



Valuation Investing: value investing supported
by thorough financial analysis

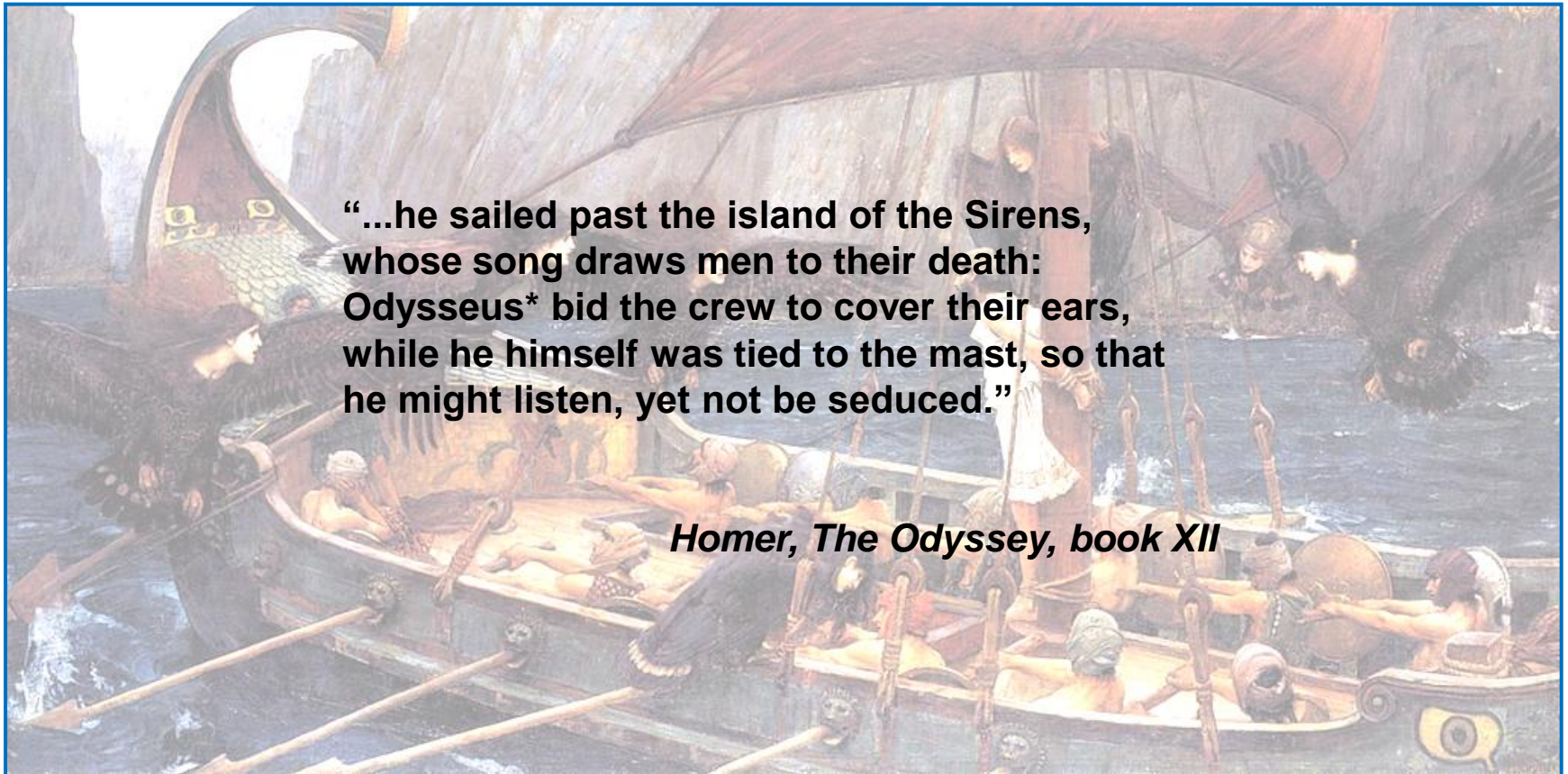
VIS 2009 – Trani, Italy

July 2009

DISCLAIMER

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OUR PHILOSOPHY



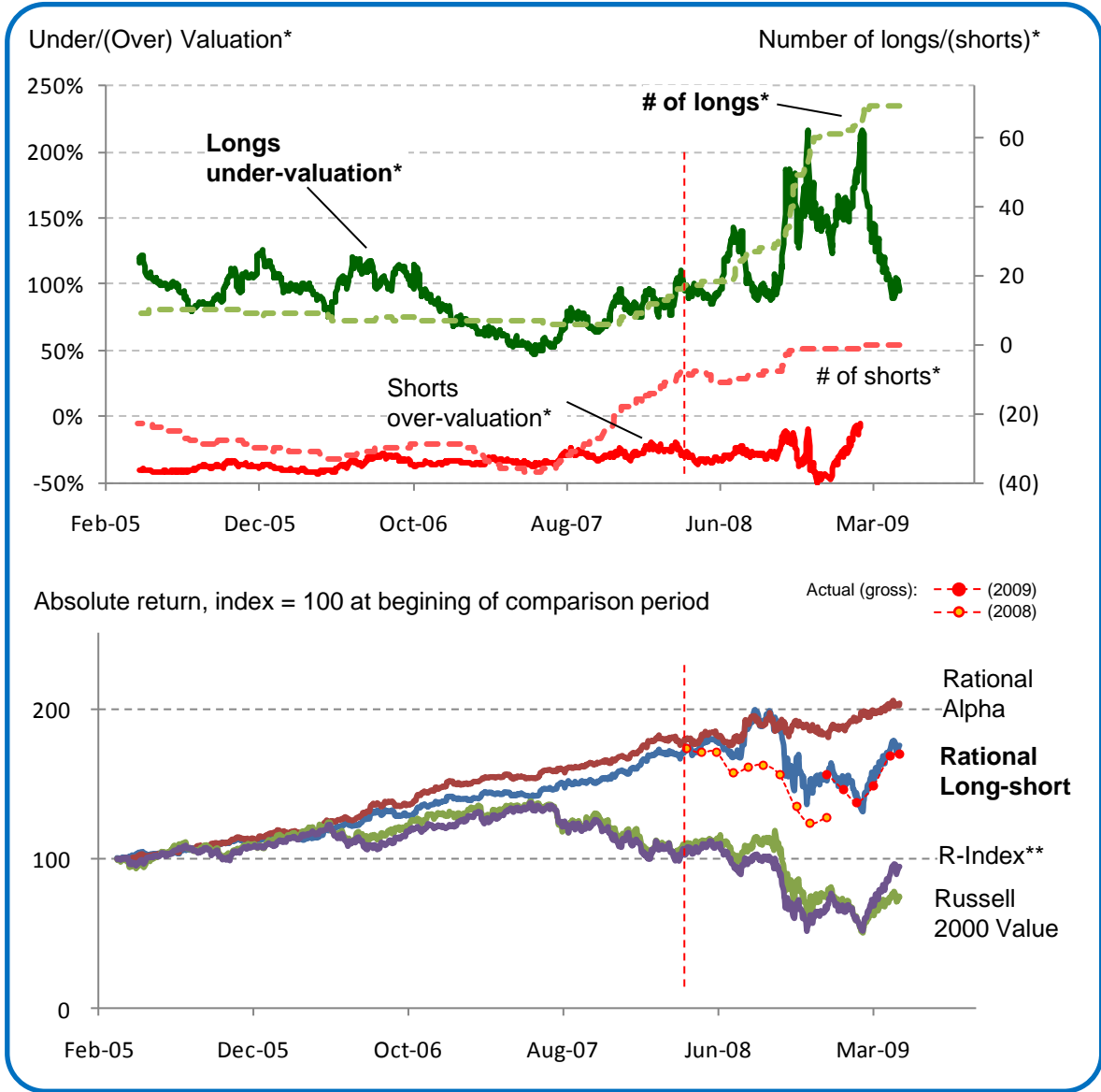
**“...he sailed past the island of the Sirens,
whose song draws men to their death:
Odysseus* bid the crew to cover their ears,
while he himself was tied to the mast, so that
he might listen, yet not be seduced.”**

Homer, The Odyssey, book XII

Like Odysseus, our fund seeks to avoid the siren’s call... In our case, the cycles of fear and greed and the short term noise of the equity market

* Odysseus is the protagonist in Homer’s Iliad; in Latin he is known as Ulysses. Painting is by John William Waterhouse : Ulysses and the Sirens (1891)

THE CURRENT INVESTMENT OPPORTUNITY SHOULD NOT BE IGNORED



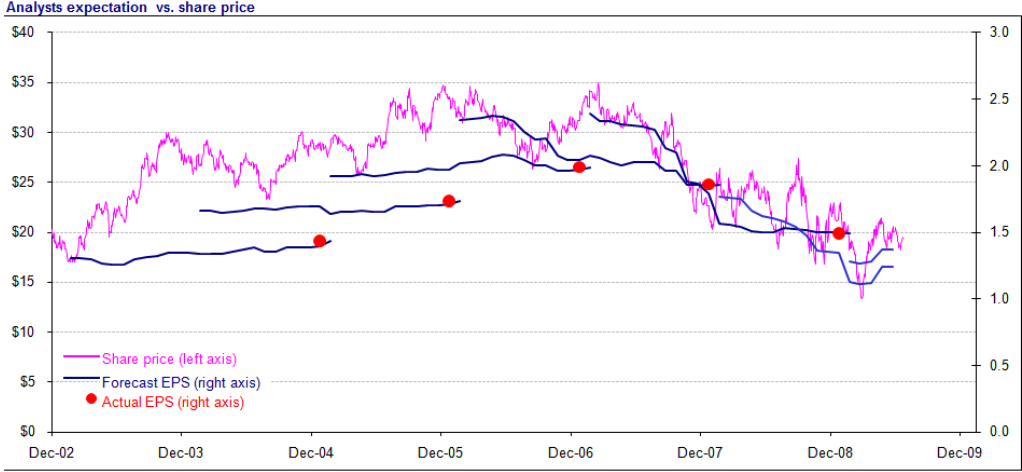
Our knowledge base has today a high number of companies with significant potential for appreciation, which is reflected in the number of long positions currently in the portfolio

Our back testing analysis shows that undervaluation relative to our proprietary “fair value” is a strong indicator of future performance

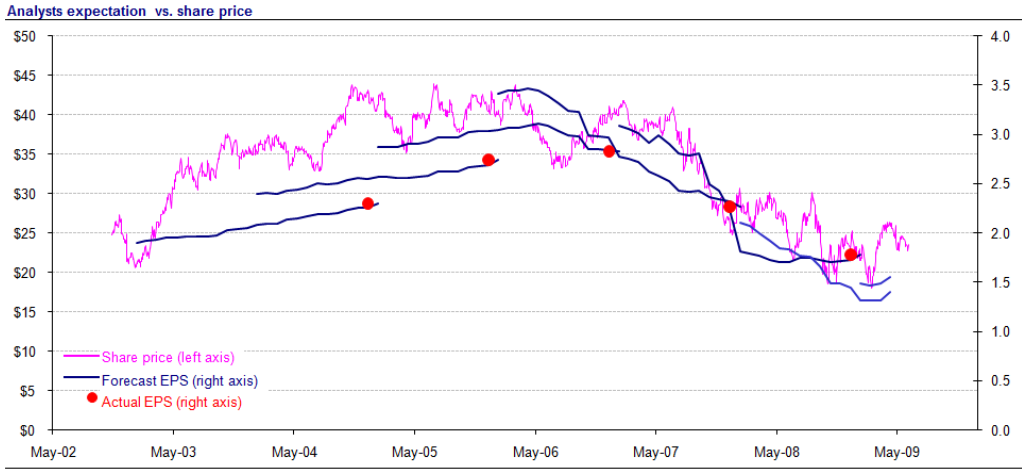
Note: reflects the result of “back testing”
 * Under-valuation / #of longs represented by a positive number; over-valuation / # of shorts represented by a negative number
 ** R-Index is a equal-weighted index using all companies on Rational’s knowledge base

THE MARKET HAS AN OVER-SIMPLISTIC APPROACH TO VALUE COMPANIES

Lowe's (LOW):



Home Depot (HD):



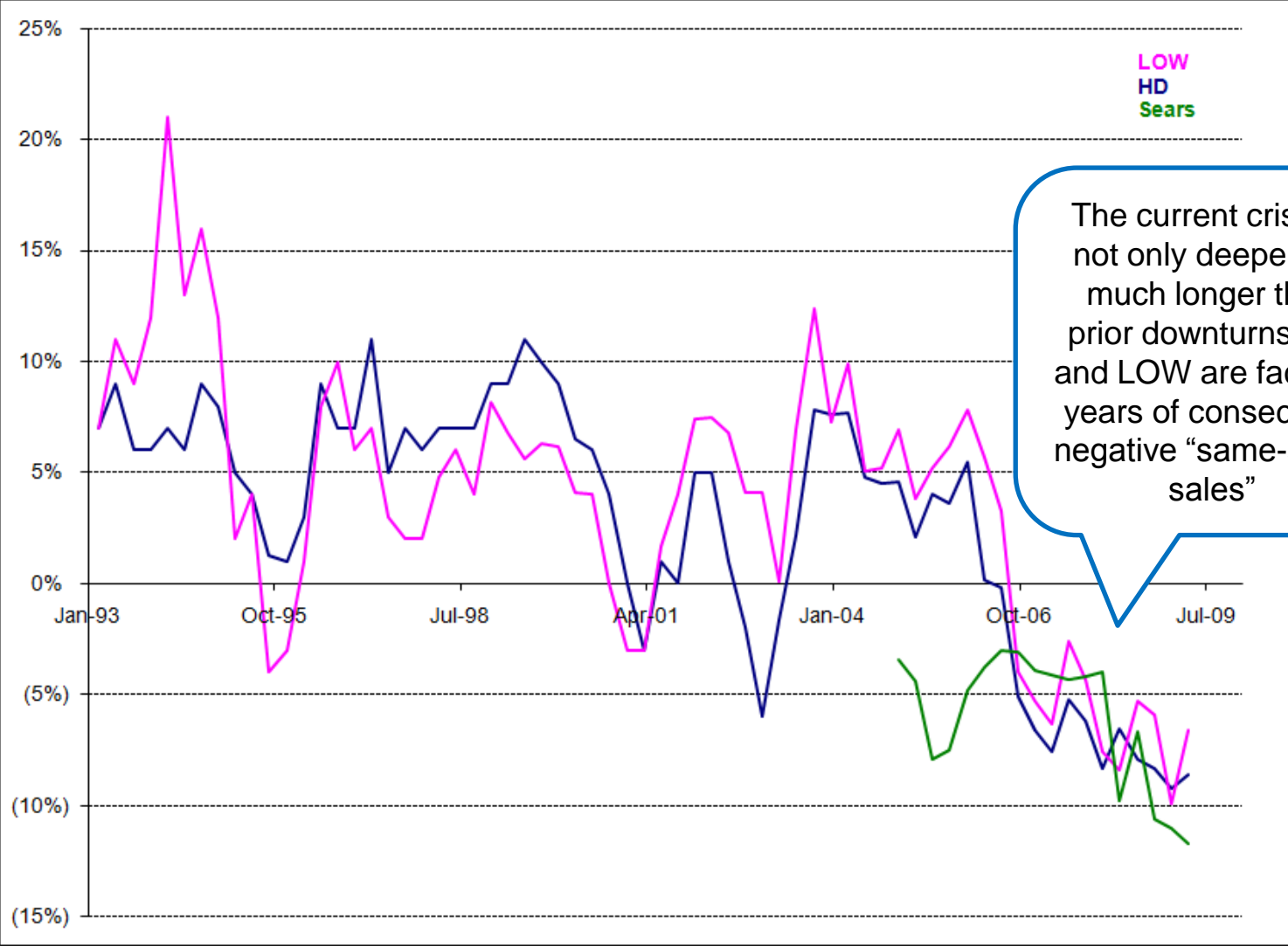
When we superimpose the share price of a stock and the average NTM EPS (Next Twelve Months EPS) estimates from sell-side analysts it is clear that “the market” is using an over-simplistic approach to investing – it uses an almost constant multiple over a short term forecast

Although this is clearly a wrong approach to investing, it offers a lot of good opportunities for the rational and methodical investor

Our analysis indicate that both Lowe's and Home Depot are currently more than 50% under-valued

LOWE'S AND HOME DEPOT FACES THE SAME MACRO CYCLES

Domestic same-store-sales (sss)

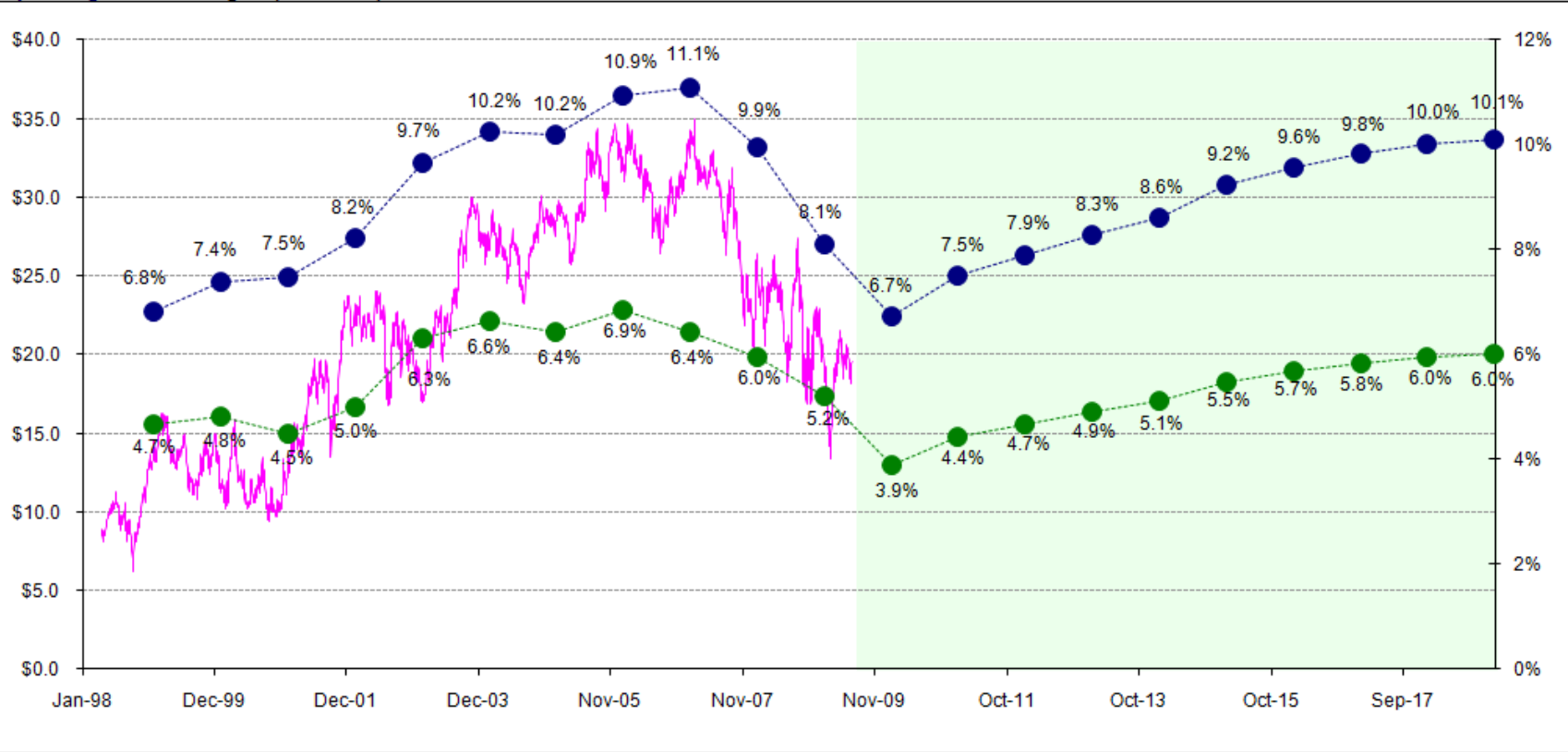


The current crisis is not only deeper but much longer than prior downturns: HD and LOW are facing 3 years of consecutive negative "same-store-sales"

LOWE'S MARGINS WILL RISE SIGNIFICANTLY IN THE FUTURE

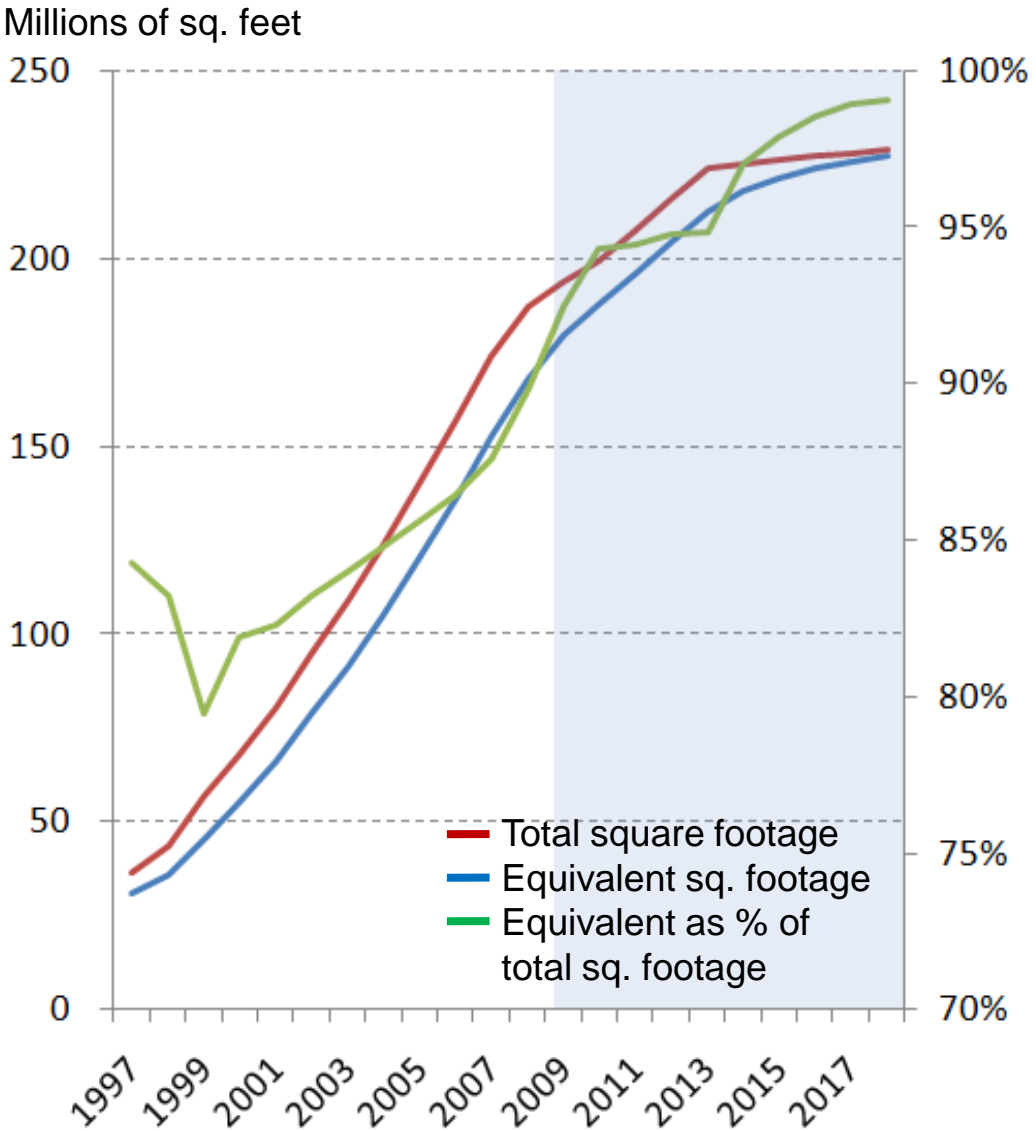
LOWE'S (LOW)

Operating and net margins (economic)*



The current recession – which has been focused on the housing sector – has obviously impacted LOW's margins, but we have good reasons to believe that they will increase from the current low level

THE EQUIVALENT SQUARE FOOTAGE CONCEPT



When analyzing a retailer's growth dynamic it is necessary to adjust calculations of sales and costs (per square foot) given the average age of the stores

At Rational we do what we call an "equivalent square footage" calculation – it shows how many "mature" square feet would be necessary to replicate the current sales level

When a retailer stops an accelerated growth pattern, the increase in their "square footage age" will provide a strong tail-wind for margins

EQUIVALENT SQUARE FOOTAGE CALCULATION - HISTORICAL

LOWE'S (LOW)

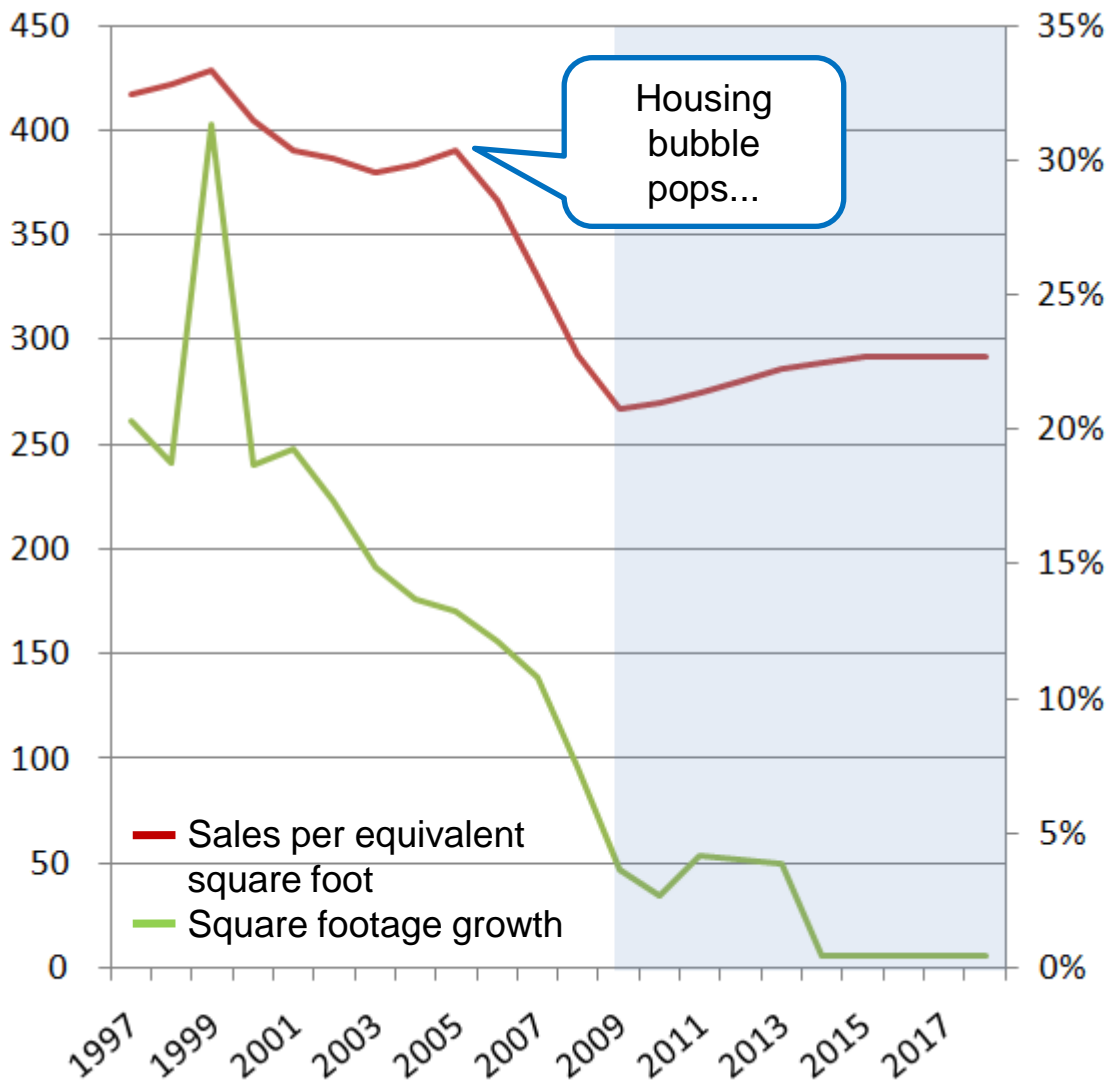
			Jan 2004A	Jan 2005A	Jan 2006A	Jan 2007A	Jan 2008A	Jan 2009A
Total revenue			30,838	36,464	43,243	46,927	48,283	48,230
y-o-y growth			16.4%	18.2%	18.6%	8.5%	2.9%	(0.1%)
Sale per <u>equivalent</u> s.f.			337	347	361	345	317	287
y-o-y growth			0.3%	3.0%	3.8%	(4.2%)	(8.3%)	(9.4%)
Domestic Equivalent Sq. Footage								
Eq. Sq. Feet			91	105	120	136	152	168
as % of total	<u>EOY</u>	<u>Av.</u>	84.0%	84.8%	85.6%	86.5%	87.6%	89.8%
Up to 1 Year Old	70%	35%	14.9	15.9	17.0	17.6	17.4	13.0
2 Years Old	77%	73%	13.6	14.9	15.9	17.0	17.6	17.4
3 Years Old	85%	81%	12.5	13.6	14.9	15.9	17.0	17.6
4 Years Old	92%	89%	10.4	12.5	13.6	14.9	15.9	17.0
5 Years Old	100%	96%	12.6	10.4	12.5	13.6	14.9	15.9
6 Years Old	100%	100%	6.8	12.6	10.4	12.5	13.6	14.9
7+ Years Old	100%	100%	38.0	43.8	55.8	65.6	77.6	91.2
Total sq footage			108.8	123.7	140.1	157.1	174.0	187.0
Total Volume [millions sq. feet]			109	124	140	157	174	187
y-o-y growth			14.9%	13.7%	13.3%	12.1%	10.8%	7.5%
Implied price/mix impact			1.3%	4.0%	4.7%	(3.2%)	(7.1%)	(7.1%)
Unit growth			14	15	16	17	17	13

EQUIVALENT SQUARE FOOTAGE CALCULATION - FORECAST

LOWE'S (LOW)

			Jan 2010E	Jan 2011E	Jan 2012E	Jan 2013E	Jan 2014E	Jan 2015E
Total revenue			47,843	51,618	55,990	60,764	65,700	69,532
y-o-y growth			(0.8%)	7.9%	8.5%	8.5%	8.1%	5.8%
Sale per <u>equivalent</u> s.f.			267	275	286	297	309	319
y-o-y growth			(7.0%)	3.0%	4.0%	4.0%	4.0%	3.0%
			Growth rate decline since 2014:					(28%)
Domestic Equivalent Sq. Footage								
Eq. Sq. Feet			179	188	196	204	212	218
as % of total	<u>EOY</u>	<u>Av.</u>	92.5%	94.3%	94.4%	94.7%	94.8%	97.0%
Up to 1 Year Old	70%	35%	7.9	6.2	9.6	9.5	9.5	1.7
2 Years Old	77%	73%	13.0	7.9	6.2	9.6	9.5	9.5
3 Years Old	85%	81%	17.4	13.0	7.9	6.2	9.6	9.5
4 Years Old	92%	89%	17.6	17.4	13.0	7.9	6.2	9.6
5 Years Old	100%	96%	17.0	17.6	17.4	13.0	7.9	6.2
6 Years Old	100%	100%	15.9	17.0	17.6	17.4	13.0	7.9
7+ Years Old	100%	100%	104.9	119.8	135.6	152.0	168.2	180.6
Total sq footage			193.8	199.0	207.3	215.6	223.9	225.0
Total Volume [millions sq. feet]			194	199	207	216	224	225
y-o-y growth			3.6%	2.7%	4.2%	4.0%	3.9%	0.5%
Implied price/mix impact			(4.3%)	5.1%	4.1%	4.3%	4.1%	5.3%
Unit growth			7	5	8	8	8	1

Sales per equivalent square foot (09' USD) Y-o-y growth



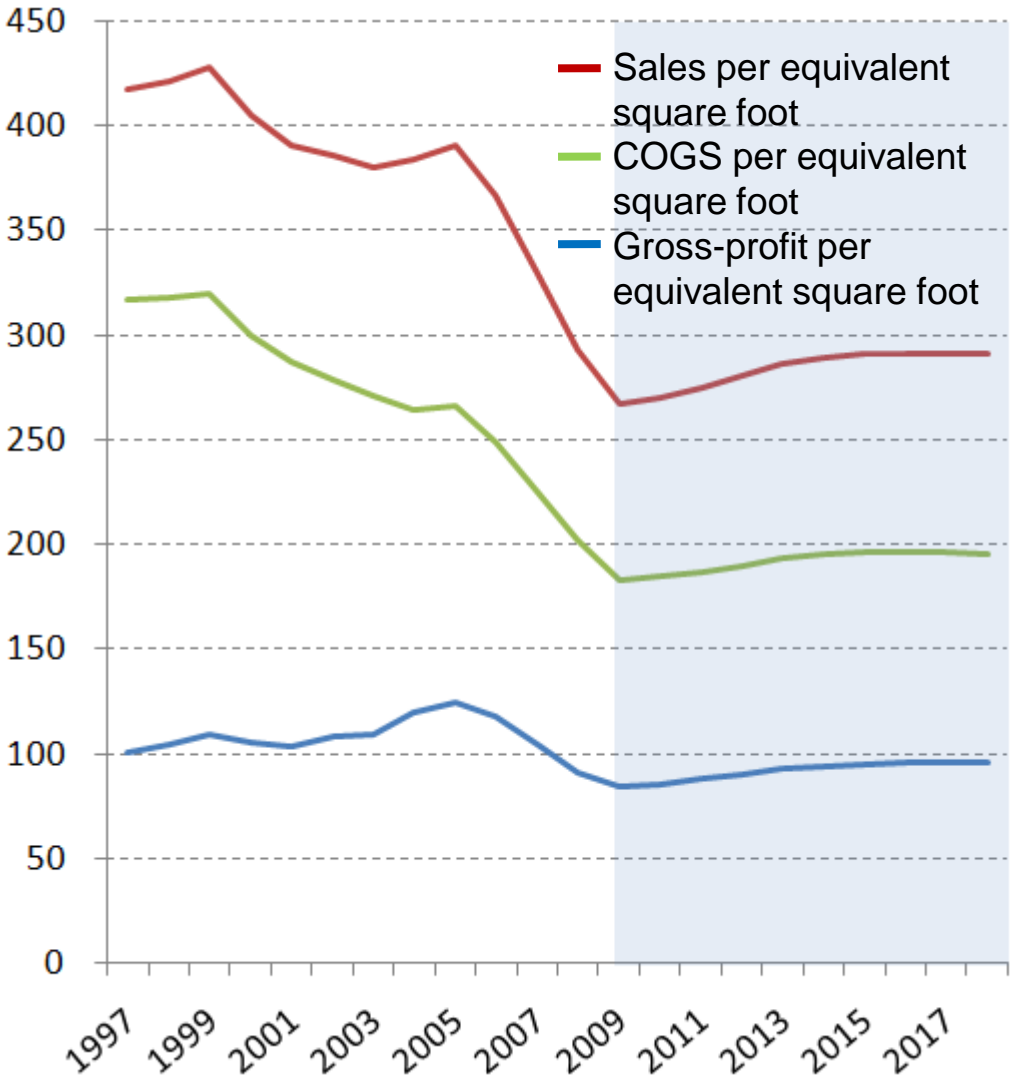
Rapid square footage growth impacted sales per equivalent square footage

Nevertheless, the current housing crisis has brought sales per equivalent square foot down significantly

Although it is hard to know what should be the normalized sales level for Lowe's, our "base case" assumes a small real growth in sales equivalent square foot from very depressed levels

GROSS-MARGINING DOLLARS ARE VERY STABLE

Sales/COGS/GM per equivalent square foot (09' USD)



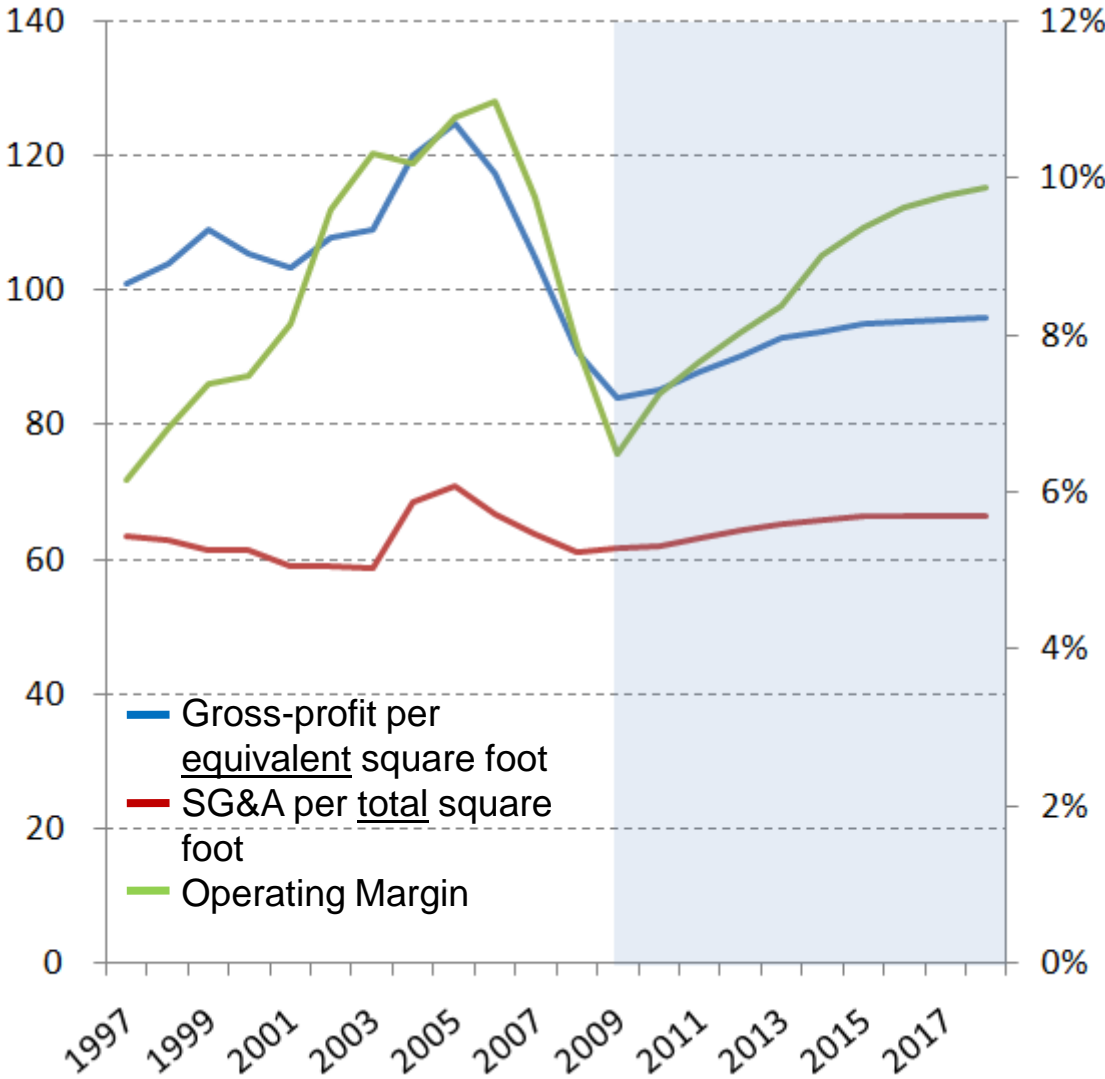
Although sales per equivalent square foot has declined, COGS per equivalent square foot has also declined

Gross-margin dollars per equivalent square foot has remained remarkably stable over more than 10 years

We forecast that real gross-margin per equivalent square foot (on our base case) will not go back even for pre-bubble levels

GROSS-PROFIT AND SG&A WILL BE DRIVEN BY EQUIVALENT AND TOTAL SQUARE FOOTAGE, RESPECTIVELY

GM/SG&A per eq./total square foot (09' USD)



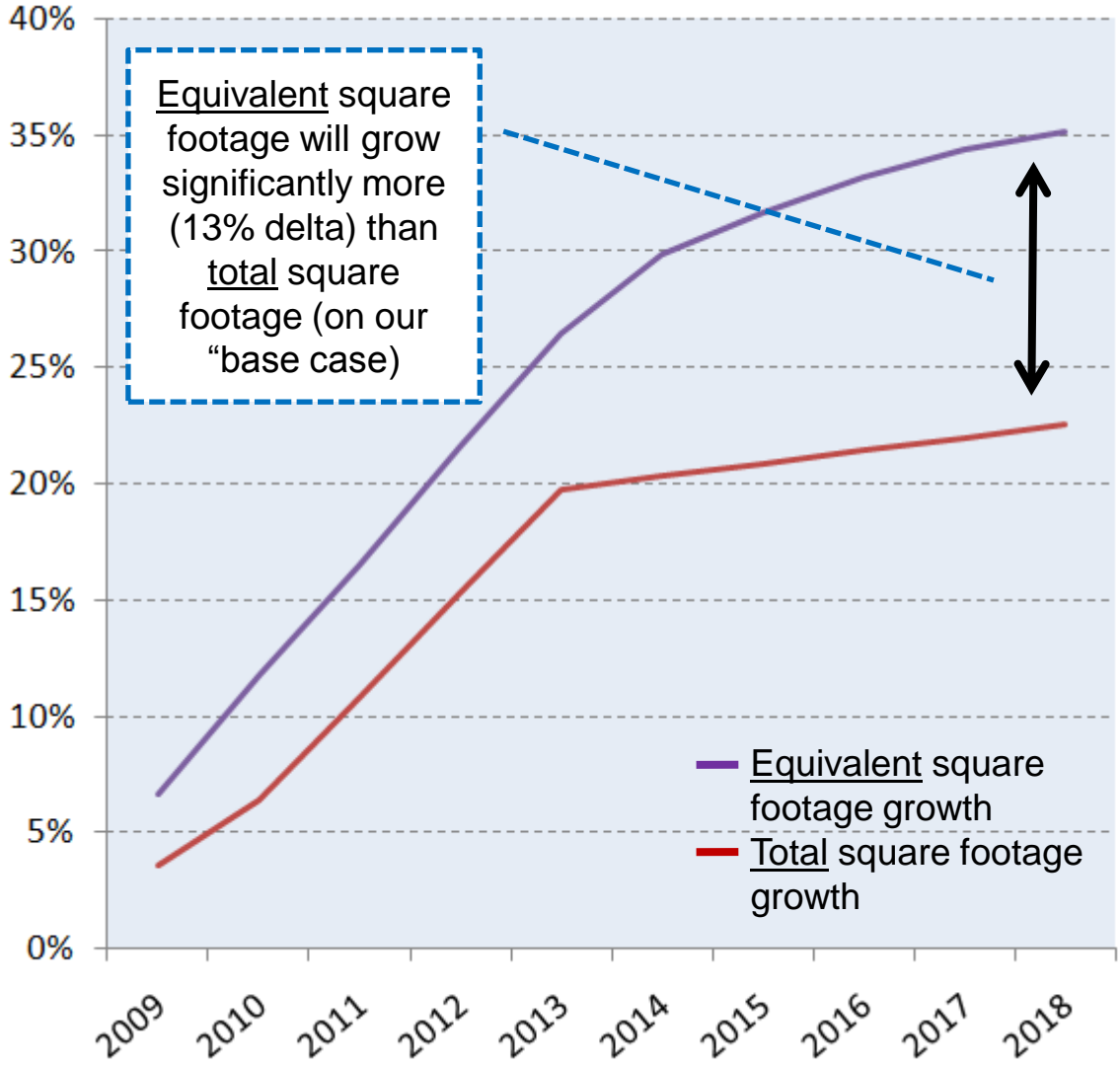
A close-up on gross-profit per equivalent square foot shows the impact of the housing bubble on Lowe's economics

SG&A per total square foot has also remained very stable over the years

Operating margins will be driven not only by the absolute figures for gross-margin and SG&A but also by future growth of equivalent vs. total square footage

A CLOSEUP ON SQUARE FOOTAGE GROWTH REVEALS AN EXTRA DRIVER FOR MARGIN IMPROVEMNT

Cumulative square footage growth



Equivalent square footage will grow significantly more (13% delta) than total square footage (on our "base case")

Total square footage growth will drive SG&A expenses

Equivalent square footage growth will drive gross-profit dollars

As a consequence, Lowe's will experience a tail-wind from the higher growth of equivalent square footage vs. growth of total square footage (i.e. gross-profit dollars will grow faster than SG&A dollars)

SUMMARY OF LOWE'S AND HOME DEPOT CASES

- Lowe's and Home Depot are probably experiencing the worst downturn on their sector they will ever face
- Nevertheless, current market valuation provides a significant margin of safety for both companies even assuming (i) a small increase on real same-store-sales (we actually think that our base-case might be too pessimistic on this driver), (ii) gross-profit per equivalent square foot below long-term historicals and (iii) room for increase in SG&A per total square foot
- As both Lowe's and Home Depot stop new store expansion, margins will increase due to a tailwind provided by the increase in average age of their stores since "equivalent square footage" (that driver gross-profit dollars) will grow faster than "total square footage" (that drives costs)



According to our proprietary analysis both Lowe's (LOW) and Home Depot (HD) are more than 50% under-valued

APPENDIX – DETAILS ON RATIONAL'S METHODOLOGY

FUND OVERVIEW / INVESTMENT OBJECTIVE

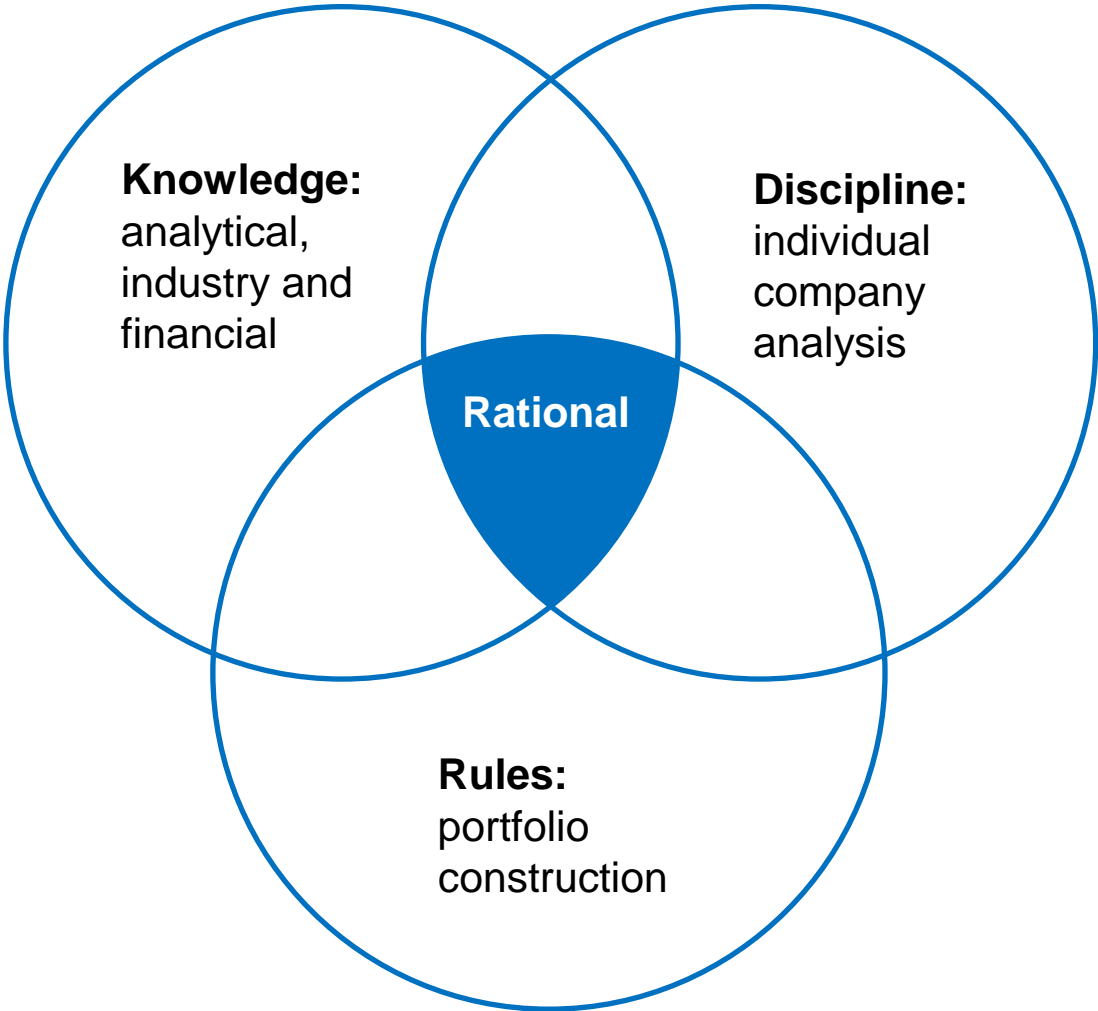
Rational Asset Management investment approach:

- Rational Asset Management is a fundamentals-based investor, which :
 - i. Focuses on publicly traded, liquid US equities
 - ii. Employs extensive industry research and analysis, building highly detailed and complete *proprietary* models
 - iii. Uses these proprietary models to determine “fair values” of companies based on forecasted *distribution* of future cash flows
 - iv. Constructs a “rules-based” portfolio with a tunable margin of safety relative to “fair value”

Rational Asset Management Investment objective:

- Absolute returns through exposure to well researched companies (long or short) that are mispriced relative to our “fair value” assessments
- We don’t target a specific index. However, our “R-Index”, an equal-weighted index using all the companies in Rational’s knowledge base, is highly correlated to the Russell 2000 Value index. Hence we will benchmark ourselves to the Russell 2000 Value index.

COMPETITIVE ADVANTAGE



Rational encompass a **unique combination of knowledge, discipline and rules** that distinguishes the fund from most players in the public equities market

TEAM WITH DISTINCTIVE CUMULATIVE INVESTMENT ANALYSIS EXPERIENCE



Partners' common background



Danilo Santiago

Rigorous **analytical training** for Electrical Engineering degree at University of Sao Paulo

Broad **industry and operational experience**, at Valeo, Citibank, and McKinsey & Co.

MBA at Columbia Business School with focus on finance (**Value Investing**) and statistics

Focus on finance related projects at the Corporate Finance Practice at McKinsey, NY, ~4 years

Senior Analyst at a **fundamental-focused hedge fund**; developed a **new valuation template** used by every analyst

Claudio Skilnik

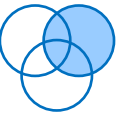
Rigorous **analytical training** for Industrial Engineering degree at University of Sao Paulo

Financial analytical experience at Banco Pactual as infrastructure analyst and as VP for ABN AMRO Project Finance group

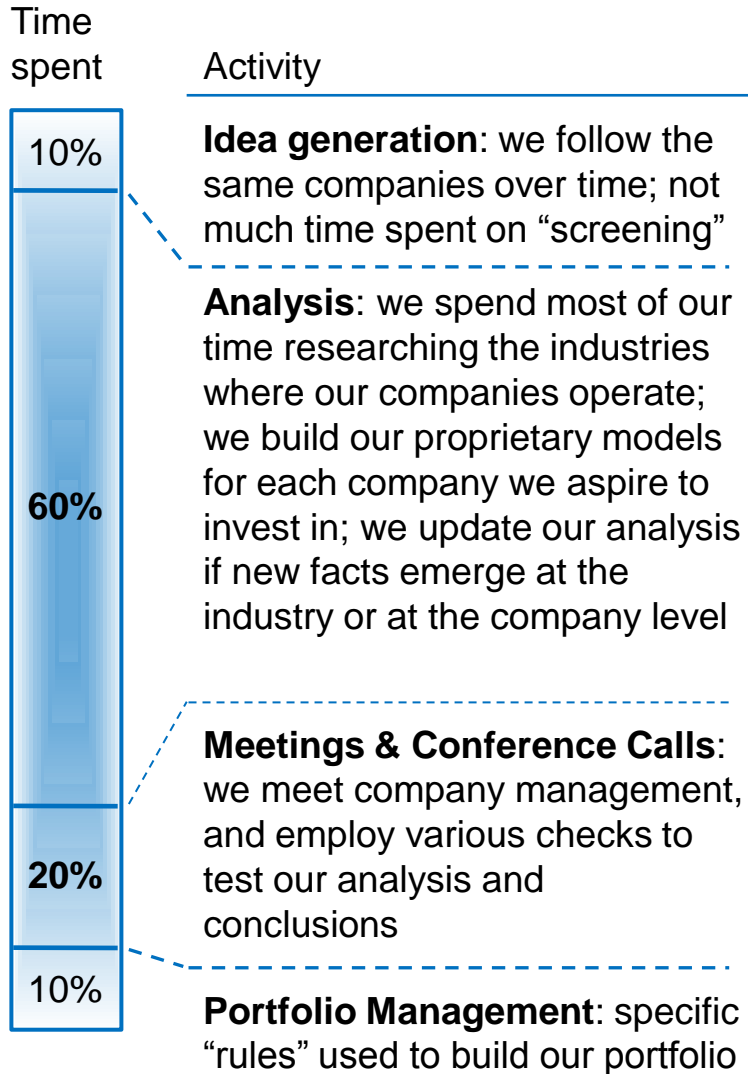
MBA at Columbia Business School with focus on finance (**Value Investing**) and accounting

Focus on private equity transactions as a VP for ABN AMRO Capital ~3 years

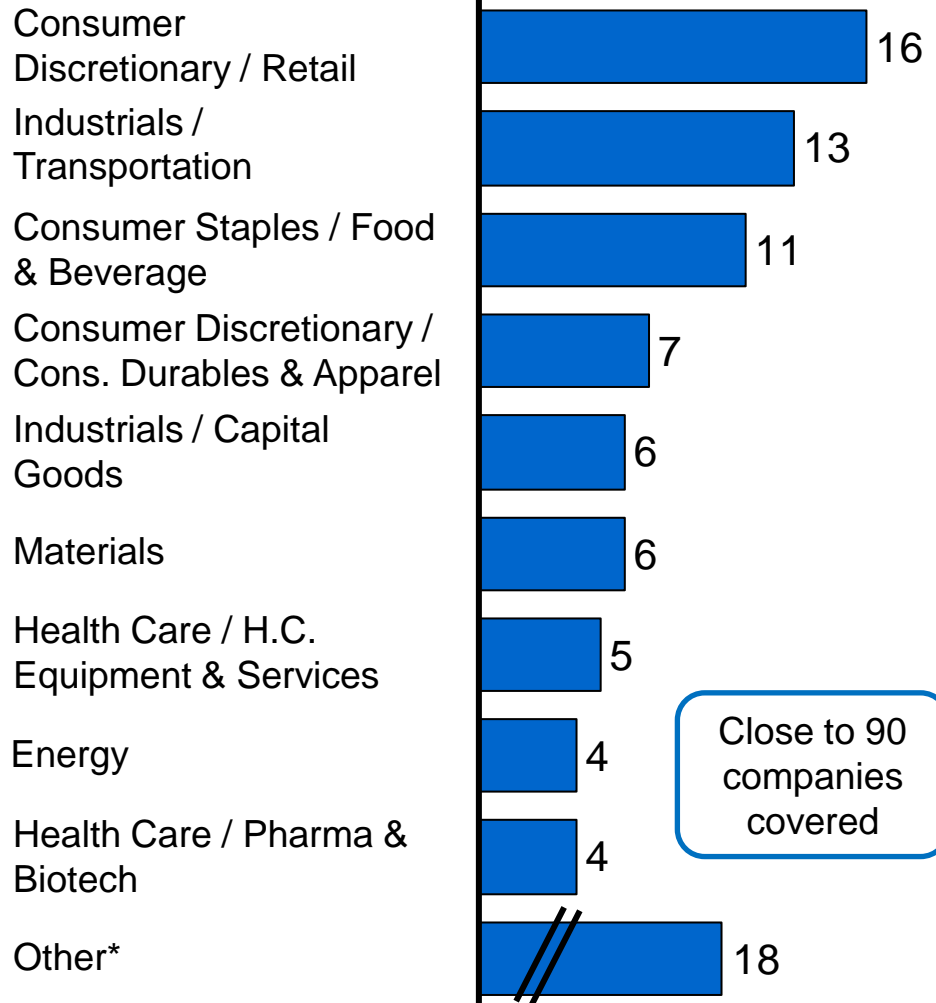
Launched hedge fund, where a **comprehensive operational structure** was built; Rational uses that low-cost structure



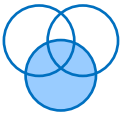
INVESTMENT APPROACH



Number of companies covered



* Other includes Financials, Industrials / Commercial & Professional Services, Information Technology, Consumer Discretionary / Consumer Services, Consumer Staples / Food & Staples Retailing, Consumer Staples / Household & Personal Products, Industrials / Commercial Services & Supplies



- **Trigger conditions for considering new positions:**
 - Longs: current stock price is close to “bad case” value
 - Shorts: current stock price is close to “great case” value
- **Conditions for initiating and closing new positions:**
 - Positions are added to portfolio after trigger conditions are met
 - Positions are closed once the stock price reaches the “base case” fair value
- **“Rules-based” portfolio construction and management minimizes risk:**
 - New positions are the smaller of (i) 5% or (ii) 1 divided by the number of longs/shorts (i.e. for a portfolio that has 29 names a new position will be 1/30th of the portfolio value)
 - Long / short positions individually never exceed 5% / 4% at any time*
 - Maximum gross long of 130%; maximum gross short of 70%; maximum net long of 60%; maximum net short of 20%*
 - Gross and net exposure will fluctuate within the above constraints based on the under- and over-valuation of stocks within the firm’s knowledge base
 - Position size is increased if there is space in the net/gross long/short limits – “size push”
 - Long positions are not increased if the stock price falls after a position is initiated; short positions are not increased if the stock rises after initiation

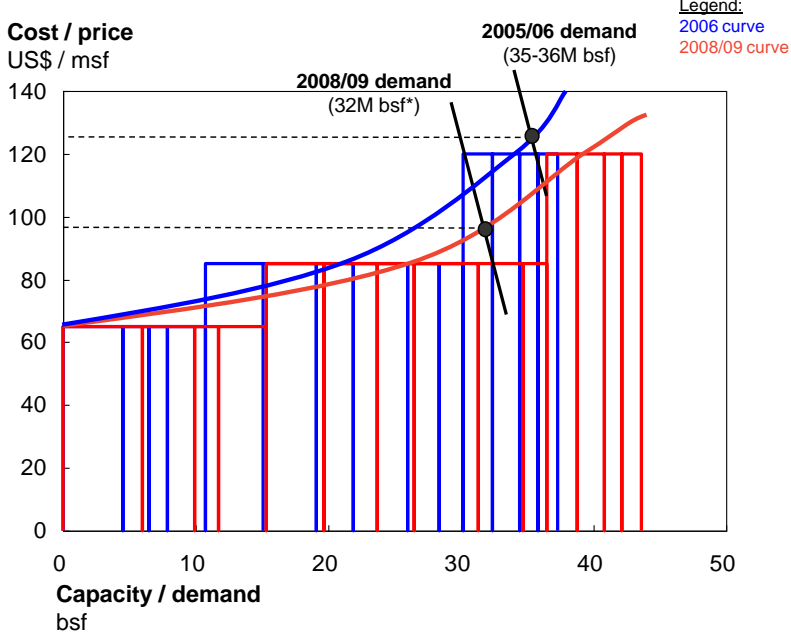
* To avoid excessive trading costs we might elect to allow a position or the portfolio to be a few basis points above the set limit. At the end of the month (or when the partners find it necessary) the portfolio is adjusted to perfectly match the “ideal portfolio” suggested by Odysseus (our proprietary portfolio construction tool)

EXCERPT OF USG CORP. ANALYSIS

Company analysis and investment thesis

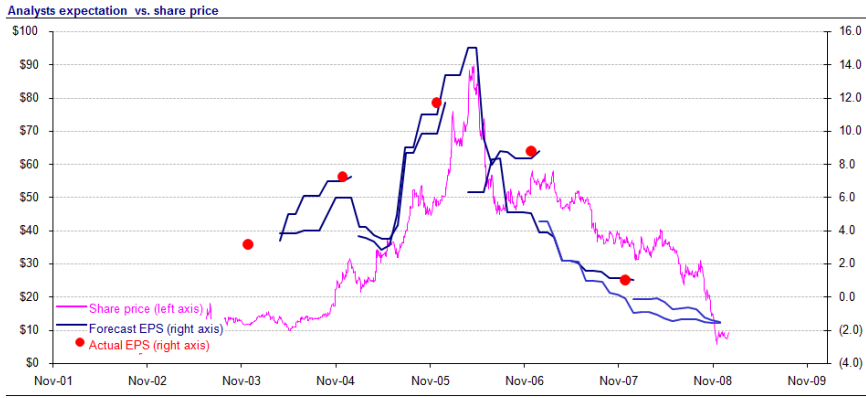
- USG is a manufacturer and distributor of building materials, the most significant one being wallboard (or “drywall”). They are the biggest player in the industry with almost 30% market share
- The company was under Chapter 11 in the late 90s due to asbestos related liabilities – that was when Warren Buffett bought a significant stake at the company, betting that the equity holders would still keep ownership after the companies involved in the asbestos liabilities case reach an agreement with the government (he was correct)
- During the housing boom earnings were inflated due to lack of capacity in the industry – the underlying commodity (i.e. wallboard) was in a classical “fly-up”, selling for more than \$200 per thousand sq. feet when the most inefficient plant could produce it for \$120 per thousand sq. feet.
- Earnings declined fast as drywall prices fell below \$100 per 1000 sq. ft., as we had anticipated (due to the combination of new capacity added and lower demand; nevertheless we didn’t anticipate the worst housing market – by far – in the post-war era). Currently, the market is overly pessimistic, this time underestimating true earnings potential for USG (even adjusting for a big dilution from expensive debt that the company was forced to accept during the 2008 liquidity crisis). Therefore we now are long USG.

Wallboard cost curve for the US



* Assuming a decline of 10% on volume demand (i.e. housing decline of 20% and housing 50% of demand)

Price vs. Earnings Estimates

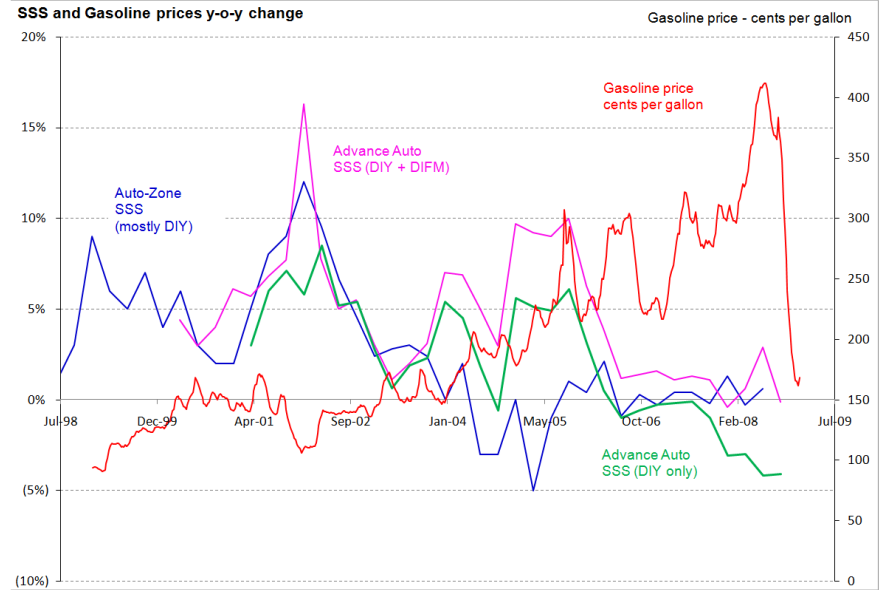


EXCERPT OF ADVANCE AUTO PARTS, INC. ANALYSIS

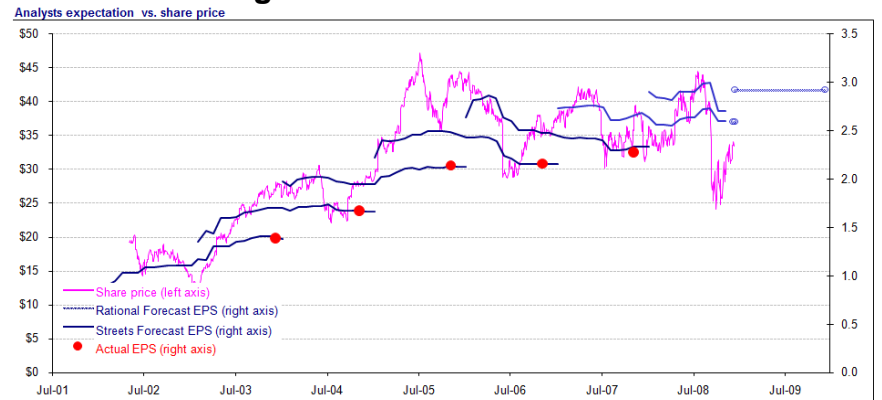
Company analysis and investment thesis

- AAP is one of the top auto-part retailers in the US, along with AZO and ORLY. This is an industry very well suited for consolidation since (i) there is an extremely high number of SKUs in the sector (imagine having inventory for parts for every car manufactured in the last 30 years) and (ii) costly IT investment is required for companies to optimize inventory turns (AAP being the best in that category), driving “Mom and Pop” shops out of business.
- AAP has a new CEO – the previous CEO expanded some services/programs at the store level that didn’t pay off. It is hard to know if this is because of poorly designed services/programs, or just bad luck, since most of these programs coincided with the gasoline price tidal wave that hit the industry hard.
- There is a clear correlation of AAP sales (and AZO for that matter) with gasoline prices – customers drive more if gasoline is at low prices and drive less if there is a spike on prices. More miles means more repair and maintenance on vehicles.
- AAP has reached our “low case” scenario a few times in the past couple of years – running against such a tough macro environment it has often missed estimates. Nevertheless AAP has shown progress on new cost-cutting initiatives, and the company is moving towards our fair value. The recent drop in gasoline prices should provide significant tail winds to the company.

Gasoline Prices and Same-Store-Sales Comparison



Price vs. Earnings Estimates



TERMS OF THE FUND AND SERVICE PROVIDERS

- **Minimum subscription:** USD 1,000,000
- **Launch date:** April 1, 2008
- **Initial lock-up:** No lock-up; 5% penalty if money withdrawal in less than 12 months
- **Subscriptions:** Monthly
- **Redemptions:** Monthly with written notice 15 days in advance
- **Management fee:** 2% per annum, charged monthly in arrears
- **Performance fee:** 20% of nominal returns, charged semi-annually
- **High-water mark:** Perennial
- **Prime Broker:** Jefferies & Company, Inc.
- **Legal counsel:** Maples and Calder (Caymans) / Carlton Fields (US)
- **Administrator:** IFCE Fund Services
- **Auditor:** KPMG

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