ValueInvestor INSIGHT
The Leading Authority on Value Investing
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Winning By Not Losing

Unlike glass-half-full peers, Charles de Vaulx and Charles de Lardemelle act as if the glass is empty and broken – to the great benefit of their investors.

They're finding equity bargains scarce, but one indicator of market sentiment followed by Charles de Vaulx and Charles de Lardemelle of International Value Advisers is not yet flashing red: "When caution is out the window, our funds are not as well liked and we see redemptions," says de Lardemelle. "We're not seeing that yet."

Investor loyalty at IVA, now with $19.4 billion in assets, has been well earned. Since their launches in October 2008, the firm's International and Worldwide funds have respectively beaten their benchmarks by an average 500 and 340 basis points per year.

Casting a wide net for underappreciated value, de Vaulx and de Lardemelle are finding opportunity today in such areas as R&D outsourcing, pharmaceuticals, hotels, casinos and satellites.

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INVESTOR INSIGHT

International Value Advisers
Charles de Vaulx (*l*), Charles de Lardemelle (*r*)

Investment Focus: Seek companies with stable long-term earnings power when the market misprices their underlying asset values and/or overstates cyclical concerns.

Divide and Conquer

Successfully betting on mean reversion is a function of being right on the opportunities chosen as well as the timing. Joe Huber has excelled at both.

INVESTOR INSIGHT

Joe Huber
Huber Capital Management

Investment Focus: Seeks companies with strong long-term assets – from brands, scale and/or distribution – that are currently under-earning relative to potential.

With a strategy targeting underperformers, mid-2007 wasn't the best time for Joe Huber to start his own firm. "We tend to do relatively well in down markets," he says, "but not so well in panic markets, when people are pretty quick to sell what we own."

Despite the rocky start, Huber Capital now runs nearly $4 billion and its small-cap strategy since July 2007 has earned a net annualized 11.9%, vs. 5.2% for the Russell 2000 Value index. Its select large-cap strategy has bested its Russell benchmark by an average 300 basis points per year.

Stepping in when many are stepping out, Huber is finding upside today in such diverse areas as insurance, energy services, information technology, personal products and agricultural equipment.

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Investor Insight: Charles de Vaulx

International Value Advisers' Charles de Vaulx, Charles de Lardemelle, Adam Ackerman, Maureen Levelis, and Thibaut Pizenberg explain their two performance goals, where they reside in value investing's "wide tent," what Ben Graham advice most resonates today, and why they see value in Hong Kong & Shanghai Hotels, Kangwon Land, Alten and Eutelsat.

You've characterized your performance goals as "atypical." How so?

Charles de Vaulx: Our ultimate goals are somewhat atypical for a long-only manager in the sense that we have a dual mandate. We try over a full economic cycle to beat our benchmarks, but over a shorter 12-to-18 month time frame we are absolute-return oriented and focused on the preservation of capital. We don't consider those goals mutually exclusive, as it's our clear belief that one of the most effective ways to compound wealth is to minimize drawdowns. It's not the only way, but it suits our temperament and our performance over time would indicate the methodology works.

Toward that dual end, what types of businesses tend to attract your attention?

CdV: Value investing, as Jean-Marie Eveillard used to say, is a very wide tent. At one end of the spectrum are those who are willing to buy statistically dirt-cheap shares of companies of dubious quality, while at the other end are those who still require a margin of safety but are much more willing to pay up for quality. We have a preference for quality, which manifests itself in things like strong barriers to entry, sustainable earnings power, high returns on capital employed, potential growth at or better than GDP, and significant free cash flow generation over a full economic cycle.

That all rarely comes cheap, so we're often trying to take advantage of cyclicality. Think advertising, or temporary staffing, or freight forwarding, or food catering. These are the types of businesses we like, with pricing power, low capital intensity and strong moats, but when economic or industry cycles turn their stocks can get sold down to the point where investors seem to forget these are cyclical businesses and that at one point the cycle will turn and things will get better.

Other situations that appeal to us might be a case like Sealed Air [SEE], where divisions doing well were somewhat hidden two years ago by a recently acquired one called Diversey, a large European cleaning chemicals and services business that was performing poorly. As that business has improved, the stock has come back nicely.

ON DOWNSIDE:

For each stock we arrive at an estimate of intrinsic value, but equally important is defining the worst-case value.

We own a stock in France called Teleperformance [RCF:FP], one of the leading call-center operators in the world. It's very profitable in markets like the U.S., but losing a ton of money in their home French market, a situation we believe will not last forever. These are typical examples where one division or one geography distorts things and we try to profit from that.

We also try to profit from valuation differences for similar companies across geographic markets. We spoke a year and a half ago about Astellas Pharma [4503:JP] [*VII*, August 31, 2012], and it remains one of our largest positions. The company has done a tremendous job in growing its intrinsic value through its own R&D and intelligent acquisitions. On top of that, totally uncharacteristic for the Japanese, its capital allocation has been squeaky clean. They're willing to pay out roughly 50% of free cash flow in the form of dividends, and whenever cash exceeds 20% of market cap they buy back stock. Even with all that, the stock [at a recent ¥6,400] trades at something like 9.5x EV/EBIT on a trailing basis, and earnings will grow significantly this year. Peers in the stock market in the U.S. and Europe trade at more like 15-16x. Local investors still don't fully understand the company yet – in particular they focus on EBIT margin as opposed to EBITA margin, which is four percentage points higher.

How does your risk aversion show up in your research process?

Charles de Lardemelle: For each stock we're looking to arrive at an estimate of intrinsic value, which we define as what a knowledgeable buyer would pay in cash for 100% of the company. But equally important is defining the worst-case scenario value for the stock. Here we basically go back in time and look at how bad things have gotten with respect to revenues and margins during the previous recession, as well as with respect to the multiples investors would pay. We make relevant adjustments if the current situation differs materially from the past – paying particular attention to the current level of financial leverage – but the goal of the exercise is to quantify our downside if we're wrong.

There's no hard rule, but if the result of the exercise is that we could face a 25% to 30% drawdown, we are less likely to go ahead. If we do go ahead, we would take a smaller-than-normal position. This will cause us to miss some opportunities, yet hopefully it more often helps us to avoid cases where there's a permanent impairment of value.

How do you define your opportunity set?

CdV: In principle, it's quite broad. In our IVA Worldwide Fund, we can invest anywhere in the world. We can invest in very small companies as well as large ones. In lieu of equities we can invest in high-yield bonds when they provide what we believe are equity-type returns. We can hold gold, either bullion or gold-mining stocks. And, of course, when we can't find anything cheap enough to buy, we don't hesitate to hold cash.

The universe of what interests us at any time is much narrower. Though this is starting to change, we have not been active in emerging markets because we are value investors, not investors in high growth or glamour. While it was an important portion of the portfolio years ago, we're finding little to own today in high-yield bonds. In equities, our watch list tends to include anywhere from 400 to 800 active ideas, most of which are names and industries that we have invested in over the past 25 years and meet our definition of quality businesses.

We try to learn new things as well. Because of how industries and companies have evolved, we're finding more of interest in technology, today including names like Oracle [ORCL] and Microsoft [MSFT]. In Japan, we've done very well with the stock of Temp Holdings [2181:JP], a temporary-staffing company that got our attention after investing globally in the industry over the years in companies like Randstad, Adecco, Manpower and Kelly Services.

We closed our funds to new investors in 2011 when we reached $15 billion in assets. A primary reason was so we didn't get so big that we couldn't invest in things like smaller stocks or high-yield bonds or companies with big insider ownership and limited float. Right now in Japan, for example, it's very clear that small stocks are much cheaper than large ones. The next time the high-yield market takes a beating, we want to be able to participate. Going after such opportunities if we were managing $50-60 billion in assets would be almost impossible.

Describe the effort you make in your equity research to "recast" income statements and balance sheets.

CdL: The goal with all our accounting adjustments is to arrive at numbers that best reflect true economic reality. This is exactly what a knowledgeable buyer would do in assessing what to pay for a company, and it's especially important when investing in a number of different markets with different accounting conventions.

We look at everything, from depreciation methodology, to pension liabilities, to real estate values, to accounting for minority interests and joint ventures. If a Japanese shipping company is depreciating its assets over seven years when the rest of the world does it over 25, we'll add back a portion of that depreciation to operating earnings. If the balance-sheet value for an Asian company's headquarters far understates its actual worth, we'll increase the value in our analysis. Charles mentioned both Astellas Pharma and Temp Holdings – in each case it's rather difficult to determine how they amortize goodwill due to acquisitions, but when you do, you find their earnings as reported are substantially understated.

ON MEETING MANAGEMENT:

From a time-management standpoint, doing independent research is a more valuable use of our time.

CdV: Another important adjustment, for somewhat capital-intensive businesses, is to understand what maintenance capex is as opposed to stated depreciation. It's quite striking in many cases in the gold-mining or oil-and-gas industries the extent to which the cost just to maintain production can dwarf depreciation. Not understanding that can lead to significantly overpaying for a stock.

CdL: While U.S. firms may not require the number of accounting adjustments we make elsewhere, going through the financials with a fine-tooth comb is as important here as anywhere. Charles mentioned that we own Oracle, for which we believe the market has exaggerated concerns about cloud computing. We've also looked at IBM [IBM], however, and see it playing some of the same games that a GE or a Tyco played back in the day. Cash flows are actually weaker than reported results would indicate. We worry that the company is goosing up its top line through acquisitions, masking declining businesses. Margins also seem substantially higher than those of competitors in the same businesses, which might not be sustainable over time. We see none of these issues at Oracle, but we're quite concerned about IBM.

You generally don't put much weight on speaking with management. Why?

CdV: When you look to interview a money manager, isn't it first much more important to know everything you can about the firm's strategy, what its track record is, how it communicates and how it allocates capital? That's our approach. There's so much available material out there. If it does make sense to meet – and sometimes it does – we want to know as much as possible so that the conversation more reflects what the board would be discussing with top management.

CdL: Especially in the Anglo-Saxon world where management tends to be compensated with options and speaks from a polished script, I have yet to hear from a CEO or CFO how the stock is overvalued, or how they've done a bad job of allocating capital, or why they see big challenges ahead. All of that they won't tell you – you have to find it for yourself. From a time-management standpoint, we'd argue doing independent research on a company, going through the footnotes to try to connect all the dots, is a much more valuable use of our time.

You've been known to articulate well-developed macro views. How do they get incorporated into your process?

CdV: The cornerstone of our process is bottom up, focused on the quality and sustainability of the business and how it's currently being valued. But given the importance of cyclicality in many of the situations we look at, you have to consider the macro backdrop. If we believe we're on the eve of a multi-year economic recovery in Europe, that will have a direct bearing on the assumptions we make in valuing companies heavily reliant on Europe.

Are we on the eve of a multi-year economic recovery in Europe?

CdV: Everyone is getting more excited about Europe and things are improving, but we are still mindful that European banks overall remain undercapitalized and bank loans are still declining. Our medium- to long-term outlook for Europe is tentatively positive, but we would feel more comfortable if the banks were better capitalized and able to put more money to work.

Another direct way I'd mention that macro views come into play is in our currency hedging. Chuck would say it probably reflects betting on the best house in a bad neighborhood, but today as U.S. dollar investors we are roughly 50% hedged against exposures both to the euro and the Japanese yen.

Equities in emerging markets have been less than buoyant. Is that creating investment opportunity?

CdV: As I mentioned earlier, it's been difficult to find quality businesses in emerging markets at reasonable prices. It's been much easier for us to participate in the growth there through developed-market companies like Nestle, which earns a substantial portion of its profits in developing countries.

Last year emerging-markets stocks were down on average 5%, while mature markets were up by 25%. So by June and July of last year we started looking more closely at a number of emerging-markets names. We made our first investment at IVA in Brazil, buying Itau Unibanco [ITUB3:BZ]. We bought into three small- to mid-cap companies operating in China but listed in Hong Kong: Springland International [1700:HK], Uni-President [220:HK] and Digital China [861:HK]. In India, we found South Indian Bank [SIB:IN]. I wouldn't at all characterize this as signaling a big change in how we look at emerging markets, but we are doing more work in these areas.

CdL: To give you a sense of the difficulties involved, look at our investment in Itau Unibanco. On the one hand, Brazil has a nice consolidated banking system, where regulators have done a good job in making sure banks are disciplined and well capitalized. Leverage in the industry is relatively low and margins are high. On the other hand, though, you've seen policy makers interfere by encouraging banks to lend at lower rates, putting potential pressure on net interest margins going forward. Also, just in the time we've owned Itau Unibanco, the Brazilian economy has deteriorated quickly and the medium-term outlook for the currency, the real, is highly uncertain. There will be opportunity in emerging markets, but caution is still very much necessary.

ON EMERGING MARKETS:

There's no big change in how we're looking at emerging markets, but we are doing more work in these areas.

As absolute-value investors, what discount to your intrinsic value estimate do you require in order to buy?

CdV: We absolutely require some margin of safety, but the margin varies. If the underlying company is generating good free cash flow, allocates capital well, is organically growing and has very little downside, we might be willing to buy it with only a 20% discount. Conversely, if the company is less attractive on those fronts, has more debt than we'd like and is less liquid then we'd like, we might require a 50-60% discount. All of that comes into play as we size positions as well.

On the subject of position sizing, you typically hold 100 to 120 positions at a time. Why that level of diversification?

CdV: Because we invest on a global basis, we prefer a certain level of diversification to help protect against poor corporate governance, insufficient disclosure or simply "unknown unknowns." But I would add that the number of positions we hold has nothing to do with trying to match the benchmark. Active portfolio management doesn't just mean concentrated portfolios, it can also mean running diversified portfolios that look nothing like the benchmark. When we were at SoGen Funds and then at First Eagle, that meant owning almost no technology or telecom in the late-1990s and having very little exposure to banks in the mid-2000s. It IVA, it's included being very light in emerging markets over the past couple of years.

Some argue that in owning 100-plus names you can't really know your companies. But history has allowed us to test the accuracy of our intrinsic-value estimates, since roughly 15% of our portfolio companies over the past 20 years have been taken over. In those cases, our intrinsic values on average have come in about 10% too low. We may not know every detail about every company, but history suggests we're pretty good – even with our number of holdings – at zeroing in on the four or five issues that really drive the value of each stock.

Your largest position by far today is cash, accounting for 32% of the IVA Worldwide Fund at the end of 2013. Why is that?

CdV: We hold cash when we can't find enough cheap securities that we like, which is obviously the case today. Ben Graham used to say that even if you had assembled a portfolio of what you considered genuinely cheap stocks, if at that same moment the market as a whole was fully priced or overpriced, you should keep 20-25% of your portfolio in cash or liquid bonds. You're deluding yourself if you believe your stocks, however cheap they are, won't temporarily go down when Mr. Market decides to correct. When that happens, your cash becomes ammunition for future bargains.

When we look around the world, we don't see stocks as grossly overpriced, just trading at or close to their intrinsic values. That's a bottom-up conclusion and explains why we have the level of cash we do. Why on earth would we justify buying names that are fully priced?

We understand why stocks have gone up, and we understand why they may go up some more. But the recent period of what I call rational exuberance in equities will likely hit a wall if and when interest rates normalize, and – one stock at a time – if and when corporate profit margins decline. We are prepared in either case.

Turning to some ideas you do find interesting, describe the investment case for Hong Kong & Shanghai Hotels [HK:45].

Thibaut Pizenberg: The company operates in three main businesses. The Peninsula Hotel Group consists of 12 five-star hotels worldwide, with 3,300 total rooms and an average room rate of more than $720 per night. The company owns eight of the hotels outright, while the other four are joint ventures in which it owns 20% to 50% stakes. The second business is luxury residential properties, mostly located near the ocean in Repulse Bay, which is only 15 minutes from central Hong Kong. The third piece is commercial real estate, which comprises retail and office rentals within large Peninsula Hotel complexes, primarily in Hong Kong, Beijing and Paris.

The company is controlled by the Kadoorie family, which owns just over 50% of the shares outstanding. The chairman of the board since 1984 is Sir Michael Kadoorie, one of the ten wealthiest people in Hong Kong, whose father Lawrence acquired the Peninsula Hong Kong hotel in 1928. They've proven to be very shrewd investors and allocators of capital, the types of insiders we're more than happy to invest alongside.

Chuck mentioned earlier the importance we put on our worst-case-scenario valuation, so it might be illustrative to start there. For each of the three businesses we started by looking at what happened between 2008 and 2009. For hotels, we assume in our worst-case analysis that revenues fall 23% from the current level and EBIT declines 30%, which is what happened in 2009. With residential properties, we assume revenue and EBIT go down by 6%, also what happened in 2009. Commercial rentals were resilient, with revenues and EBIT falling only 5% in the recession, but to be conservative we're using a 15% decline.

For multiples, we assume a per-room value for the hotels of 350 times the average room rate, the lowest we've seen in comparable M&A cash transactions over the past 20 years. For the residential properties, we assume an EBIT cap rate of 6%, which implies a per-square-foot value of $700, against more like $1,600 in recent transactions. For the commercial rentals, we use a 7% EBIT cap rate, at a time when comps in Beijing and Hong Kong have sold at 2-3% cap rates.

Altogether, after subtracting debt, our worst-case scenario would result in a value of around HK$9.70 per share. That's just 9% below the current share price [of HK$10.65]. Given how harsh our assumptions are, that's an extremely small downside.

Walk through how you're estimating the upside.

INVESTMENT SNAPSHOT

Hong Kong & Shanghai Hotels
(Hong Kong: 45:HK)

Business: Holding company whose primary assets include The Peninsula Hotel chain and other commercial and residential properties located primarily in Southeast Asia.

Share Information
(@1/30/14, Exchange Rate: $1 = HK$7.767):

Price	**HK$10.64**
52-Week Range	HK$10.38 – HK$14.20
Dividend Yield	1.3%
Market Cap	HK$15.98 billion

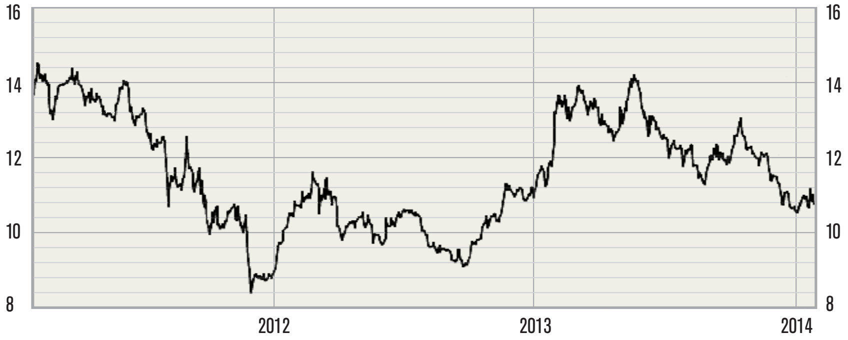
Financials (TTM):

Revenue	HK$5.30 billion
EBITDA Margin	27.0%
Net Profit Margin	11.9%

Valuation Metrics
(Current Price vs. TTM):

	45:HK	HSI
P/E	10.1	9.9

45:HK PRICE HISTORY



THE BOTTOM LINE

While the company owns world-class hotel and residential properties and is controlled by one of Hong Kong's wealthiest families with a long record of astute capital allocation, the market is treating the stock as if time has passed it by, says Thibaut Pizenberg. His sum-of-the-parts estimate of per-share intrinsic value, HK$21, is double the current price.

Sources: Company reports, other publicly available information

TP: The sum-of-the parts methodology is the same. Using in our intrinsic-value calculation a per-room value of 700 times the average room rate – deals for luxury hotels have been done at 1,000x – we arrive at a value for that business of HK$9.50 per share. For luxury residential, recent transactions have been at 2% EBIT cap rates, but we use 4%, implying a $1,200 value per square foot. That comes to another HK$9 per share. We use a 5% EBIT cap rate on the commercial properties, which yields a value of about HK$4.50 per share. Subtract HK$2 per share in debt and our sum-of-the-parts value comes to HK$21 per share, double the current price.

Why would this be so misunderstood?

TP: We think there are a couple primary reasons. I've tried to summarize it all relatively clearly, but given the different businesses and ownership stakes in certain properties, this is a very difficult and complicated company to piece together and analyze.

In addition, the flagship Peninsula Hong Kong hotel went through a HK$450 million renovation from January 2012 to June 2013, which left 50% of the hotel rooms closed on average. That left 10% of group EBIT missing, which the market doesn't seem to appreciate is more than coming back. Since the renovation was completed, room rates at the hotel are up 22%, to over $1,000 per night.

CdV: Another factor may be the relatively low dividend yield. Hong Kong companies traditionally pay out a substantial proportion of their earnings, while this one has chosen not to. Over time they have done an outstanding job at capital allocation, so we don't mind at all if the dividend isn't so high.

Your next idea, Kangwon Land [035250:KS], has a somewhat different controlling shareholder.

TP: It certainly does. Kangwon owns and operates South Korea's largest casino, which is also the only one at which Korean nationals can gamble legally. It's located in Gangwon province, about three hours east of Seoul. The company came public in 2001, but it's still 47% owned by state-related entities.

The history of Kangwon Land is fairly interesting. It was established in 1998 to boost the economy in Gangwon province after the government abandoned a large coal-mine operation in the region. In return for monopoly rights to serve Korean citizens, it's required to pay special taxes and fees that support employee welfare and promote the provincial economy. Despite those added costs, the casino operation is one of the most profitable in the world, resulting in company EBIT margins in 2013 of 30% and a more than 50% return on capital employed. People stand in line an average of two hours to get in the door, and the company prior to a recent expansion put capacity utilization of the property at well over 100%.

What is the market missing here?

TP: For reasons we don't fully understand, the market seems unwilling to recognize the upside potential of the capacity expansion that is now coming fully on line. The expansion adds 68 table games and 400 slot machines, which the company says at 100% utilization would translate into a 40% increase in annual revenue. For 2014, we assume only 80% utilization of the new capacity, which we estimate will result in 27% revenue growth and an increase in the EBIT margin to 38%.

INVESTMENT SNAPSHOT

Kangwon Land
(Seoul: 035250:KS)

Business: Partly state-controlled owner and operator of South Korea's largest casino/hotel resort, the only one at which the country's citizens are allowed to gamble.

Share Information
(@1/30/14, Exchange Rate: $1 = ₩1,080):

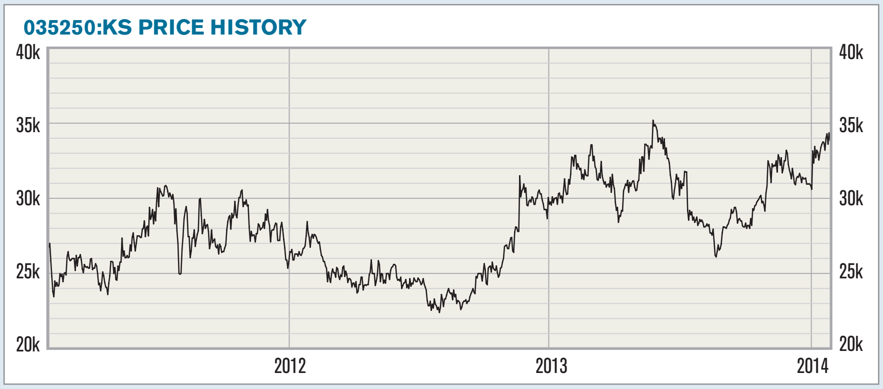
Price	**₩33,850**
52-Week Range	₩25,750 – ₩37,000
Dividend Yield	2.2%
Market Cap	₩7.24 trillion

Financials (TTM):

Revenue	₩1.34 trillion
EBITDA Margin	39.2%
Net Profit Margin	23.7%

Valuation Metrics
(Current Price vs. TTM):

	035250:KS	KOSPI
P/E (TTM)	22.1	18.7



THE BOTTOM LINE

The market has been surprisingly slow to assign value to the revenue and profit growth expected from the company's newly expanded casino operation, says Thibaut Pizenberg. Assuming 27% revenue growth this year and expansion of already-high EBIT margins to 38%, he estimates intrinsic value per share at nearly 50% above today's stock price.

Sources: Company reports, other publicly available information

Based on our numbers using those assumptions, the stock today [at a recent ₩33,800] trades at an EV/EBIT multiple of just 7.5x. Comparable properties in Singapore, Macau and Las Vegas trade at roughly twice that multiple. Even at a 12x multiple – the very low end of where cash M&A transactions are usually done – our intrinsic value is ₩50,000 per share. That includes net cash on the balance sheet that is just over 25% of the current market cap.

How does the worst-case scenario look?

TP: This is very important here as well. In our worst case, we assume a 25% decline in EBIT, resulting from the new capacity being utilized at only 50% and from the company basically throwing 10% of annual EBIT out the window on loss-making regional-development projects and promotion. By the way, that 10% number is not far from what's happened in the past, but the government starting in 2012 stopped asking the company to spend on such extraneous projects. For our worst-case, we assume they return.

For a multiple we use 8x EV/EBIT, the lowest we've seen in M&A transactions over the past 20 years. On the lower EBIT, that would result in a worst-case share price of ₩30,000 – again, very limited downside given the harshness of the assumptions.

CdV: I'd add just one thing, on the currency. The Korean won has been very strong against the dollar. To guard against that reverting, we recently hedged the currency to the tune of 50%. Interest rates are quite low, so the cost of the hedge is minimal.

From Asia to Europe, describe the opportunity you see in France's Alten [ATE:FP].

Maureen Levelis: Alten employs more than 14,000 engineers that work on-site in client R&D departments on an outsourced basis. It's an industry somewhat particular to Europe, where because companies can be so restricted in reducing headcount, they value the flexibility that comes with outsourcing even highly skilled jobs.

More than 60% of the company's business today is in France, with most of the rest elsewhere in Europe. It's well diversified across industries, with banks and financial services, telecom, aerospace, autos and energy accounting for between 14% to 19% of the customer base. The overall R&D-outsourcing market in Europe – which the company says generates €22 billion in annual revenue – is highly fragmented, with Alten the #2 in the industry, just behind another French company, Altran, which has maybe 6% market share.

Is this a growing industry?

ML: Market penetration appears to be increasing. In France, for example, 14% of companies outsourced some portion of R&D in 2000, while that number today is over 20%. Overall, Alten believes the market will grow at 5-6% annually, which we consider reasonable.

The company also has the potential to grow by acquisition. It currently has net cash on its balance sheet and has so far proven disciplined in buying small consulting businesses to expand in various geographic or vertical markets. Just last month it finalized four deals that will add 720 consultants and roughly €80 million in annual revenue.

With the shares at €33.25, how are you looking at valuation?

ML: Given that broader-based IT consultants like Accenture trade at up to 15x

INVESTMENT SNAPSHOT

Alten
(Paris: ATE:FP)

Business: Provider of engineering staff – on an on-site, outsourced basis – primarily engaged in research and development capacities for large European enterprises.

Share Information
(@1/30/14, Exchange Rate: $1 = €0.738):

Price	**€33.25**
52-Week Range	€25.40 – €36.01
Dividend Yield	3.0%
Market Cap	€1.10 billion

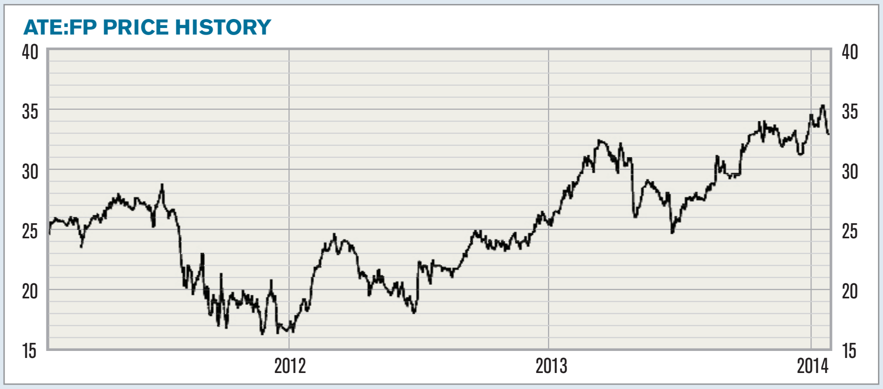
Financials (2012):

Revenue	€1.20 billion
Operating Margin	10.7%
Net Profit Margin	6.5%

Valuation Metrics
(Current Price vs. TTM):

	ATE:FP	CAC
P/E	14.1	13.8

ATE:FP PRICE HISTORY



THE BOTTOM LINE

The company's resilience through the cycle and growth potential in a fragmented and organically – and potentially cyclically – growing industry is currently underappreciated by the market, says Maureen Levelis. She estimates today's intrinsic value at €39 per share and over the medium term believes that value can grow at a low double-digit rate.

Sources: Company reports, other publicly available information

EV/EBIT and at almost 2x sales, we think it's conservative to value the company at 10.5x EBIT on an enterprise-value basis and 1x revenues. That gives us an intrinsic value of €39.

Is that an adequate margin of safety from today's price?

CdL: In today's environment, we believe it's adequate to hold. Alten is a higher-quality business than it seems to get credit for – it's not quite an Accenture, but it performs very well through the bottom of a cycle. It's not exposed to cheap offshore competition from places like India. Unlike traditional temporary staffing, it also has more growth upside. With organic growth, some acquisitions and maybe some share buybacks as cash builds up, a 10% annual compounding of intrinsic value is certainly achievable.

I'd be more concerned about owning this stock at a small discount if we were at the top of the economic cycle in Europe, which we don't believe is the case. As the broader economy improves, especially if Alten continues to be successful in expanding outside of France, there's plenty of upside here from both earnings growth and multiple expansion. We believe the intrinsic value of Alten will continue to compound nicely over time.

Satellite-company Eutelsat [ETL:FP] appears to nicely fit the IVA mold. Why is the stock interesting today?

Adam Ackerman: Eutelsat does have the type of stable, high-quality and low-risk business model we like. It operates and leases out a fleet of 23 communications satellites that are in fixed, geo-synchronous orbit 22,000 miles above the earth. Such satellites are well suited for transmitting video – roughly two-thirds of revenues come from television-service providers – and for the transmission of data through broadband Internet access.

Unlike in the U.S. where wireless spectrum is auctioned off to the highest bidder, the orbital slots for geosynchronous satellites were allocated long ago by a regulatory body operating under the United Nations. The slots were more or less free and the rights to them basically perpetual. To us, the perpetual rights Eutelsat and its peers have result in a business model similar to owning high-quality commercial real estate in an attractive city center.

The economics are quite compelling. Satellites cost €200-225 million to build, launch and insure, a process that takes about two years. They then spend roughly 15 years in the sky, with transponder capacity leased out under average contract lives, for video, of around 7.5 years. Since the company went public in 2005, revenues and EBITDA have grown at an annual rate of 7% and the EBITDA margin – even through the financial crisis and the Euro crisis – has been in a very tight 77-79% range. After subtracting annual maintenance capex to refurbish and upgrade the fleet, operating margins are still 45-50%. Return on capital employed, after our adjustments, has historically been in the high-teens or low-20% range, a further testament to the quality of business.

Describe the competitive environment.

AA: There are three large players in the industry, with Eutelsat ranking third globally behind SES, based in Luxembourg, and Intelsat of the U.S. But market shares differ by the regions in which they compete: Eutelsat is #1 in Europe, for example, where it generates nearly 70% of its revenues and has 37% market share. Its expansion efforts have been focused

INVESTMENT SNAPSHOT

Eutelsat
(Paris: ETL:FP)

Business: Global owner and operator of a fleet of satellites whose capacity is leased primarily to providers of television, radio, Internet and mobile communications services.

Share Information
(@1/30/14, Exchange Rate: $1 = €0.738):

Price	**€22.83**
52-Week Range	€20.41 – €28.15
Dividend Yield	4.7%
Market Cap	€5.03 billion

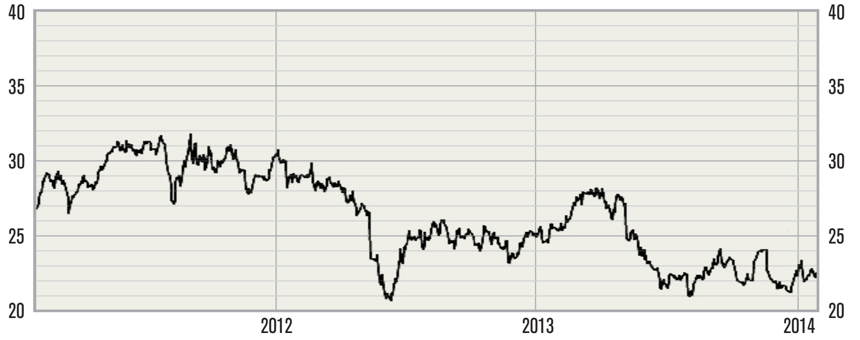
Financials (FY ending 6/30/13):

Revenue	€1.28 billion
Operating Margin	77.5%
Net Profit Margin	27.6%

Valuation Metrics
(Current Price vs. TTM):

	ETL:FP	CAC
P/E	14.1	13.8

ETL:FP PRICE HISTORY



THE BOTTOM LINE
The company has exactly the high-quality and low-risk business model IVA likes, says Adam Ackerman, but faces temporary pressures that appear to be unnerving the market. As new transponder capacity comes on line and revenue growth returns to normal levels, he expects the share price to rebound to at least his €26.25 intrinsic value estimate.

Sources: Company reports, other publicly available information

primarily on Africa, the Middle East and Latin America, where it just completed the acquisition of Satelites Mexicanos for around $1.1 billion.

In general, the competitive dynamics are positive. The last time the supply/demand balance and pricing got out of whack was in the early 2000s, but we consider that far less likely today with the global market having consolidated to three well-run and shareholder-focused competitors.

What's amiss that might be dampening enthusiasm for the shares?

AA: Revenue growth has slumped to 2-3% annually from the 7% historical average, and capacity utilization is currently at 74%, from the more typical high-70s or low-80s. That's a function of several small pressures, such as the timing of capacity launches, slower-than-expected uptake for a new consumer-broadband initiative, pricing issues in Germany and slack demand from the U.S. military. None of those should cause lasting trouble and we're comfortable that revenue growth will return to more normal levels. Eutelsat's transponder capacity is expected to grow 22% over the next three years, while the contracted backlog of future business today is €5.4 billion, 4x the annual revenue run rate.

How cheap do you consider the shares at today's price of €22.80?

AA: Our intrinsic value today, using an EV/EBIT multiple of 13.5x, is €26.25. That's 15% above today's price and on top of that we're earning a dividend yield on last year's payout – which we expect to increase in 2014 – of 4.7%.

This is reminiscent of a very successful investment we made in a slightly different satellite company called Inmarsat [ISAT:LN], which also had been going through a growth slowdown prior to an increase in capacity. The valuation went up substantially even in advance of the resumption of revenue growth. We're counting on this being a replay of that same playbook.

Turning to the subject of gold, your position in it today appears to be smaller than usual. Why?

CdL: We will own gold because we believe it can provide a good hedge against inflation – as well as against deflation, incidentally. It can also help mitigate currency debasement over time. Our allocation today is around 3%, all in gold bullion.

ON RESOLVE:

Two-thirds of the time we look bad because we lag our benchmarks. Your ego has to be prepared for that.

In terms of what's driving our tactical allocation, we would argue the Federal Reserve slowing its purchases of Treasuries and mortgage-backed securities at the same time the European central bank is shrinking its balance sheet is not bullish for gold near-term. In addition, if you look over fifty years of history at metrics like how many ounces of gold it takes to buy a house or how many hours you need to work at median wage to buy an ounce of gold, in each case a reversion to the mean argues for sub-$1,000-per-ounce gold. But given the amount of leverage in the global economy, we still believe some allocation to gold at these prices makes sense.

Devastated gold-mining stocks haven't caught your eye?

CdV: Anything that goes down in price catches our eye. But the sad reality is that production costs for gold miners have gone though the roof over the past ten years and will be very difficult to reduce. For most gold-mining companies the total cost to extract an ounce of gold today, including capex, is $1,100 to $1,200 an ounce. With gold at $1,250 per ounce, there isn't much margin to work with. I won't deny that some gold miners are cheap, but be very mindful of the downside.

Stockpickers often contend it's a "stockpicker's market," as you have of late. Why do you think that's so?

CdV: Part of it is just a function of equity correlations coming way down, an environment that clearly puts more of a premium on one's ability to analyze individual industries and markets and who the winners and losers will be.

It also reflects our belief that one of the biggest analytical challenges facing investors over the next few years is divining the path of corporate profit margins, which in the U.S. and around the world are at very high historical levels. In which industries and companies will those margins be maintained, and in which ones are they most at risk? Investors that are best able to discern the sustainability or vulnerability of competitive advantage on a company-by-company basis are likely to come out way ahead.

One could imagine launching IVA shortly before the financial crisis would have been terrible timing, but that turned out not to be the case. Was that in your master plan?

CdV: We've always said that minimizing drawdowns was a primary key to success, but people don't always want to hear it, especially when markets are going up. It turned out we were lucky to prove that out of the gate, and for this notion of winning by not losing to start resonating with more and more individual and institutional investors.

If you look over the past five years – from January 1, 2009 – our Worldwide Fund has trailed the index. But when you add in the first quarter of the fund's existence, Q4 of 2008, we trounce the index. Again, winning by not losing.

One thing that's difficult about being a value investor as we are is that over a full economic cycle, roughly two-thirds of the time we look bad because we lag our benchmarks. Only one third of the time do we shine, and we end up shining over the whole period. You need clients who get that, which we have, but your ego has to be prepared for that as well. VII

Investor Insight: Joe Huber

Huber Capital's Joe Huber, Brenda Cullen, Chris Karger, Tom Schloemer and Gary Steiner describe the tools they use to identify value traps, why they believe large caps can be less efficiently priced than small caps, which sector they're buying again after many years, and why they see upside in Ensco, Herbalife, CNO, Titan Machinery and Hewlett-Packard.

Reversion-to-the-mean is a central tenet of your investment strategy. Describe how that helps you identify opportunities.

Joe Huber: Economic theory tells you that reversion is powerful. Companies with low returns on capital benefit from capital exiting the industry and their returns get driven up over time. Companies with high returns on capital invite competition and their returns get driven down over time.

Empirical evidence also shows reversion is very powerful. We did a long-term study comparing the returns of high-ROC companies to low-ROC companies over time and found that there was no statistical difference in how they were performing after a period of around 16 years. So take Apple or Bank of America today, and it's a coin flip which one is going to be earning higher returns 16 years from now.

We're students of behavioral psychology, and one of the many behavioral biases humans have is to extrapolate the present into the future, which creates the potential for decision flaws when it comes to reversion. In particular, companies that are under-earning can be valued as if those levels of earnings will persist in perpetuity, even though theory and evidence would argue for reversion. In other words, if a business isn't doing well today, the result can be an absurdly low stock price relative to the long-term outlook. We try to take advantage of that.

In identifying specific opportunities our focus is on companies that are likely to follow shorter reversion patterns, in the three- to five-year range. Such companies exhibit certain traits. They tend to have good long-term assets, which we define as sustainable competitive advantages that come from brands, scale and distribution. They also have stable businesses, hard assets and decent balance sheets, decreasing the risk they won't make it through the reversion process.

Why do such companies tend to be under-earning?

JH: It can be any number of things. Maybe a competitor has the hotter product at the moment. Maybe management made a bad acquisition or has let costs get out of control. Maybe the company is operating at a bad point in the economic cycle.

Tom Schloemer: We own shares in Titan Machinery [TITN], for example, which owns a network of agricultural and construction equipment distributorships. The stock has been beaten up over the past year due to declines in gross margins, a weak cycle in construction equipment and perceived vulnerability to a downturn in farm incomes. Our view is that the gross-margin decline is only temporary, that the construction-equipment market will eventually improve and that any pain from a decline in farm incomes will be mitigated by a thriving parts and maintenance business. If we're right, earnings will come back faster and further than the market is currently expecting, which should have a positive impact on the share price.

How do new ideas hit your radar screen?

JH: It's all driven by the potential upside from reversion. The dividend discount model [DDM] we've developed applies what's called a Sorensen normalized approach to earnings, which essentially models a reversion of projected free cash flows over time and then calculates the present value of those cash flows discounted back at the implied market discount rate. We run that every weekend and on Monday have a list of every stock in the Russell 3000 index ranked by the potential alpha from the current price based on a naïve application of reversion.

We start at the top of the list and first weed out ideas we consider to have exces-

Joe Huber

Playing the Field

Eager to find a company with more traditional value-investing roots, Joe Huber in late 1999 found the job market less than welcoming. "There were two kinds of value firms, those that had capitulated and modified their strategy for the 'new economy,' and those that hadn't but were getting killed. I was only interested in the latter, but they weren't exactly hiring."

He found an amenable home at the beginning of 2000 at Los Angeles-based Hotchkis & Wiley, where as head of research he fully developed the quantitative and qualitative strategy and process he now employs at his own firm, Huber Capital Management, founded in 2007.

A key impetus for going out on his own: increased investment flexibility. Given his preferred level of concentration, even in large caps in the Russell 1000 he says he can invest only up to about $10 billion and remain liquid, which he defines as having less than a 5% stake in each company owned. As assets increase from there, his opportunity set shrinks and what he does own is less liquid, "both of which chew into my alpha," he says. That hasn't been a problem ... yet. Huber Capital's assets deployed across the market-cap spectrum now total nearly $4 billion.

sive downside risk. For example, we've owned very few banks over the past five years, even though our model was identifying it as the cheapest sector. The reason is that banks' asset values have been particularly volatile, which when combined with high levels of leverage takes away downside protection. Small changes in asset values have an enormous impact on the value of the equity. We found we were able to get similar exposure to banks – without similar risks – through investments in insurance, guaranteed lenders like Nelnet and homebuilders.

Are banks still off-limits?

JH: In fact, we're in the process of gradually adding banks to our portfolio. It's still one of the cheapest sectors and as the economy improves and there's greater equilibrium in the housing market we believe the underlying assets have become more stable. One of our most recent purchases is SunTrust Banks [STI]. Increases in the values of land, housing and commercial properties in its primary markets have significantly stabilized the balance sheet, helping make the risk/reward at today's share price quite attractive.

Where does your research focus next?

JH: The next part of the process is meant to identify potential value traps. We do that in a variety of ways, but key among them is reconciling the income statement to the cash-flow statement to identify permanent or semi-permanent shortfalls in cash flow relative to earnings. These tend to be businesses that serially underperform because they don't have the cash flow either to reinvest back in the business or to return to shareholders.

Not all shortfalls in cash flow are negative. A company could be spending heavily on a high-return investment that initially hits cash flow harder than GAAP income, where the expense gets capitalized and depreciated over time. But the reconciliation can highlight important negatives. We're often asked why we don't own a certain large aerospace company, which has a decent balance sheet, trades cheaply on normalized earnings and has great assets in terms of brand, scale and distribution. But it chronically throws off less cash flow than it prints in earnings. One item alone – what it actually pays for U.S.-employee retirement health benefits vs. what it accrues through the income statement – accounts for a cash-flow shortfall relative to earnings in excess of $300 million per year. If you use the actual cost, a low P/E stock becomes one trading at a very high price to normalized free cash flow.

ON RESEARCH:

One important way we unearth hidden value is by breaking down companies into their constituent parts.

Brenda Cullen: Another reconciliation we'll do to look for value traps is comparing the GAAP balance sheet to a replacement-cost balance sheet. In early 2011 Hewlett-Packard [HPQ] at around $45 started hitting our screens as a cheap stock on normalized earnings. In reconciling the income statement to the cash flow statement, everything looked fine. But when we converted to a replacement-cost balance sheet – by removing all intangible assets, adding back off-balance-sheet liabilities and capitalizing things like operating leases and research and development costs – it became clear that the company had been underinvesting in R&D during the previous few years. When we applied what we considered appropriate levels of R&D spending to each business, the resulting decrease in earnings made the stock not nearly as attractive, so we passed.

You also have a "red flags" list for identifying value traps. What's on it?

JH: Whenever you make a mistake, there's an opportunity to identify clues that might have indicated the problem before it became known. The items on our red-flags list include more obvious things like an industry that's in secular decline or a change in the CFO, as well as more subtle items like raising the discount rate used to calculate future pension obligations or making a material change in the quarter-to-quarter wording of the management, discussion and analysis section of 10-Ks and 10-Qs.

I should say that just because something is identified as an issue in our initial review, it doesn't mean we'll throw it out of the review process. That's often what happens, but if what we've uncovered is well understood in the marketplace, we may still move forward with our research.

Are there other aspects of your research process you consider relatively unique?

JH: One important way we've found to unearth hidden value in the research process is by breaking down a company into its constituent parts, each with its own income statement, cash-flow statement and balance sheet. That isn't always easy given what companies are required to report, but we've found ways around that. A key one is using publicly traded monoline competitors of the individual businesses as reasonable proxies of how those businesses would look on their own.

A classic example of how this type of analysis can pay off is an investment we made a few years ago in a company called Global Traffic Network, which provided traffic services to radio stations in three primary markets, Australia, Canada and the U.K. A key attribute of the business was that it required a certain level of scale within a geographic market to be profitable. So a business that can be unprofitable at lower market-share levels could generate 80% incremental margins at higher market-share levels. When we got interested in the stock it was trading at around $4.50 per share and the company overall made no money.

We broke the business down by geography and found a mature Australian business earning 30% EBITDA margins, and two newer businesses in the U.K. and

Canada that were losing money – not because they were poorly managed or had poor business models, but because they were earlier in their evolution. We estimated the Australian business was worth $6-7 per share, giving us free options on the Canadian and U.K. businesses succeeding, which wasn't a stretch given their progress to date and management's track record. Further mitigating the downside was the fact that management could shut down these newer operations at any time if they didn't work, leaving the Australian business that we believed was worth considerably more than the stock price at the time. If we had looked at the company on an aggregate basis, we would have passed. Breaking it down we found what we thought was a materially undervalued stock. [*Note*: GTN was taken private in mid-2011 at $14 per share.]

How do you estimate intrinsic values?

JH: Once we're done with our detailed review, we reconsolidate everything into explicit free-cash-flow estimates for the company going out five years, where year five is the "normal" year. Our dividend-discount model then generates intrinsic values based on future cash flows.

One adjustment we make in our model that's somewhat non-traditional is to not assume every company's returns revert to their cost of capital over time. We assume reinvested free cash flow reverts to the cost of capital, but that the "embedded" capital in a high-quality business can keep earning at higher rates. Coca-Cola gets very high returns on selling its sugar water, always has and probably always will. We find doing it this way gives us a better mix of good businesses and bad businesses. We can invest in a high-quality business when it becomes cheap, not just those that will only earn their cost of capital over time.

What makes it into the portfolio?

JH: We typically own 40 to 50 stocks and the calculated upside to intrinsic value is the biggest driver of what's in the portfolio and how it's sized. That's not a purely rote exercise, as we will adjust position sizes for other reasons.

One tenet of our portfolio construction is that we want it to be balanced relative to major macroeconomic factors. My fundamental belief is that neither we, nor anyone else, can systematically make successful macro calls. Therefore we want to be indifferent to whether there's unexpected inflation or deflation, or if employment gets better or worse, or if the yield curve goes up or goes down.

ON DIVERSIFICATION:

We want to be indifferent to things like employment getting better or worse, or if the yield curve goes up or down.

We use third-party software for this, but the basic idea is that the portfolio's exposure to things like changes in interest rates, inflation, oil prices and exchange rates should be roughly in line with the overall economy's exposure to those same factors. So a position that on potential alpha would be sized at 3%, might be higher or lower than that depending on how it affects the portfolio's factor exposure.

Another adjustment we might make is to try to limit the bias all value investors have for buying too early. For example, if a company's earnings are getting worse at an accelerating rate – regardless of the level of alpha our model shows for it – we'll take no more than our minimum 1% position size. That helps us avoid putting a lot of capital into a security when it appears to be cheap but the potential is higher that it might get cheaper. If the rate of earnings decline starts to decelerate, we can open it up and buy more.

A third adjustment could reflect the level of risk in the underlying assumptions we use. For a cement company, we probably have good data and are grounded in our assumptions. But for a cloud-services company, the potential outcomes are much wider so there's more risk in our assumptions. All else equal, we'll hold a smaller position in the cloud company than the cement company.

Are you always fully invested?

JH: Yes. The dividend discount model is a great relative-value tool and the process is consistent and repeatable across all industry sectors and market caps. Clients investing with us have already made their asset-allocation decisions – our job is to give them the best possible return from the strategy they've chosen.

I see my primary role as the peer reviewer for the process. That involves challenging the critical assumptions being made and ensuring consistency from analyst to analyst. If one member of the team is more conservative than another, for example, that introduces biases that can corrupt the output resulting from all our great work. It's my job to ensure that doesn't happen.

Many argue that inefficient pricing is more prevalent in small caps. Do you agree?

JH: I actually argue the opposite, that large caps can be much more inefficient. This gets back to what we discussed about breaking the business into its component parts. In monoline small caps we lose one of our key tools for adding value. In large caps there are more moving parts that the bulk of investors and analysts can miss by being too focused on the aggregated entity or too focused on the short term. Forty analysts may be covering Hewlett-Packard, but if few or none of them are looking separately at each business or at normalized cash flows, there's plenty of opportunity for its stock to be mispriced.

Describe why you consider drilling-services company Ensco [ESV] a positive reversion candidate.

Chris Karger: Ensco is the second-largest contract driller in the world, behind Transocean, with a large fleet of deep-water and shallow-water equipment. Its deep-water exposure is primarily in the Gulf of Mexico and off the coasts of West Africa and Brazil, while in shallow water it competes in most key geographic regions. The full product and geographic reach is definitely a positive, supporting today a contracted backlog of around $11 billion, which is more than two full years of revenue at 2013's level of around $5 billion.

There are a few aspects of the business we think the market isn't fully appreciating. One is that the company is at the tail end of a large new-build cycle, which means that starting in the next year or so the depreciation on new rigs – a deep-water rig can cost $650 million – is going to substantially exceed actual maintenance capex, resulting in a significant increase in free cash flow. That gives Ensco the flexibility not only to keep reinvesting in the business, but to increasingly return capital to shareholders. It raised its dividend twice last year, and the yield is currently 5.8%. There's also a $2 billion share-buyback program in place, which could certainly be expanded.

Another positive dynamic we expect is increased utilization of the shallow-water fleet. There's typically a five-year upgrade and maintenance cycle on this equipment, but the company in the past year refurbished 55% of its rigs, which took capacity away that is back on line this year. That should be a plus for earnings.

A third upside we see is changing regulation in Mexico that should open it up to big increases in outside energy exploration and production investment. The country has severely underinvested in its energy assets for at least the past 10-15 years – as that corrects we believe Ensco, given its experience in the region, is very well positioned to benefit.

The market seems to be concerned that a decrease in oil prices – reflected in futures markets – could cause trouble ahead for firms like Ensco. How important do you consider that risk?

CK: We've built some pricing softness into our model, but we believe the company is less vulnerable to any pullback in overall demand. Its customer base is primarily the largest and most sophisticated E&P companies, which make investment decisions over multiple years, not just on what oil prices may do this year or next. Also mitigating pricing pressure is the fact that Ensco has one of the most-modern fleets in the industry. The average age of its ultra-deep-water rigs is 3.7 years, which compares to competitors like Transocean at 9.5 years and Noble at just over 8 years. If market demand lags, it's the day rates on older assets that get hit much harder.

If oil prices drop to $50, that's obviously going to be a problem. But if prices fall a bit according to the futures curve, the cyclicality attached to that for Ensco strikes us as overstated.

What do you consider a more reasonable value for the shares, now at $50.70?

CK: We model every asset in the fleet, using existing contracts and then our estimates for normalized utilization factors and day rates. Our estimates for utilization are around 90% for deep-water assets and in the mid-80s for shallow-water rigs. On average, our normalized day rates are 5-10% less than current rates. All in, we're estimating annual EPS growth over

INVESTMENT SNAPSHOT

Ensco
(NYSE: ESV)

Business: U.K.-based provider of contract drilling services – utilizing a broad fleet of "jackups" and "floaters" – to national and international energy companies.

Share Information
(@1/30/14):

Price	**50.67**
52-Week Range	50.15 – 65.82
Dividend Yield	5.8%
Market Cap	$11.83 billion

Financials (TTM):

Revenue	$4.75 billion
Operating Profit Margin	35.6%
Net Profit Margin	26.9%

Valuation Metrics
(@1/30/14):

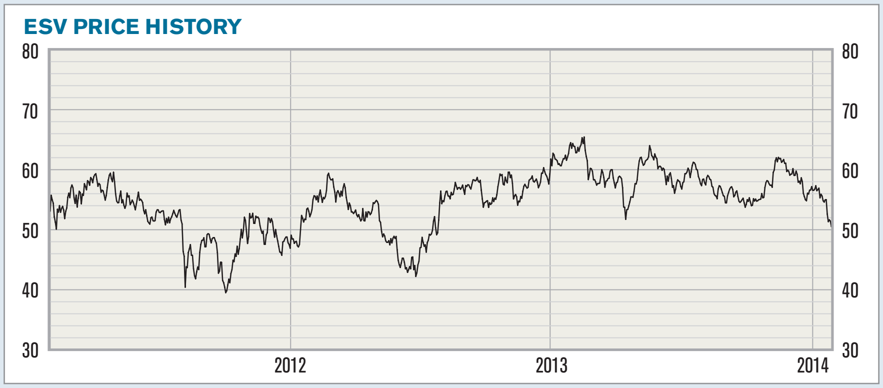
	ESV	S&P 500
P/E (TTM)	9.3	18.2
Forward P/E (Est.)	7.6	15.4
EV/EBITDA (TTM)	7.3	

Largest Institutional Owners
(@9/30/13):

Company	% Owned
Fidelity Mgmt & Research	6.4%
Vanguard Group	5.0%
State Street	4.3%
JPMorgan Chase	3.6%
Allianz Asset Mgmt	3.0%

Short Interest (as of 12/31/13):

Shares Short/Float	2.9%


ESV PRICE HISTORY

THE BOTTOM LINE

Market fears over oil-price declines appear overstated in the company's case, says Chris Karger, mitigated by rising expected cash flows, higher capacity utilization and growth upside in regions like Mexico. With assumptions including EPS growth over the next two years at a 20% annual clip, his current fair value estimate for the shares is over $100.

Sources: Company reports, other publicly available information

the next two years to be around 20%, slowing to closer to 10% in 2016.

For our DDM, we assume an equity discount rate that normalizes at just under 7% and that all excess cash flow is reinvested in the business at steadily lower returns. With that, we arrive at a fair value in excess of $100 per share. If we allocated some of the cash flow to increased dividends and share repurchases, the potential upside would be quite a bit higher.

What attracted and has maintained your interest in insurer CNO Financial [CNO]?

JH: CNO is an excellent example of where analyzing a company by its constituent parts can highlight potential value. It's a domestic insurer with three lines of business: term life, Medicare supplement and long-term care. We first became interested in 2009, creating balance sheets for each business and concluding that the term-life and Medicare-supplement businesses were earning low-double-digit ROEs, while the long-term-care business – which accounted for 60% of total capital – had a mid-single-digit *negative* ROE. Overall the returns looked terrible, and the stock traded at a discount to book value that indicated the market expected that terrible ROE was as good as it was going to get.

But the company was doing exactly what it should given the situation. It put the long-term-care business in runoff, so as policies matured and fell off, statutory capital would be freed up and could be put to work in the two profitable businesses or returned to shareholders. We modeled 6% of the capital being redeployed each year for the next ten, resulting in a dramatic increase in earnings power over time.

As they've continued to execute on the runoff, the non-core business is still losing money, but now it's less than 45% of the book. The other two businesses are now the majority of the book and are earning 13-14% ROEs. Over the same time, the company has reduced its diluted share count by about 30%, buying back around $800 million in common and convertible shares. That's more than the entire market cap of a few years ago.

The market, pricing the stock today at $17, hasn't fully figured this out yet?

JH: The stock has done well, but the reversion we're betting on is only slowly working its way through the financials. Overall ROE has moved from below 5% to about 7% and should be north of 9% within the next two years as the mix shift continues. Combined with continued share buybacks, we expect the increase in EBIT per share to accelerate. The market may continue to discover all of this gradually.

Within six or seven years, term life and Medicare supplement should account for close to 100% of the business, taking the ROE over that time to 13% or so. Given an estimated cost of capital of 7%, the ratio of ROE to capital cost would imply a share-price multiple of around 2x book value. On today's book, that implies a share price of $40, which is roughly the output of our DDM as well.

Are there any pricing or interest-rate risks of note?

JH: The two ongoing insurance businesses are about as stable as they come. Both are short duration, so you don't have big

INVESTMENT SNAPSHOT

CNO Financial
(NYSE: CNO)

Business: Develops, markets and administers health insurance, individual life insurance, annuities and other insurance products sold primarily in the U.S.

Share Information
(@1/30/14):

Price	**16.98**
52-Week Range	9.98 – 18.33
Dividend Yield	0.7%
Market Cap	$3.77 billion

Financials (TTM):

Revenue	$4.38 billion
Operating Profit Margin	12.5%
Net Profit Margin	10.8%

Valuation Metrics
(@1/30/14):

	CNO	S&P 500
P/E (TTM)	8.5	18.2
Forward P/E (Est.)	13.7	15.4
EV/EBITDA (TTM)	8.0	

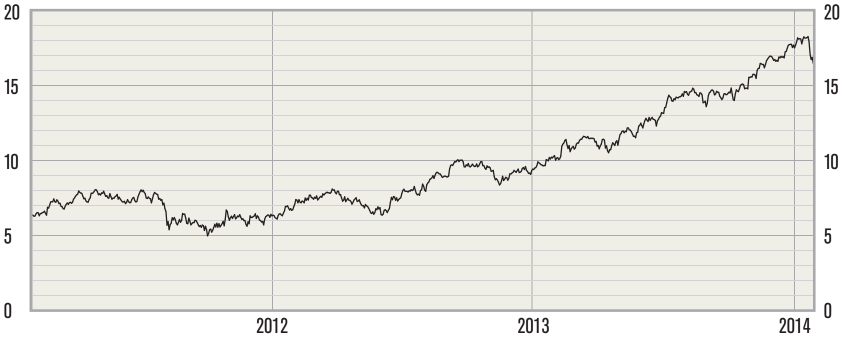
Largest Institutional Owners
(@9/30/13):

Company	% Owned
Dimensional Fund Adv	8.6%
Huber Capital Mgmt	5.9%
Paulson & Co	5.6%
Vanguard Group	5.5%
BlackRock	5.4%

Short Interest (as of 12/31/13):

Shares Short/Float	1.9%

CNO PRICE HISTORY



THE BOTTOM LINE

The company through a slow and steady process of reallocating resources is substantially increasing its profitability and earnings power, says Joe Huber. Over time it expects to be fully focused on two solid insurance businesses earning 13% or so ROEs, which he says would justify a multiple of book value of 2x and a share price of closer to $40.

Sources: Company reports, other publicly available information

swings in loss ratios and there's less interest-rate risk. The sectors are also quite mature, so changes in pricing tend to be fairly glacial.

This is a classic case of what we do: break apart the balance sheet, identify the potential for reversion and then wait for it to happen. It's not sexy or even a great business, but if you see the reversion before it actually happens, you can generate a lot of alpha.

From unsexy to the height of intrigue, walk through your investment case for Herbalife [HLF].

Gary Steiner: The company probably doesn't need much introduction at this point, but it's a direct marketer primarily of weight-management, energy and nutritional products. The key to the business is not so much the products, but the more than 3.5 million distributors Herbalife has globally and the support network they've built around their customers.

With all the commentary back and forth about the business model, little has been said about what's actually going on in the business. We estimate revenues last year were up around 18%, a growth rate that's almost unheard of among consumer non-durable companies.

The growth is being driven by a few key initiatives. One developed a few years ago in Mexico, the company's second-largest market, where distributors started selling things like weight-loss-shake mixes in less-than-bulk quantities and promoting sometimes daily visits with customers to help them prepare the shakes. While some people in the U.S. might find that unusual, this "daily-consumption" model has been an absolute homerun in Mexico and every other major market in which it's been rolled out.

Another marketing tactic that has gotten a lot of traction is the opening of "nutrition clubs," in which one or multiple distributors rent storefront space through which they sell products and organize any number of health and wellness events. In West L.A., people meet through the club and do a yoga class together or go for a run, and then go back to the store for an Herbalife shake. In other markets, they may participate in a weight-loss challenge program, with classes and check-ins at the club. It's all part of building community, which when done well has a very positive impact on sales.

Emerging markets have also been a big driver of growth. Sales in China, for example, rose about 50% last year and it is now the company's third-largest market. There's been controversy there as well, but our expectation is that China and other developing markets are significant growth vehicles going forward.

Let's talk about the recent controversy, prompted by news that Chinese regulators were looking into competitor NuSkin's sales practices, which by extension caused Herbalife's shares to swoon. How do you process things like that?

GS: To put China in perspective, it represents about 10% of Herbalife's sales and I'd estimate maybe 5% of profits at this point. In the week after this "news," the market wiped 17% off the company's market value. There's no question that Chinese regulation can be unpredictable, but the company has modeled its business

INVESTMENT SNAPSHOT

Herbalife
(NYSE: HLF)

Business: Global seller – through a broad network of individual sales representatives – of nutritional-supplement, weight-loss, energy and personal-care products.

Share Information
(@1/30/14):

Price	**64.77**
52-Week Range	30.84 – 83.51
Dividend Yield	2.0%
Market Cap	$6.54 billion

Financials (TTM):

Revenue	$4.62 billion
Operating Profit Margin	15.4%
Net Profit Margin	11.2%

Valuation Metrics
(@1/30/14):

	HLF	S&P 500
P/E (TTM)	13.7	18.2
Forward P/E (Est.)	11.0	15.4
EV/EBITDA (TTM)	7.7	

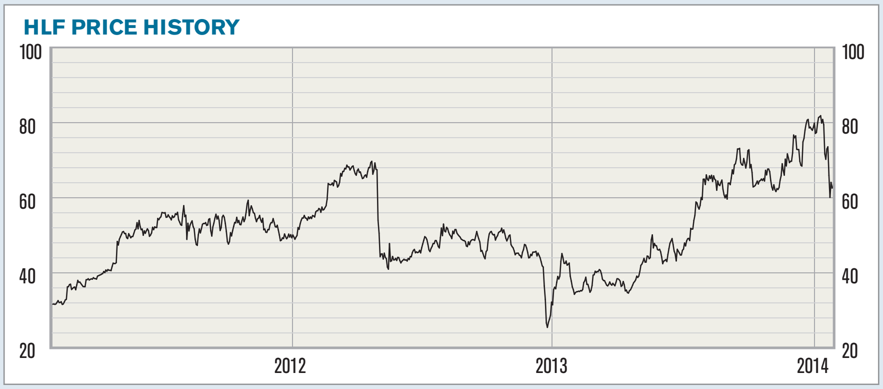
Largest Institutional Owners
(@9/30/13):

Company	% Owned
Carl C. Icahn	16.8%
Fidelity Mgmt & Research	12.7%
Capital World Inv	5.0%
Soros Fund Mgmt	5.0%
Morgan Stanley	4.9%

Short Interest (as of 12/31/13):

Shares Short/Float	28.4%

HLF PRICE HISTORY



THE BOTTOM LINE

Having concluded that Herbalife's regulatory risk has been widely overstated, Gary Steiner expects the market eventually to do the same and focus on the company's excellent growth prospects and cash flow. If that happens, he expects the shares to earn at least a 16x P/E, which on his 2014 EPS estimate would result in a $100 share price.

Sources: Company reports, other publicly available information

in the country after Amway, which has operated successfully there for a very long time. We obviously don't know what's going to happen on the regulatory front, but we don't presuppose the worst and even if it occurred, we'd argue the market has significantly overreacted.

While we're on the subject of regulation, how do you handicap the risk that Bill Ackman is right on Herbalife?

GS: From a practical standpoint, we've spoken with enough distributors to be comfortable that the business model is not a pyramid scheme. The notion that no one is really using the products and distributors only buy them to get discounts just isn't the case.

From a legal standpoint, there are no bright lines delineating what is and what is not a pyramid scheme. There is case law supporting both the longs and the shorts. Our end conclusion is that Herbalife has been in this business for a long time and has taken care to abide by the regulatory guidance it's given. The FTC has also overseen the company for a very long time, and we assume they have concluded it isn't a pyramid scheme.

The shares, now at just under $65, are off 22% since hitting their 52-week high earlier this month. How are you looking at valuation?

GS: On 2014 consensus earnings estimates, the shares trade at an 11x P/E. Those estimates are driven by the company's guidance, which it has consistently ended up beating by 15-20% over the past four or five years. At a minimum, we'd expect the current-year EPS number to be more like $6.25.

So at today's price, we think we're paying a roughly 10x earnings multiple for a consumer-products company that is a double-digit top-line grower. Less controversial food and personal-care companies typically have low-single-digit growth but trade at multiples in the high-teens.

What we ultimately expect to happen is that over the next 12 to 18 months the short thesis gradually dissipates and more traditional investment firms come back into the stock. The big buyers so far have been hedge fund managers like Carl Icahn or George Soros, very smart investors who are in a better position not to be concerned about all the controversy. If we're right, it's hard to imagine Herbalife trading at less than 16x earnings, which on $6.25 in EPS would result in a share price of $100. Our DDM arrives at a similar price.

ON HERBALIFE:

We ultimately expect the short thesis to dissipate and more traditional investors to come back to the stock.

Given all the free cash flow the company generates, we think there's a good chance there's a large share buyback here sometime this year. The economics of that are much more interesting at a $60 stock price than they were at $80.

Explain in a bit more detail your thesis for Titan Machinery.

TS: The company owns distributorships for the CNH brands of agriculture and construction equipment, the best-known of which are Case and New Holland. It has been a well-executed roll-up over the years and now consists of around 120 dealerships, 90% of which are in the U.S., with the remainder in the Eastern European farm belt. The roots of the company are primarily in agriculture, but through the downturn in construction-equipment spending it has been expanding more aggressively into that sector. The revenue mix today is now roughly 80% agriculture, 20% construction equipment.

Dealerships make their money by selling new or used equipment, by supplying parts and service, and through ancillary revenue like rentals. Gross margins on equipment sales over the past ten years have been around 10%, but recently have fallen below 8%. Our view is that is not a structural problem, but reflects temporary over-building of inventories and what appears to be an issue around new Tier-4 engine emission-control regulations on tractors. Manufacturers are so far refusing to discount as they typically would on these newer products, so distributors are facing a bit of a squeeze between farmers who don't want to pay and OEMs who are toeing the line on pricing. These are fixable issues and we see no reason margins don't revert to the historical norm.

The construction end of the business has clearly been weak. Titan in many cases bought unprofitable dealerships knowing it would take time before residential and non-residential construction spending got back to normal in the U.S. after the financial crisis hit it so hard. One dealership the company bought, for example, had at its peak over $50 million in revenue, but when they bought it that was down to $5 million.

Maybe it and other dealerships they bought don't get back to peak, but with any normal reversion you'd see the profitability in that part of the business increase dramatically. I'd argue Titan is one of the few opportunities to participate in a turnaround in U.S. construction markets where the stock hasn't already run up.

Isn't that likely due to concerns that farm incomes are poised to turn down?

TS: Sales of agricultural equipment track closely to farm income and I don't dispute that farm incomes may be at or near a peak. But when we model out declines in farm incomes and the declines in equipment sales that would go with that, we find the stable and high profitability of the parts and service business – which accounts for nearly 50% of gross profits – softens the blow pretty nicely, particularly if margins on the equipment side revert to normal. In other words, we think the worry about farm incomes is adequately priced into the stock.

What upside do you see in the share price, now at $16.50?

INVESTMENT SNAPSHOT

Titan Machinery
(Nasdaq: TITN)

Business: Owner and operator of a full-service retail stores, located in the United States and Eastern Europe, that sell agricultural and construction equipment.

Share Information (@1/30/14):

Price	**16.47**
52-Week Range	14.19 – 32.00
Dividend Yield	0.0%
Market Cap	$344.2 million

Financials (TTM):

Revenue	$2.30 billion
Operating Profit Margin	3.0%
Net Profit Margin	1.1%

Valuation Metrics (@1/30/14):

	TITN	Russell 2000
P/E (TTM)	14.2	85.0
Forward P/E (Est.)	17.3	24.7
EV/EBITDA (TTM)	14.3	

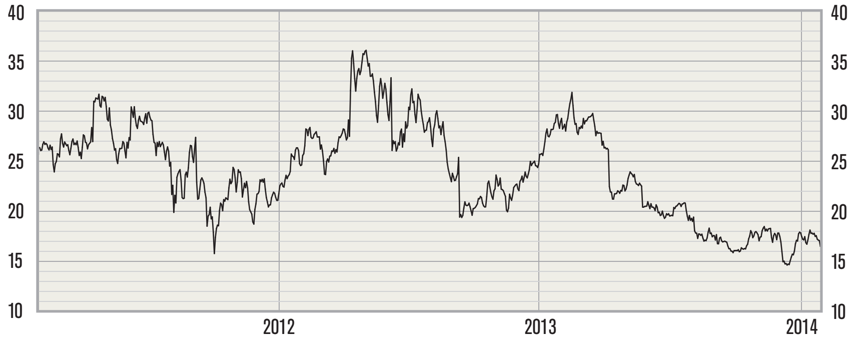
Largest Institutional Owners (@9/30/13):

Company	% Owned
Invesco	16.6%
Opus Capital	5.4%
Columbia Wanger Asset Mgmt	4.5%
Robeco Inv Mgmt	4.4%
Dimensional Fund Adv	4.1%

Short Interest (as of 12/31/13):

Shares Short/Float	38.5%

TITN PRICE HISTORY



THE BOTTOM LINE

The perfect storm of market concern about the company – due to declining gross margins, weak construction-equipment sales and potentially peaking farm incomes – is closer to its end than its beginning, says Tom Schloemer. If proven out, he sees no reason the stock can't return at least to its year-ago level of roughly double the current price.

Sources: Company reports, other publicly available information

TS: The company in 2013 is likely to have earned less than $1 in EPS, against $2-plus earned in prior years. Its return on equity will likely come in at less than 5%, which over the cycle we believe should be above 10%. A year ago the stock was at $32 – with the reversion we expect, we see no reason it can't get back there in the next couple of years.

One thing I'd add is in relation to downside protection: The company's tangible book value is over $17 per share. Almost 75% of the assets are cash and equipment inventories, so it would seem there's a real valuation floor here.

The market seems to believe the worst has passed for Hewlett-Packard. Why do you believe it's still selling the company short?

Brenda Cullen: It's well documented that H-P has suffered from a lack of leadership and of a coherent and consistent strategy. But while I mentioned we passed at $45, in 2012 we started to build a small position in the stock in the mid-$20s. The company had good assets as we define them, meaning good brands and economies of scale and of distribution. Meg Whitman had taken over as CEO in late 2011, articulating a more coherent vision for the company and bringing earnings forecasts down to a more reasonable level, so we thought we could value the assets with more certainty. It turns out we were somewhat early and the share price kept falling until turning near the end of 2012.

The main concern today, of course, is the perception that some of H-P's key businesses are in secular decline. The personal-computer business is being cannibalized by tablets and smartphones. The printer business is threatened by the increasing use of digital documents. The server-and-storage business is challenged by the movement to the cloud. You can see those pressures in the company's metrics – annual revenues are at a run rate of about $110 billion, down from $125 billion in 2008, while operating income is now below $11 billion, down from $15 billion.

While we don't at all minimize the secular issues, we believe many of the businesses are under-earning their reasonable potential. There is substantial evidence, for example, that enterprises have significantly pulled back on technology-related capex in the last several years, so we anticipate a refresh cycle to positively impact H-P's personal systems, enterprise and printing businesses.

Another important area of potential upside is the IT Services division. Primarily composed of the EDS business bought years ago, H-P is the second-largest IT-outsourcing enterprise in the world. Due to an abundance of poor-profitability legacy contracts that are still rolling off, operating margins in that business are below zero, while peers earn margins in the high single digits to low teens. As the division refocuses and unprofitable contracts are replaced by ones with higher returns, we see no reason why operating margins can't improve to at least 4-5%. Were that to happen, it would generate about 40 cents per share in incremental earnings.

After coming back so strongly last year, how cheap do you consider the stock at today's $29.25?

BC: Even with a small overall improvement in margins on flat revenue growth,

INVESTMENT SNAPSHOT

Hewlett-Packard
(NYSE: HPQ)

Business: Diversified information technology provider selling hardware and software systems and services to individual and enterprise customers worldwide.

Share Information
(@1/30/14):

Price	29.25
52-Week Range	16.03 – 30.13
Dividend Yield	2.0%
Market Cap	$55.83 billion

Financials (TTM):

Revenue	$112.30 billion
Operating Profit Margin	7.5%
Net Profit Margin	4.5%

Valuation Metrics
(@1/30/14):

	HPQ	S&P 500
P/E (TTM)	11.2	18.2
Forward P/E (Est.)	7.7	15.4
EV/EBITDA (TTM)	5.0	

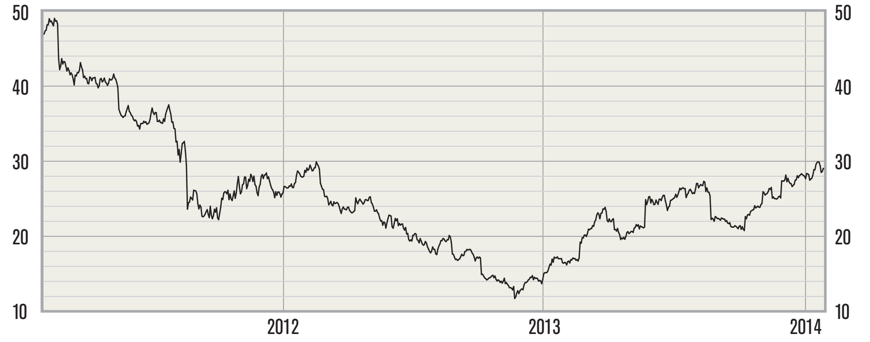
Largest Institutional Owners
(@9/30/13):

Company	% Owned
Dodge & Cox	8.5%
State Street	5.1%
Vanguard Group	4.7%
Capital Research Global Inv	3.3%
BlackRock	2.9%

Short Interest (as of 12/31/13):

Shares Short/Float	1.4%

HPQ PRICE HISTORY



THE BOTTOM LINE
While the company clearly faces a variety of secular challenges, many of its divisions also have what Brenda Cullen believes is unrecognized upside potential from cyclical improvements, better operational execution and cost savings. Currently trading at a free-cash-flow yield of 14.5%, she estimates the stock's fair value to be in the high-$30s.

Sources: Company reports, other publicly available information

H-P can earn about $8 billion in free cash flow this year, giving the stock a 14.5% free-cash-flow yield, which is still extremely attractive.

In modeling the company, we generally assume that the businesses with secular issues will see revenues and earnings stabilize and then experience a conservative level of organic growth thereafter. Divisional margins should modestly improve due to restructuring efforts, but will probably be lower than historical levels. At the corporate level, we expect another $1 billion in cost savings in 2014. When we run everything through our model, we arrive at a fair value for the stock that's in the high-$30s.

The biggest risk is that the secular issues turn out to be worse than we expect. The one we're probably watching most closely is the server/storage business and how it's impacted by the movement to the cloud. H-P will have to figure out a way to compete effectively with commoditized white-box vendors.

Describe your general sell discipline.

JH: We primarily sell for three reasons. Stocks with zero remaining alpha are sold automatically. We also sell when we find a better opportunity with similar macro exposures and higher levels of alpha. As we added SunTrust to the portfolio, for example, we took MasterCard [MA] out. MasterCard performed extremely well for us over the years and we believed it still had some room to run, but the upside in SunTrust as it became less risky made it a better candidate for the portfolio. Lastly, we sell if there's a deterioration in the business that in our judgment takes away too much of the downside protection. It may still have alpha, but we consider it too risky to hold. Happily, there have been very few of those of late.

When you do make a mistake, what tends to be the cause?

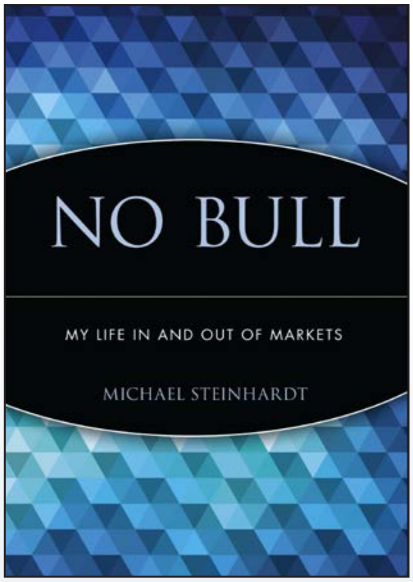
JH: Our process is about finding situations where the reversion period is shorter than usual, but we don't always get that right. We've been counting on a reversion in uranium prices benefitting Uranium Energy Corp. [UEC], for example, but it hasn't happened. I would say, however, that while we can appear wrong for some time, it doesn't always mean we end up wrong. Some of my best successes over time have been by averaging down in companies that revert more slowly than we expect, but the reversion still occurs.

In setting performance goals, you don't talk about beating benchmarks, but say you want to be #1 in each of your strategies over time. Why so audacious?

JH: I love the fact that in this industry we have an unbiased scorecard that tangibly measures success. If you're the best accountant or best lawyer it's difficult to show tangible proof of that. However, one thing that peeves me about this industry is that beating a benchmark indicates success. The benchmark is average – in the absence of trading costs, half of all managers will beat it and half won't. That's a pretty low hurdle. The Yankees don't make it their goal each year to be 82 and 80. My view has always been that the goal should be to be the best.

Variant Perception

Michael Steinhardt met unparalleled success during the vast majority of his 28-year career managing others' money. In this excerpt from his memoir, he describes lessons learned from a period of unaccustomed failure.



When Oakmark Funds' Bill Nygren was asked recently to name his all-time favorite investor, he first mentioned industry legends John Templeton and Warren Buffett, but then concluded with a less-well-known choice, "I'd have to say the investor I most admire is Michael Steinhardt."

Steinhardt plied his trade as one of the first modern-age hedge fund managers from 1967 to 1995, over which his Steinhardt Partners compounded its investors' capital at nearly 25% per year, against 11% for the S&P 500. As a testament to the power of compounding, $1 invested with Steinhardt would have grown to $481, while the same dollar in the S&P 500 would have become $19.

Though long removed from managing client assets – he currently serves as Chairman of ETF-purveyor WisdomTree Investments and is very active in supporting Jewish philanthropic causes – Steinhardt in 2001 wrote *No Bull: My Life In and Out of Markets*, in which he shared many insights into his investing style and success. Snippets from among those for which he is best-known:

On "variant perception":
"I defined variant perception as holding a well-founded view that was meaningfully different from market consensus. I often said that the only analytic tool that mattered was an intellectually advantaged disparate view. This included knowing more and perceiving the situation better than others did. It was also critical to have a keen understanding of what the market expectations truly were. Understanding market expectation was at least as important as, and often different from, fundamental knowledge.“

On good ideas:
"Ideally [an analyst] should be able to tell me, in two minutes, four things: the idea; the consensus view; his variant perception; and a trigger event. No mean feat."

On valuation:
"We had an aversion to paying high multiples even when we were sufficiently persuaded of the growth prospects. It seemed to us that unless one could realistically seek the expansion of a multiple as well as earnings growth in a long investment, it wasn't worth doing."

On buy-and-hold:
"Warren Buffett has said, 'If you are not willing to own a stock for 10 years, do not even think about owning it for 10 minutes.' The truth of the matter is, I have never owned a stock for 10 years, but I have had the unique and profitable experience of owning some very good companies for 10 minutes."

On "starting over":
"I would decide I did not like the portfolio writ large. I did not think we were in sync with the market, and while there were various degrees of conviction on individual securities, I concluded we would be better off with a clean slate. In an instant, I would have a clean position sheet. Sometimes it felt refreshing to start over, all in cash, and to build a portfolio of names that represented our strongest convictions and cut us free from wishy-washy holdings."

For all his many successes, Steinhardt also devotes one *No Bull* chapter, titled "The Worst Year of My Life," to his experience in 1994 and the lessons learned from his first material brush with investing adversity. With the permission of the book's publisher, John Wiley & Sons, the bulk of that chapter is excerpted below.

The Worst Year of My Life

During the early 1990s, our capital base grew enormously. Everything we invested in worked spectacularly. Our performance was superb, three consecutive 60 percent years, and with that came a newfound recognition. The bull market of the past decade had made many people rich and had created new interest in aggressive money management. It seemed every "sophisticated" investor wanted to participate in hedge funds, perhaps because their cachet denoted a peculiar exclusivity. Hedge funds became a buzzword. Our firm was bombarded by potential investors who were begging us to let them invest. I could not attend a social event without being besieged with requests to take money from potential investors. This made it easy to develop hubris and, unfortunately, I was not immune.

Unless constrained, a hedge fund with excellent performance over time will grow rapidly, double charged with both internal returns on capital and enhanced reputation. In 1993, we launched Steinhardt Overseas Fund, Ltd., our second offshore fund. We were now running just under $5 billion, an enormous amount back then, and even now. As our asset base grew, we began to reach for larger, now global, markets to employ the capital, even as we continued to run a huge portfolio of domestic stocks. More and more, we moved into the "macro" arena, a term used to describe investing in global stock, bond, and currency markets. Having been successful in the markets that I had ventured into over time, I had confidence that the quality of my investment judgment was applicable worldwide. Perhaps rapid success had bred complacency.

Furthermore, it had become harder for our traditional positions in domestic equities, particularly those in small- or mid-capitalization companies, to have a meaningful impact on the portfolio. The challenge became finding opportunities that were large enough to employ our expanded capital base in a way that could contribute to the overall performance of the capital under management. We wanted not only to be right in our views but also to have enough money invested in each idea to justify the time committed to researching it. It took no more time to be intellectually competitive in a $20 million investment than in a $2 million one.

With growing confidence, and with swelling assets under management, we began to hire people with a more global range of investment experience. We added international portfolio managers and analysts, economic consultants, and "think tanks" to our payroll. It became vital to expand our intellectual resources commensurately with our financial resources. Overnight, it seemed, we needed a team that could competitively analyze and invest in markets around the globe.

Invariably, in its early stages, this type of expansion is filled with risk. I, who had never been a model manager of personnel, now found myself spearheading an organization of more than 100 people who were trading across a spectrum of financial markets around the globe. With more assets in more places, my role of understanding each and every position became exponentially harder.

I used to say, not quite kiddingly, that I would never invest in a country where I did not know the area code. Now I found myself tempted to own fledgling companies in the hinterlands of Brazil, Venezuela, Morocco, Zimbabwe, and even the former Soviet Union, where recently converted ex-communists were now virgin capitalists. Suddenly, with my new team and newfound global perspective, I was actively trading the French CAC 40, the German DAX, and the Japanese Nikkei indexes. Through derivatives, we shorted volatility in the United States, Japanese, and German equity markets. Along with international equity markets, fixed-income opportunities, remote and familiar, were now available to us. Unfortunately we walked forward unafraid.

ON SEEDS OF TROUBLE:

I had confidence the quality of my judgment was applicable worldwide. Perhaps success had bred complacency.

In Europe, monetary union was hotly debated. This uncertainty created speculative opportunities in French bonds (OATs and BTANs) and futures (notionals), German bonds (BUNDs and OBLs), Italian bonds (BTPs), and Spanish bonds (BONOs). We put on convergence trades between the government debt of Canada and the United States, the United Kingdom and Germany, Italy, and Spain. We initiated swap spreads (fixed vs. floating rates) in France, Italy, and Japan. We held directional bets on the debt of most of Europe, Australia, New Zealand, Japan (JGBs), and other countries. Boldly venturing into foreign exchange markets, we held multiple currency cross-trades, including Mark/Swiss, Sterling/Yen, and Mark/Paris. We had a sizable bet on the continued strength of the dollar across the board. My daily Profit and Loss (P&L) Statement was now 30 pages long and read like the German code from World War II. To further complicate matters, our methodology for calculating risk, while accurate, was tedious and behind the times. I found myself trying to be at least knowledgeable about names that, six months earlier, I had never heard of.

Many of the new opportunities in international markets allowed the firm to employ significantly greater amounts of leverage. Moreover, Wall Street was flush with bull market success, and credit, at at-

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tractive terms, was readily available. New derivative products (bets that hinged on the price of underlying securities) abounded, required almost no money down, and created unseen leverage in the portfolio.

We purchased and then repurchased (financed) our enormous bond portfolio for as little as a 1 percent "haircut" (collateral). This meant that for every $100 million of bonds, we sometimes had to utilize only $1 million of capital. By 1993, we were more confident than ever, and our foreign bond portfolio totaled more than $30 billion. With each basis point (a one hundredth of a percentage point) move in bond yields, we made or lost $10 million.

In particular, 1993 had been a fabulous year. We were up more than 60 percent, primarily because of our significantly levered bet on European bonds – mostly, German bunds and French betans. Then, in the fourth quarter, U.S. economic growth surged, prompting the Federal Reserve to begin raising short-term interest rates for the first time in five years. On February 4, 1994, the first rate hike of one quarter of a percentage point caught us and many other leveraged bond players off guard. We were wrong in thinking that our optimistic interest rate outlook would continue. Because we were heavily leveraged, the consequences were grave.

United States bonds toppled, but the losses in domestic treasuries paled in comparison to the hits taken in European markets, which were much less liquid. In Europe, the selling was also sparked by fears that the Bundesbank would halt the trend under way to ease credit. The rise in U.S. interest rates made U.S. bonds relatively more attractive than other global fixed-income opportunities and, with a jolt, these markets fell precipitously. Catching me unaware, European bonds plummeted as liquidity dried up. In addition, we held small positions in some emerging bond markets, and these too fell apart.

In periods such as this, exits quickly become small and crowded. We soon discovered that far too many other "speculative" investors like ourselves (i.e., other hedge funds) had made the same bets in European bonds. Their lack of experience, like ours, compounded the absence of liquidity. Emboldened by their success in investing abroad during a sustained period of declining interest rates, much of the hedge fund world had ventured into newer, broader, less efficient markets as well. In short, the trade in European bonds was crowded, a fact that totally passed me by.

To make matters worse, the proprietary trading desks of the major brokerage firms – including Bankers Trust, Merrill Lynch, J. P. Morgan, and Goldman Sachs – had made some of the same bets on foreign bonds. There was a substantial overlap between our positions and theirs. Ordinarily, one's broker or dealer is there to make markets and provide reasonable liquidity, even in times of need. But the trading desks themselves were overextended in their positions, and they too were competing with us to make sales. Furthermore, Askin Capital Management, a hedge fund that specialized in trading leveraged mortgage securities, collapsed during this period, forcing the trading desks at some of the big firms to further curtail their market making. Suddenly, events that were not ordinarily connected were.

ON THE PAIN OF LOSING:

I could not avoid feeling as if my very worth as a human being depended on my continually making money.

One point cannot be overemphasized: Global bond markets were, for me and for too many other leveraged hedge funds, a relatively new medium. I was experienced in dealing with liquidity, constraints, and leverage in many markets, including the U.S. bond market, but the European markets were new ground. With our new and relatively inexperienced team, we simply were not on top of the game. Without knowing it, our confidence had lured us into becoming too big in these markets. The instincts that had been honed during the decades of dealing with domestic stocks were simply not applicable. I had prided myself in having an edge in most investments. Instead, I was caught investing in countries where I did not know, or even want to know, the area code.

In these markets, there simply was not the same flow of information. Moreover, it was not exactly clear where I stood on the chain of knowledge. When it came to forecasting geopolitical and economic trends, I did not have a competitive or intellectual advantage. The normal flows of input, which would usually ring warning bells in the domestic financial world, were perhaps somewhere on a distant continent. There I was, reliant on new people with whom I had never before been in the trenches. It was a formula for disaster.

I had misjudged the liquidity of the positions we held. Faced with a massive sell-off, there was no painless way to get out. Traders know that, in times of market stress, they sometimes need to sell what they can sell, regardless of price. The sad irony was that everybody else needed liquidity at the same time that we did, so there was not much selling to be done.

We watched the screens in awe as wave after wave of sellers threw in the towel. Everyone was looking for a bid but there were no bids to hit. In my February monthly letter to investors, I reported that we were already down almost 20 percent and we were not out of many positions yet. My traders were shell shocked and hoped that the worst had been seen, but because we, and most others who had crowded into the same trade, had not yet sold much, they were wrong. After the market started its decline, we sold some bonds; as it went down more, we sold more; and so on. Even worse, it seemed that every time we went to sell, the Street knew what we were doing and followed.

John Maynard Keynes said: "Markets can remain irrational longer than you can remain solvent." Thus it is rare, particularly with leveraged securities, that one can endure a substantial decline without being a victim of it. Even if one has great confidence in a position, which then declines substantially, the process by which the loss is experienced is always so unnerving and detrimental that the position is a victim of the decline itself. Price creates its own reality. Obviously, dramatic declines often end with liquidations at the bottom. This is the insidious impact of panic and leverage. We felt it.

But I would be wrong to characterize myself as simply a victim of a liquidity squeeze or an unexpected market turn. If I was a victim of anything, it was of hubris or unjustified confidence in my abilities – perhaps the result of too many too-easy successes. In the end, I was responsible for thinking that I could successfully conquer a spectrum of markets around the globe. I had lost sight of my own limitations. I was shocked and humbled by my failure.

I was also wrong to think that because I held positions in various global markets, my portfolio was truly diversified. If so, it might then have provided some reduction in the overall risk. In times of stress, inevitably, markets that are not normally correlated suddenly are. I might have learned this lesson during the 1987 debacle, but I now ignored it. There was no one at the firm whose judgment I could rely on. Again, I felt alone.

We finally finished liquidating the entire portfolio at the end of March, only three months into the year. At that point, we were down 30 percent. I felt more depressed than I had ever been. This was worse than 1987. That crash had only negated most of our work for the year; we actually posted a slight gain. Now, we were down, way down. Indeed, this was by far the only substantial loss the funds had ever suffered. Our only other loss years had been 1969 and 1972, when we were down by approximately 1.5 percent in each year. I had failed in the most fundamental tenet of money management: capital preservation.

At year's end, we were down 31 percent. It was the one year in which I actually lost a meaningful amount of money. In 1987, I had given back the profits we had made earlier in the year, but I did not lose money. In this year, I truly lost a great deal of money, and, even with all the years of success, this failure dominated my life. I could focus on nothing else. However, the only redeeming part about ending an awful year is that you wipe the slate clean and start all over again.

I had to try and put everything into perspective. After all, from July 1967, when we first opened Steinhardt, Fine, Berkowitz & Company, until the end of 1993, the funds' annual returns had averaged 33.5 percent. Even so, I anguished over 1994 as if my entire career had been a failure. I could not avoid feeling as if my very worth as a human being depended on my continually making money. What was I worth when I lost?

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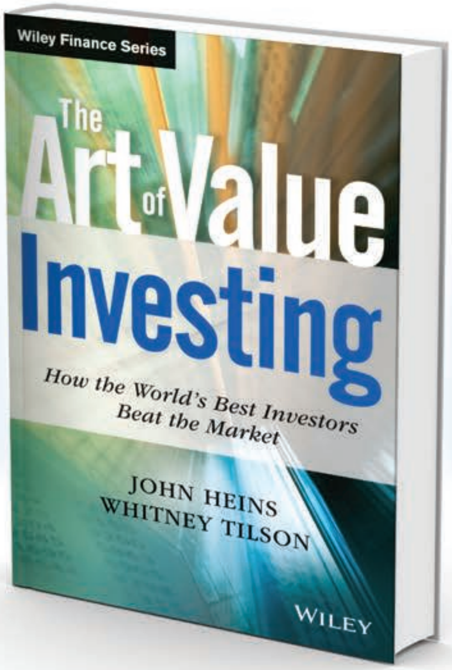
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Additive Property

Defensive stocks are typically expected to underperform when times are good, but not to the extent the shares of food-additive maker Ingredion Corp. have over the past year. Has the market's pessimism gone too far?

While stocks of companies in "defensive" sectors aren't expected to shine when the economy and market are buoyant, shareholders of Ingredion Corp. might consider that trait a bit overdone. Known as Corn Products International before a 2012 name change, the company specializes in turning food products such as corn, wheat and potatoes into sweeteners, starches and other ingredients used primarily by food and beverage manufacturers worldwide. Its additives help sweeten soft drinks, make crackers crisper and reduce the oil content in salad dressings – all of which contributes to a solid, if hardly sexy, profile for the $6.5 billion annual-revenue company.

As defensive as its profile might appear, Ingredion's shares over the past year have been a lead weight, down 6% over a period in which the market has risen nearly 20%. After three strong years of results following the large 2010 acquisition of Akzo Nobel N.V.'s National Starch division, the company's last two reported quarters have underwhelmed, which it attributed to weak Latin American sales volumes, higher raw materials costs and negative foreign-currency exposures. As even modest growth hit the skids, so did the share price.

Michael Dzialo, chief investment officer of Rochester, Michigan-based Managed Asset Portfolios, argues that the market is overreacting to what he considers the company's temporary travails. The National Starch acquisition not only added a number of higher-margin food ingredients to Ingredion's stable of products, he says, but it also expanded its geographic footprint in emerging markets where, despite recent worries, the long-term outlook for the branded food and beverage companies that the company serves is robust. "We like that this is a defensive play in slow-growth developed markets, while being an offensive play in higher-growth emerging ones," says Dzialo.

Despite recent earnings hiccups, he believes Ingredion's growth will rebound this year and estimates that as investments the company has been making in new products, sales and distribution start to pay off, that it can earn $6.50 per share by 2015, up from an estimated $5.70 this year. He expects such growth to be accompanied as well by an expansion in the multiple the market is willing to pay – not to the levels of its name-brand customers, but at least to a market level of 15x. If he's right, that would result in a $95-plus share price within the next two years.

The company is also a potential beneficiary of what he expects to be ongoing consolidation in a global food-products industry in which scale can impart significant benefits. "Ingredion is big enough to be an acquirer and small enough to be an easily manageable buy for an Archer Daniels Midland, Cargill or Bunge," he says. "Either scenario could be quite positive for shareholders."

INVESTMENT SNAPSHOT

Ingredion
(NYSE: INGR)

Business: Production and sales of starch and sweetener ingredients primarily derived from corn and used in food and beverages.

Share Information (@1/30/14):

Price	**61.98**
52-Week Range	60.62 – 74.31
Dividend Yield	2.6%
Market Cap	$4.75 billion

Financials (TTM):

Revenue	$6.47 billion
Operating Profit Margin	10.0%
Net Profit Margin	6.2%

Valuation Metrics
(@1/30/14):

	INGR	S&P 500
P/E (TTM)	12.1	18.2
Forward P/E (Est.)	10.8	15.4
EV/EBITDA (TTM)	7.2	

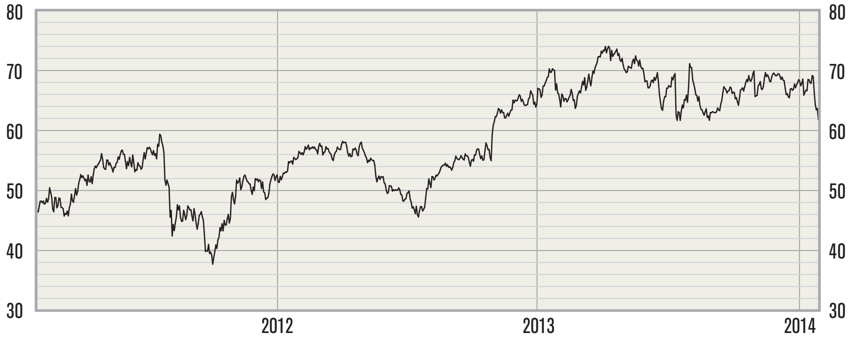
Largest Institutional Owners
(@9/30/13):

Company	% Owned
Vanguard Group	6.1%
BlackRock	5.2%
LSV Asset Mgmt	5.0%

Short Interest (as of 12/31/13):

Shares Short/Float	2.4%

INGR PRICE HISTORY



THE BOTTOM LINE

Michael Dzialo believes the company's product and geographic breadth make it a defensive play in developed markets and an offensive play in developing ones. As investments in new products, sales and distribution start to pay off, he estimates EPS can hit $6.50 by 2015. At even a market multiple, that would result in a $95-plus share price.

Sources: Company reports, other publicly available information

Fine Print

Given the volume of information investors are required to process in their research, it's obviously critical that they're able to see the proverbial forest from the trees and zero in on what's most important in any given idea. But as important as these kinds of reflective views are to investing success, they're less likely to bear fruit without the added support of a tremendous amount of detailed, painstaking and sometimes mind-numbing work.

In our interview with him for this issue, Joe Huber of Huber Capital Management recounted a past triumph in the shares of a large food-processing company that brought this point home:

> At the beginning of the year, management told us they were gaining market share by out-executing the competition. As it stated in the Management Discussion and Analysis section of the company's 10-K, "we have great visibility for our business this year and beyond." First quarter earnings beat the estimate handily, the stock soared, and everything looked great. When the 10-Q came out, however, the MD&A section now read, "we have great visibility for our business long term." Two words – "this year" – were omitted from the prior quarter.
>
> As soon as we saw the change, we called the company and requested a visit. We were able to glean that everything they were saying was technically true, but discovered that end customers were pulling way back on inventories. This information wasn't well understood in the market, so we sold down our position in advance of it becoming well understood. In announcing earnings for the second quarter, management guided down for the rest of the year, investors were surprised and the stock dropped 30%.
>
> For us, the value of the company hadn't changed at all, so we rebuilt our position at a 30% percent discount to the prior sale. We gained nearly 100 basis points of alpha from one security based off of two words in a single document.

A verity of investing to remember: Never neglect the fine print.

R.I.P.

We've always found obituaries to be compelling reading, often filled with triumph, tragedy and keen insight into the human condition. So it made us laugh to read the "obituary" The Motley Fool's Morgan Housel recently wrote for Long-Term Thinking. A tragic tale to be sure, and filled with keen insight into the human condition:

> Long-Term Thinking lived an illustrious life since the start of the Industrial Revolution, when for the first time, people could think about more than their next meal. But poor incentives and the rise of 24/7 media chipped away at his health. The final blow came Monday, when a trader on CNBC warned that a 10% market pullback – which has occurred on average every 11 months over the last century – could be "devastating" for investors. "That's it," Long-Term Thinking whispered from his hospital bed. "There's no more room for me here." He died soon after Bloomberg published its daily tally of how much the net worths of the world's billionaires changed in the previous 24 hours.

The final wishes of the family, according to Housel: "In lieu of flowers, his family asks that you turn off CNBC and stop checking your brokerage account."

John Heins   Whitney Tilson

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