up to just under 4, and there is a large outside shareholder in Lacy Linwood, one of the founders of Ingram. Linwood has also been acquiring shares in the open market - he's the one providing all that support around 3 the past few years - and now ones over 25% of the shs out. Employees are participating in the employee stock plan but many are also buying lesser amounts of stock in the open market.

In addition to the obvious advantages of having a large outside shareholder with an illiquid stake, Linwood also provides some alleviation to the fear that Ingram or its ilk would jump in and compete GTSI out. If anything, his actions seem to indicate GTSI makes a good takeout for such a company (his stake is very very illiquid in terms of public market exit strategies yet he buys more).

In fact, knowing the business means knowing that such competition isn't much of a risk anyway. As with a lot of government vendor stuff, this is a relationships business. GTSI is well-ingrained into the procurement system, and has expertise in getting the right forms in the right hands at the right time.

GTSI just won the MMAD contract for over $857 million in technology products to be supplied to the military, IRS, and other branches of government over 5 years. The news of this award sent the stock skyrocketing last year. A protest was lodged, which was resolved in GTSI's favor. The poor stock market has helped stifle any positive reaction in the stock. But the win is indeed real, and the company isn't sure why the stock didn't react like it has in the past to such announcements. Indeed, in the 4 hours or so after the news was announced, only 7,000 shares traded hands.

GTSI will compete with IBM for bids to supply various projects under the MMAD contract. GTSI is confident of getting the majority of the money from this contract because historically they have done so when competing against big name suppliers. Why? Basically GTSI is willing to pay more attention to the process and get down and dirty in the whole government procurement area. They make money for the same reason plumbers get paid well. As well, they have the longstanding relationships on their side.

The trading strategy with this stock has always been to buy just under 3 and wait for a spike - there have been a few - and sell it. The last two spikes have occurred after the last two quarters produced blowout earnings. The stock is starting to stick at higher prices though, as the more permanent nature of the positive changes in the company is getting noticed. For the first time, true fundamental change for the better is starting to gain traction in sustainably higher stock prices. A nice trend to join early.

Also, because the buyer here is the government, there is a tremendous built-in backlog of demand. The computer equipment at the IRS, for instance, was legendary a decade ago. And the demand is seasonal (government is a procrastinator, rushing to buy a lot at the end of contract terms and at the end of years, therefore making contracts more profitable later in the cycle and years more profitable as the quarters wear on), but not cyclical. Moreover, obsolescence is less an issue because the government doesn't demand the latest and greatest. Management is taking advantage of the advantages of working with the government while minimizing the disadvantages.

There is a lot of operating leverage in the business that is just starting to be realized on the positive side (they lost over $2/share before new management came in), and with few shares outstanding, it would not be surprising if pre-tax income starts to approximate the share price myself and others paid back in the $3 range last year. Like Buffett's WPO, though on a much, much smaller scale. I'm still accumulating the stock.

A risk is a takeunder. I wouldn't get too extended in my buys from the price the large shareholder and management have paid (which ranges up to 3.75). I'm buying up to 5. Buying at 6 and waiting 3 years to be bought out at 7 wouldn't be very fun.

As a side note, on the last conference call, a private investor called in and ID'd herself as an employee of GTSI. This was an error, though I know a few investors whose initial reaction was that something stunk. I was one of them.

Catalyst

Gross margin improvement, better management's effects being felt and recognized, first-ever road show coming up in next few months showcasing new COO (comes from the Executive Office of the President with a lot of government contacts and know-how), expected strong stock price reaction to developing trend of consistently good earnings (40% upside from here just to get to net net value), acquisition target/buyout target, outside shareholder with illiquid, large minority stake and uncertain agenda/exit strategy

Huttig Building Products(HBP) - $4.3125 on Aug 27, 2000

I just finished entering a bunch of data such as trailing EPS and revenues. Throw it all out the window. Huttig Building Products may be one of the most ignored, misunderstood stocks on the market, and a big reason is that superficial analysis with readily available data is, well, too superficial. Huttig Building Products (NYSE: HBP), spun-off from Crane (NYSE: CR) last year, is a leading distributor of building products such as doors, windows and trim. Value investors may recognize the opportunity that so often occurs with spin-offs. In this case, simultaneous with the spin-off, Huttig issued 6.5 million shares to acquire Rugby USA from Rugby Group PLC. The net is that even the proxy for the spin-off was worthless because it wouldn't account for the acquisition. As a spin-off from an S&P 500 company, Huttig was guaranteed hot potato status anyway. But factor in confusing offering documents and an admittedly poor marketing job, and the stock simply could not avoid the doghouse.

The beneath-the-surface numbers follow. The leader in its very fragmented industry, Huttig has a market share of just 8% and will earn revenues topping $1.2 billion. Razor-thin margins are offset by industry-leading working capital management. In fact, the company has been profitable since the Civil War. This year, the company will see about $60 million in EBITDA plus a substantial one-time gain, yet carries an enterprise value ($89 market capitalization plus $122 million debt less $6 million cash) just about $205 million.

As the industry's most efficient operator (with management firmly ensconced in a shareholder-friendly EVA compensation model straight out of Stern & Stewart), Huttig is ahead of plan to squeeze $15 million in synergies out of Rugby as well as bring Rugby's poor working capital management more in line with Huttig's other operations. Expect another $20 million to drip out of working capital within the next year. Because of these savings, Huttig in effect paid just $40 million for Rugby's $30 million in annual EBITDA.

While Huttig's management should get credit, some of it must be shared with the motivated seller. Rugby Group PLC is not the world's best-managed company, to put it lightly.

Going forward, Huttig will have tremendous free cash flow. Free cash flow averaged $21 million per year for the three years before the acquisition of Rugby. Now, EBITDA jumps to at least $60 million, and free cash flow jumps to at least $35 million. Plus, in the short term, we get the $20 million or so that comes out of Rugby's working capital. As a result of this, during calendar 2000 Huttig is well on track to bring its $122 million in debt down to $82 million. Management's reasons for the debt-reduction? Reduced interest expense and expanded ability to pursue acquisitions. So what we are looking at is an enterprise trading at just 3.1 times EBITDA, and only about 5.1 times free cash flow. Remember – 130 years of continuous profitability.

Management follows strict return-on-investment criteria according to Stern Stewart's EVA theory and model's operations on GE's Six Sigma program. The Chairman comes from Crane and is known to be a shareholder advocate.

Catalyst

Sheer value is something of a catalyst here, but there are other key aspects to consider. Rugby Group PLC holds nearly a third of Huttig's share and is a price-insensitive seller on the market. This introduces price risk but not business risk. The shares are not liquid, and Seth Klarman is said to have bought up to 20% of Huttig's shares. If so, consider those shares locked up. Klarman is known as an extremely disciplined deep value investor. Once the Rugby Group shares are on the market, look for a buyout of Huttig. The buyout could come from inside (management) and a private market valuation based on recent activity places the shares at a worth over $12-15/share. Again, the Chairman is a shareholder steward - Crane investment arm still has an investment in Huttig - and would not let the takeout go through much lower than private market value. I'm looking for action within the next year. In the meantime, a large distributor of wholesale doors left the business. Huttig is expanding to meet the demand. Because of this, sales may rise over the next year or two even if, as seems probable, the homebuilding market turns south. Finally, spin-offs often reach a price nadir about one-year after the spin-off date; it takes that long for the knee-jerk sales to stop. By early 2001, the nadir should be behind us.

Industrias Bachoco is the $1 Billion sales leading poultry producer in Mexico, where chicken is the number one meat. IBA is a NYSE-listed ADR that is as cheap as ever. Bachoco is the giant in an ultra-fragmented industry.

Summary financials (in US $) and ratios as of their most recent earnings release 10/24/02 (not carried on Yahoo news):

Market Cap $426 million
Total Cash $186 million
Total Debt $ 24 million
Enterprise Value $264 million

9 mos Net Income $104 million
9 mos OCF $127 million
9 mos Depreciation $ 23 million

* FCF roughly approximates Net income, and 2002 NI will be about $130-$140 million.
* The company has been pouring its cash flow into debt paydown after its 1999 acquisition of the industry #4 (which smartly provided both horizontal and vertical integration benefits), and is now nearly debt-free.
* The payout is around 25% of net income - so the dividend yield will be in the upper single digits.

Put in perspective, net income trends:
1998: 92.9
1999: 85.8
2000: 126.8
2001: 117.6
2002: roughly 130-140

* Nominal PE (Market Cap/NI) is 3.2
* EV/2001 EBITDA (will be higher this year) is 264/164 = 1.6
* Adj for net cash and related net interest, adj P/E is 264/125 = 2.1

Shareholders' Equity is $871 million, nearly all of which is tangible.
So P/B is ~ .50

Over last 5 yrs, ROE has been between 12 and 17% despite growing cash drag.
Return on Assets has been ranging 10-15%.
IBA's net profit margins are in the low double digits.

Comparatively, TSN and CHX, both of which have a validating presence in the Mexican market but rank behind Bachoco, carry relative valuations 3-5X higher than IBA despite profit margins less than 2% and

poor ROE's. Labor and costs are one major advantage at IBA, which continues to improve its operating margin - now 11.96%.

Risks:
1) A recent Hurricane damaged production at a small portion of IBA's farms. This is a minor, temporary issue, but appeared to hurt the stock.
2) The company is dealing with reduced protection by tariffs, which were cut in half on Jan 1 2002 and will be phased out completely in 2003. 2002 was supposed to be difficult because of this -helping to depress the share price - but the company has been faring much better than anyone expected. Pilgrim's Pride was supposed to be a big threat here, but they keep stumbling over themselves and have a weak balance sheet. This issue cuts the other way in a couple years ways when IBA gets to access feed at cheaper prices thanks to NAFTA. IBA may also be able to leverage its low costs into an export business into the US, per the CEO.
3) There is the potential that the company will lose a favored tax status, though it is unclear that this would disadvantage it significantly in relation to competitors facing similar issues. Apparently the tax would be a VAT, which would increase the prices consumers pay. This has been hanging over the company for some time, also depressing the share price.

Summary: 2X free cash flow; leading market position; large scale; tremendous financial strength with no net debt; big dividend while you wait; a statistical anomaly of a valuation

Catalyst

Resolution of tax issue, resolution of hurricane fear, and continued good cash production through tariff relief are potential catalysts. Mainly, security just needs some serious consideration by a few smart investors (most of whom won't give a Mexican chicken company the time of day). At this 2X free cash flow valuation, the share price should track cash accumulation - over $2/year - no matter whether multiple expansion occurs or not.

Pillowtex(PWTX) - $3.20 on Sep 20, 2002

Pillowtex makes pillows, blankets, comforters, sheets under the Royal Velvet, Fieldcrest, Cannon, Charisma brand names. PWTX emerged from Ch 11 late spring 2002, having erased nearly 900 million in acquisition-related debt, closed a baker's dozen plants, and laid off 4500 fewer employees. Also has 533MM in NOLs.

The current stock quote is 3.20, down from 6 at emergence and down from 9 within a month or so of emergence. Roughly 20 mill shares out give a 64 mill market cap.

POR projections, assuming no growth in the industry and stable economic conditions, projected reaching a 3.5% net margin, 7.3% op margin on 1.07 bill sales by 2004. This trajectory would provide 28 mill net income in 2003 (1.40/sh), 37 mill net income in 2004 (1.85/sh). Normalizing working capital (thanks to normalizing vendor, retailer relationships) would provide a boost to free cash flow, which would be around 35-40 mill/year before principal payments on debt.

So based on POR projections, the stock is trading at less than 3X 2003 earnings, less than 2X 2004 earnings, and at about 1.5X free projected free cash flow. Post-reorg/fresh start book value is around 200 mill, so at 64 mill we're at .32X book and at around 6% of sales.

Clearly the market doesn't believe the projections. The market is actually pricing in a catastrophic miss, and a high risk of ch 22. I don't believe the projections either - although I do believe they are attainable on a lengthened timeline, and I certainly don't take the market's view of the equity.

Of course, the market isn't entirely rational right now. All stocks have had a rough go, but reorganized equities are getting slammed especially hard as distressed securities funds find themselves in some distress courtesy of all the 2nd, 3rd, 4th, and 5th foot dropping going on in WCOM, KM, etc. PWTX is in a Buffett-certified 'bad business' and as I've heard, no price is too low for some of the sellers in the stock. As well, Westpoint Stephens' situation is worsening, spooking watchers of the sector.

The stock was distributed to bank debt holders, including vultures. Oaktree owns 20%. Lehman and BofA ended up with multi-million share chunks too. Share volumes are double counted, so it's been in distribution essentially since it emerged. A lot of it is coming through CRT in case you want to buy in volume. Just today I cleaned out a guy at 3.20 that had received stock in the distribution. A Nasdaq listing is hoped for by the end of the year, although we can't expect wide sponsorship.

A crucial point is that the company has hired new management that is widely respected. Pre-reorg management was simply horrid and attracted short sellers in droves - many of the savviest hedgies know PWTX as a great short from a few years ago. Things are different now though. Dave Perdue comes from Reebok where he has a big background in buying everything, making nothing. His position at Reebok focused on international vendor relationships. He recently replaced the restructuring-era COO with a guy who worked with Dave at Sara Lee, where they oversaw significant growth in the underwear division. Sources in the textiles industry view these

hires as very good hires. I would hope and expect the addition of more talent in the executive suite.

The strategy of the new management is emphasizing branding vs. manufacturing. They are actively seeking relationships with overseas manufacturers, and I would expect that they have some success with this, given the CEO and COO's backgrounds at places that outsourced everything. They are searching in particular for one large vendor in order to have greater control over quality.

The risks in the story are primarily in management execution of the branding over manufacturing strategy. As well, the strength of the consumer is an issue, as PWTX in present form is subject to tremendous operating leverage. PWTX, while leveraged, is not over-leveraged and has the cleanest balance sheet in the industry at present.

A good comp is Springs Industries, which was taken private by management and Heartland, advised by CRT, in late 2001. Taken private at 1.24 bill by financial buyers in a 5:1 recap. Management controlled 71% of the voting, exerting pressure on the price extracted. At that price, Springs traded at an 11.7X forward PE, 12.7X trailing PE, EV/EBITDA 5.2X, EV/EBIT 9.4X, EV/Sales .57. Springs had 3.1% net margins, 11% EBITDA margins, 2.3 bill sales. Revenues were in decline, and Wal-Mart was a big customer at 27% of sales, not unlike PWTX. The brands at Springs include Wamsutta, Springmaid, Regal, Dundee, all of which generally have slightly lower price points than PWTX's better brands. Putting any of these numbers on PWTX gets PWTX's common stock price well over $10/share - indeed, nearer $15/share. Again I'd note that the buyer of Springs was financial and the transaction was well-levered.

Other comps are relatively poor because WXS has a different mix of business, scary capital structure. DRF is lower end/different mix of biz. Springs is really the best comp, though 2X as large as PWTX. PWTX at 1 bill plus in sales is no small potato though.

Catalyst

Completion of distribution and securing of stock in stronger post-reorg, non-distressed, stock-guy hands. Appreciation potential on cessation of dumping is tremendous. Jumped 35% in one day when the sellers disappeared at the onset of the July rally. 7-8 in next 6 months are pure technical rebound is possible, with operational improvements account for remainder of appreciation to 10+.

Quipp, Inc(QUIP) - $19.85 on Apr 20, 2001

A stock that can be played multiple ways for value realization, Quipp designs, manufactures, installs, and services post-press material handling equipment for newspapers. Equipment goes by names like Bottomwrapper, Newspaper Stacker, Automatic Cart Loading System, Newspaper Gripper and Conveyorm, Automatic Palletizer, etc. They service and sell spare parts for the equipment after market as well. A neat little cyclical but growing business, with 10%/year revenue growth over the last ten years, during which they have increased earnings from 100K to $5 million. Has generated gobs of cash which does come back to shareholders.

The stock is at 19.85, and the company has announced a Dutch auction self-tender for a little over 1/3 the float, or over 1/4 total shares outstanding, at 20-23, to commence any day now. It was announced two weeks ago. So there is an arbitrage opportunity, though it is very possible that the offer will be oversubscribed, resulting in pro-rata cash out.

That's not the only special aspect of this situation, though. The Dutch auction came about after a buyout fell through on financing and the deteriorating economy. During the time the legal documents were drawn up the stock was trading in the mid-high 20's. It is likely the buyout offer would have been for $30 or higher. There has been a string of MBOs and LBOs that have fallen apart on financing since last fall, and it is becoming a common story (and a ripe field for finding value, IMO). It doesn't change that there was a private financial buyer willing to pay a significant premium to the current price. A strategic buyer would pay more, though one doesn't seem readily available.

The valuation is fairly compelling. With 1.9 million shares out, the market cap sits around $38 million. There is about $17 million in cash and securities, the result of slowing capital expense, and no significant debt. 2000 EBITDA ex-cap ex and ex-interest income was $6.5 million.

Free cash generation has been great relative to market cap. Total cap ex the last three years was only about $1 million, and Total operating cash flows the last three years were $14.4 million. With EV at just over $20 million, that's pretty cheap. Two years ago, the company paid a $7/share special dividend because of the cash build up. Book value rebounded to near pre-dividend levels in just two years, and the share price recovered within 1 1/2 years. Margins are good, and ROA, ROE and ROIC have all been trending strongly higher with increased scale economies, offset by economic slowing.

So you have a stock in a company that generates lots of cash and does not reinvest it in the business to any great length (R&D at 2% of sales, cap ex at just a few hundred thousand - nearly all maintenance). So every few years a sizable cash and investment portfolio accumulates. Two years ago it paid the $7/sh special dividend, and this year it is buying back 1/3 the shares in a Dutch auction. Over the years the stock has been steadily appreciating. In recent years, cash flow has really jumped, and it has not been reflected in the share price.

The fall-off in operating performance at newspapers has had an effect. No single newspaper accounted

for more than 10% of sales, though Gannet and Knight Ridder were 18% and 12% of sales last year. That concentration is down from 1998, when Gannett was 32% of sales. Also, foreign sales are at 13%. At year end, backlog was $1.5 million higher than last year, but the incoming orders have slowed as much as 50% in the first quarter. International avenues for growth are being pursued, but its two biggest competitors worldwide are Swiss and German in origin. Given the company's small size and low-tech, brandable product line, growth should nevertheless be good through cycles and in excess of the industry trends.

The stock sold off after the buyout fell through - the stock is fundamentally illiquid and those hoping for a quick buyout were natural sellers when it fell through. This is a readily overlooked stock, and buyers didn't materialize to catch the shares. The Dutch auction is meant to shake out remaining weak holders without wreaking havoc on the share price. Management have not been buyers recently (not a surprise since legally they couldn't be), and they own about 21%. The buyer was a financial one - strategically, it is not clear that there is a shoe-in for a potential buyer, but the industry for newspaper equipment is relatively stagnant to shrinking, which is spurring consolidation. There is some evidence that there is a brand here with a good reputation.

There is some logic in not tendering shares here and just awaiting or instigating for value realization. After the tender, assuming it goes off at about 21 or so, you'll still have a stock bought at $19.85 with $4/sh cash and history of value creation for shareholders as well as strong free cash flow averaging $3.30/share the last three years. So market cap/ avg FCF (over last three years) is around 6. Back out the cash and it falls to less than 5. Don't need growth or even less-than dramatic long-term revenue shrinkage to make that attractive. EV/EBITDA (ex-cap ex, ex interest income) is 15.85/4.81= 3.3X on last year's strong (but not all-time peak) numbers. It is not terribly hard to buy shares, as the largest shareholder has been steady liquidator and to my knowledge a disintrested wholesaler has a large block ready to go at 19.80-19.85.

<u>Catalyst</u>

Low tech, cash-generating business offers several catalysts 1) Arbitrage with Dutch auction 2) Ultimate sale of company at a nice premium from current price once economy turns/debt markets recover 3) Await realization of value in market. 4) Not really a catlyst, but ultimately, if one wants a control situation, management are not majority owners here, and the cash flow could substantially eclipse purchase price over next 5+ years. Two largest shareholders are non-management, which provides some undefinable but real catalyst as well. To the extent one wants out, as seems to be the case, it also creates additional pressure on an illiquid stock that will not last forever.

ValueClick, Inc.(VCLK) - $4.4375 on Nov 6, 2000

ValueClick is an internet asset play trading below cash and equivalents, with no debt and with an expectation of positive operating earnings by the end of the next fiscal first quarter. Join the crowd, right? There's more, but please do read the disclaimer at the bottom of this entry.

Most intriguing is a 53% ownership stake in ValueClick Japan valued at about $135M. This is largely in addition to $117M in cash and about $10M in Doubleclick (DCLK) shares, but you won't find it glaring at you on the balance sheet, since the operations are reported together. There is about $25M on the Japan side that you don't want to double count. Nevertheless, add these things up and with a $124M market cap, we're being paid a pretty penny to take the US and non-Asian business. ValueClick took in a little over $1M in cash last quarter by selling just 17 shares of ValueClick Japan, so the stake is very real - and there are over 8000 more shares where those came from. In recent years, these situations have been limited mainly to apparel retailers loaded with inventory, so net current assets was next to meaningless. Here, though, the assets are quite real, and there is no inventory to verify.

There are reasons to believe the natural price level for the business - and the shares - should be higher. Therefore I see a margin of safety in the current price even without playing the obvious arbitrage.

The business is in transition but still growing. What is the business? An internet advertising network whereby advertisers pay ValueClick, and ValueClick in turn pays the publisher, only when a web surfer clicks on the advertiser's banner. They are pruning their customers, taking it from 82% dot coms to 72% dot coms, while maintaining their absolute numbers. Overseas contribution will be 50% by the end of next year, and revs should hit $63M. Advantageous is that ValueClick has been able to maintain its pricing and streamline operations on the cost side, resulting in gross margin growth even as the general market for internet advertising gets hit - thanks to the performance-based model, which is more attractive in times of uncertain effectiveness of internet advertising.

VCLK is acquiring competitor ClickAgents with stock. This seems like the bonehead move of the century. The stated reason is that the deal was negotiated with the stock up at $10+, and they would have had to pay more in cash. Still, sheesh, I say buy with cash, and I admit I do not buy the CFO's reasoning. Advertising.com is a private competitor with similar revenues, but with worse profitability measures relative to ValueClick, or so I understand.

Doubleclick owns 28% of ValueClick, with rights to buy up to 45% at nearly $22/share. There is a significant lock-up on these shares that takes us well past 2001.

Founding investors and insiders had margined themselves somewhat heavily on this stock, and had to sell as it fell below five. The general lock-up on shares ended in September, precipitating a fall as well. Together, these things caused a pretty serious spike down to the 3 5/8 range, from which the stock has yet to really recover. Hence, I believe it is in a rather artifactual trading range caused by massive margin calls and abandonment by the growth and momentum fiends. Clearly it will take some time for the value

guys to embrace an internet play, but the ValueClick Japan factor should make it relatively easy once open minds prevail.

Already management is starting to hear less inquiries from investors about click-through rates (they're stable) and more inquiries regarding quality of accounts receivable (relatively small and high-quality, or so I'm told). I don't expect the value guys to take too long to catch on. I'll try to answer a few questions if they come up, but I must admit I won't support this idea as much as I did Huttig - my time pressures are greater now than then [not to say that they are greater than yours ;)]

DISCLAIMER: I benefit from this stock's appreciation, and have acquired it at a price significantly below the current one. I do not have a specific exit price in mind at this point, and make no promises that I will notify people here when I sell. I therefore prescribe two grains of salt and a ton of due diligence. You never know my motives, although I will say that I am just trying to put a second idea up in accord with the requirements of VIC, and in good faith.

Catalyst

I feel value makes a great catalyst, but in this case you have artifactual trading pressures due to margin calls, tax-loss selling, and insider lock-up expiration. All of these pressures, once released, may provide catalysts for near-term price appreciation as we move into 2001. Doubleclick owns a bunch of the stock, and it would not be terribly surprising to see a takeout, although I have not investigated this aspect very thoroughly yet. The industry is consolidating, and we're talking at the most expensive a free business here. Positive net income next year will likely put the operations on the valuation map, which could take the shares to $10 with only the slightest change in perception.

Wellsford Real Properties(WRP) - $16.60 on Jun 1, 2001

WRP is an opportunity to buy real estate at as little as 50 cents on the dollar (and at most 61 cents on the dollar), with a plan for value realization in place and virtually no downside. Wellsford Real Properties is a real estate operating company (REOC) and as such its value is in wealth creation rather than earnings distribution. Third Avenue (Whitman's group) has a nice dissertation on why REOC's can be superior to REITs in its latest semi-annual. Third Avenue's also been accumulating this stock.

The stock's at $16.50. Book value is $26.93 and understates true net asset value. For four years others have done the waiting for me (and are likely to sell now in pure disgust), and now I do believe the next couple years will see value realization - and hence a nice return/risk ratio. Here's why:

Wellsford is an incomplete liquidation story now divided operationally into three strategic units:

1) Wellsford Commercial ($10/share book value, liquidating, no recourse debt) - primary asset is a 39% interest in Wellsford/Whitehall, a joint venture with Goldman, valued at 86 million at March 31st. This value will continue to increase. W/W has been in the business of buying up turnaround properties and putting some sweat equity into them, then filling them. This naturally causes book value to drastically understate net asset value. This is important because Wellsford/Whitehall is being liquidated on a 3 year plan at Wellsford Real Properties' insistence. Two recent properties sold at 25% and 40% premiums to book, respectively. Today, the Parsippany announcement - a 43 million book value property sold for 61 million. There was $582 million in assets on W/W's books (213 mill in equity) at last report - but the realizable value is higher.

Just looking at the Parsippany sale, equity in W/W pre-tax will jump over $18M - that's nearly 8 mill to Wellsford. Wellsford only has 8.35 million shares, so that's a pre-tax gain of roughly 84 cents/share on the sale of just one property representing just 6.9% of the JV's assets. With the stock at 16 1/2 and book at 27, you can see where this is headed.

Management certainly considers the $582 million number to understate the true asset value in Wellsford/Whitehall. I've heard management laugh at that number. A 25% premium to book realized on the liquidation of these assets would jump Wellsford's book value nearly $6/share to $33/share. The most recent Parsippany sale went at a 40% premium, and another recent sale went at roughly a 25% premium. Obviously not all will go at such great prices, but it's a good trend. Management told me earlier the 25% premium they fetched earlier was on one of their average properties, and implied there was better stuff to come. Today's 40% premium with the Parsippany sale is consistent, and certainly doesn't make management a liar.

Why liquidate W/W? According the Chairman, "I know real estate. I have fundamental way of analyzing this, and we're in the 9th year of a 7 year boom" and hence he thought it was a good time to start liquidating the Goldman JV. Goldman disagreed. Both offered to buy the other out (Goldman first), but both bid low and neither accepted. So, an arrangement was worked out where WRP sent its employees

working on the JV to Goldman and Goldman's man manages it with a newly created company. Goldman has since decided it too doesn't want to expand this business anymore given the stage of the real estate boom. So now, essentially, they're presiding over the liquidation of the JV. Expect good news to come out of this liquidation (like today), with more readily identifiable cash assets appearing on the balance sheet. To be clear, the liquidation is occuring primarily because it is the smart thing to do given the cycle, and a secondary effect is it will make the value more obvious to those reading the balance sheet.

Commercial ADJUSTMENT to book get to NAV: + $3 to $7/share; but again, we've already got a big discount to book, so the key is that there is a liquidation ongoing.

2) Wellsford Capital ($12/share book value; continuing; no recourse debt) -As the real estate market peaks, the Chairman wants to get out of equity, but sees future potential for buying real estate debt on the cheap as things turn sour. So Capital is an ongoing operation with more to come in the future. Management is quite dismissive of "S&L's on steroids," mortgage REITs, and the structure of entities such as CMM. They feel they can be much safer and smarter than using those strategies, and yet by buying smart earn great returns despite not taking on substantial risk.
a) $35.4 mill direct investment in 11.5% meezzanine loand, 277 Park Avenue (DLJ's building, well known to some of you I'm sure 'hedge fund hotel')
b) 51% interest in Second Holding, LLC, another JV that invests in real estate debt. They have been ramping this up. Carried at equity method and equity in Second Holding is roughly $27 mill. That's the limit of their liability. Debt/equity in Second Holding at 12X but of course debt within the JV is non-recourse to WRP. This is the current main vehicle for investment in debt, and it has recently raised several hundred million, which for now is just sitting, earning slightly more than its cost. How this will be used is an unknown, but presumably they'll be smart about it. The stock hasn't been recognized, but management has been creating value, and Capital is a bet they ought to be able to in the future. Again, the equity value at risk herre is only a little over $3/share.
c) $7 mill investment in REIS, a real estate information services company - I write this down simply because there's a family relation behind this investment, but it is possible the 6.9 million may even underrepresent the value of that asset.
d) VLP is being liquidated - another $11 million or so to come.

Capital ADJUSTMENT to book to get to NAV: -1 buck for the nepotistic investment in REIS, though it might work out. One only need look at Homestore.com to see that real estate e-commerce ventures have not been the terrible bombs so characteristic of the .com genre. REIS is not infrequently cited in respectable press, and may have a niche.

3) Wellsford Development ($4/share book value; liquidation?; $99 mill mortgage debt) - 86% interest in an JV with Equity Residential (EQR) which is an 1800 unit multifamily development in a nice area south of Denver. 760 units being rented. Converting 264 more units to condos, and first sales have gone well at nearly $200K/pop (they cost about $166K/pop to build). Sold a 344 apartment project for 22.5 mill last year, for a gain of 3.5 million. Totalling up the value of the various pieces here and I get a small premium to book value. The key is that portions of it are being liquidated at a slight premium.

Development ADJUSTMENT to book to get to NAV: none, maybe +1 buck/share on the upside. Chairman talks this one up as a "no-brainer" but I'm unwilling to give much credit yet.

That's it; because of the nature of the turnaround properties, I don't anticipate much long-term downside there from the book level. Potential losses in Capital are maybe $3/share in book value. Face value of a $25 mill convertible preferred is more than offset by cash on hand. As time goes by, earnings will add about $1.25 to $1.50 per share to book value each year as well.

The company has been buying back shares when blocks become available, retiring 2 million shares in this fashion in the last couple of years. The Chairman vows to continue doing so, claiming the illiquidity of the stock is the greatest impediment - he doesn't want to run it up. BTW, a strong advocate of share buybacks in undervalued securities, I have never found myself on the receiving end of a management lecture on why buying back stock is such a good idea. That's what I got from this Chairman. "Look, I know what I got..." He gets points for mentioning Berkshire Hathaway in his annual letter, too: "Our business strategy model, based on the Berkshire Hathaway model of net asset value growth being reflected in share price, has thus far not been transferable to the real estate industry."

The history of Wellsford is that management presided over Wellsford Residential Property Trust - of which WRP was a subsidiary - from 1992-1997. The Trust merged with Equity Residential Properties at a price that gave a 23% annualized return since inception to shareholders. The stock had done nothing for years and then ran up for the buyout. Still, that's a source of pride for the Chairman, who points to the annualized return rather than the long stagnation, and I don't believe he is adverse to selling out again so he can have a similar "achievement" here. He is not comfortable with the lack of recognition in the public markets. In any case, WRP was a subsidiary of the Trust, and was spun off immediately prior to the merger. A private placement for 6,000,000 shares at book value ensued the next month. And the stock hasn't done anything since, even though value has been created.

Franklin Mutual (Beacon, Qualified) owns 24% of the common from the initial private placement, and Morgan Stanley owns 17% of the common from the same. Neither have been buyers recently. MJ Whitman Advisors upped its position 25% during the 1st Q.

A decent sized seller (probably Fleet or Advisory Research or both) has been offering shares whenever a decent-sized order comes up to buy, so in my experience at least the illiquidity is less a problem than it appears.

Catalyst

Liquidation of real estate per plan with $200 million in properties being marketed for sale right now; possible sale of whole company; commitment to share buyback at deep discont to intrinsic value; dollar on sale for 50-60 cents with no significant downside; possible Russell 2000 inclusion on June 30th but is one of the few such candidates that hasn't really moved yet.