

DOWNSIDE PROTECTION REPORT

Edited by the Research Team of
Ideas
THE MANUAL OF

"Confronted with the challenge to distill the secret of sound investment into three words, we venture the motto: Margin of Safety." —Ben Graham • August 30, 2009



With
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Stocks We're Buying This Month

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About Downside Protection Report

Our mission is to uncover stocks with a large margin of safety and bring them to you once a month.

John Mihaljevic, editor, is a fund manager, former banker and analyst. He is a member of Value Investors Club, an exclusive community of top money managers, and has won the Club's prize for best investment idea. John is a trained capital allocator, having studied under Yale chief investment officer David Swensen and served as research assistant to Nobel laureate James Tobin. John holds a BA in Economics, *summa cum laude*, from Yale and is a CFA charterholder. He resides in New York City with his wife and two kids.

Stock Market Cheapness Snapshot

% of U.S. stocks trading for less than...	All stocks	MV > \$1bn
...net net current assets	3%	0%
...net cash	4%	1%
...tangible book value	20%	6%
...5x trailing EPS	3%	1%

Data as of August 28, 2009.

Dear Fellow Idea Seekers,

So far we have focused on finding good stocks to buy and bringing them to you on these pages. We have assembled a portfolio of ideas that has trounced the broader market (see scorecard on page 8). As our featured ideas hopefully make money for you, the question of when to sell becomes increasingly important.

Knowing when to sell a stock that has outperformed is no small task. The danger is dual: We can either sell too early, foregoing future gains; or we can sell too late, giving back the gains we have enjoyed on paper. There are additional wrinkles that complicate the decision to sell, including taxes and broader portfolio considerations.

Selling too early is a common "mistake" of value investors. While we make money on undervalued stocks that become less undervalued, we also frequently "leave money on the table." Avoiding this predicament is difficult, perhaps even impossible — for it's the same value-driven mindset that gets us to buy an undervalued company and to sell it when it trades closer to fair value. If we could hold onto a stock as it rises in price from fairly valued to overvalued, we might lack the mindset that allows us to buy the same stock at a bargain price in the first place.

Selling too late is rarer among value investors, but the danger exists nonetheless. We have a tendency to hang onto something that's been good to us — a winning stock falls into this category. We may become emotionally attached or view a stock as *our* idea. The pain of selling and then seeing someone make more money from *our* idea might be too much to bear, influencing us to hold onto a company too long. There's also the danger of keeping losers around merely because we want to break even. Facts, rather than "mental accounting," should dictate the timing of a sale.

This brings us to two companies that we're putting on the sell list this month — **PDL BioPharma (PDLI)** and **Sierra Wireless (SWIR)**. Whether or not to sell is a "good problem" in each case, as PDLI shares have gained 15% since we featured them in our July 13th issue, while SWIR has gained 192% since March 23rd. In the case of PDLI, while our analysis remains intact, one of the key validations of our work is no longer in place: Seth Klarman's investment. When a superinvestor like Seth Klarman of The Baupost Group sells a company we own, the question must be, "How confident are we that we either know more than Klarman, or that our judgment is superior to his, or that he was selling for non-fundamental reasons?" In the case of PDLI, prudence requires us to take our gain and move on. In the case of Sierra Wireless, we have obviously enjoyed a strong gain in a short time, and we hope you have as well. We simply cannot make a no-brainer *valuation-driven* case for Sierra any longer, even as the company has many other things going for it.

Finally, just as with buying a stock, the decision to sell must be driven by your own particular circumstances. There may be tax or other considerations that make holding onto a stock the correct decision, even if the valuation gap has narrowed.

Sincerely,

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SCORECARD

Performance of Past Monthly Picks versus S&P 500 *

On this page, we provide a quick update on past featured investments and let you know if it's time to sell.

(sorted by date of initial write-up)	Featured		Latest Price	Price	S&P 500
	Price	Date	as of 8/28/09	Change	Change
Greenlight Capital Re / GLRE <i>HOLD</i> Valuation gap has narrowed, but we continue to like David Einhorn's investment strategy and portfolio.	\$10.85	12/5/08	\$18.37	+69.3%	+17.6%
EchoStar / SATS <i>HOLD</i> Tivo litigation increases downside risk, but shares remain cheap.	\$14.84	1/16/09	\$19.27	+29.9%	+21.5%
Microsoft / MSFT <i>BUY</i> Trades at discount to sum-of-parts valuation of business units.	\$19.71	1/16/09	\$24.68	+25.2%	+21.5%
Capital Southwest / CSWC <i>BUY</i> Trades at wide discount to estimated fair value of investment portfolio.	\$87.69	2/9/09	\$77.53	-11.6%	+18.9%
K-Swiss / KSWS <i>BUY</i> Trades close to tangible book value, despite good normalized economics and excellent management.	\$7.80	3/20/09	\$9.97	+27.8%	+34.8%
Harvest Natural Resources / HNR <i>BUY</i> Shares trade at material discount to estimated fair value.	\$3.51	4/14/09	\$5.24	+49.3%	+22.6%
Gravity Co. / GRVY <i>BUY</i> Shares trade below net cash despite major profitability inflection point.	\$0.95	4/14/09	\$1.70	+78.9%	+22.6%
MI Developments / MIM <i>BUY</i> Shares trade at steep discount to fair value of real estate holdings.	\$8.64	5/21/09	\$13.66	+58.1%	+15.9%
WellCare Health Plans / WCG <i>BUY</i> Shares trade close to net cash despite profitable operations.	\$19.04	5/21/09	\$25.09	+31.8%	+15.9%
Kenneth Cole Productions / KCP <i>BUY</i> Shares trade at discount to estimated fair value.	\$7.00	6/26/09	\$10.02	+43.1%	+12.6%
KHD Humboldt Wedag / KHD <i>BUY</i> Shares trade close to adjusted net cash; business is nearly "free."	\$8.28	6/26/09	\$9.78	+18.1%	+12.6%
Contango Oil & Gas / MCF <i>BUY</i> Trades at big discount to PV-10 valuation using NYMEX strip pricing.	\$40.80	7/13/09	\$45.48	+11.5%	+14.7%

Closed Out Positions:

	Featured		Closed Out		Price Change		S&P 500 Change	
	Price	Date	Price	Date	Absolute	Annualized	Abs.	Ann.
Crawford (CRD-A, CRD-B) (pair trade)	\$2.89**	2/9/09	\$1.02**	6/28/09	+65%	+271%	+6%	+15%
Sierra Wireless (SWIR) <i>SELL</i> Gap to fair value has narrowed materially, adversely affecting the risk-reward tradeoff of holding the shares.	\$2.89	3/20/09	\$8.45	8/28/09	+192%	+1,039%	+35%	+97%
PDL BioPharma (PDLI) <i>SELL</i> Klarman's sale makes us more cautious on the outlook for royalties and legal challenges to PDLI's patents.	\$7.88	7/13/09	\$9.06	8/28/09	+15%	+203%	+15%	+198%

* We measure the performance of the S&P 500 Index by the price changes of the S&P Depository Receipts (SPY), which is an investable vehicle for the S&P 500.

** Represents spread rather than market price. Percentage return represents percentage narrowing of arbitrage spread.

FREQUENTLY ASKED QUESTIONS

Some of your top picks fell sharply in price before you picked them. How can you assert that a stock that has fallen precipitously has strong downside protection?

Our assessment is based on protecting your capital *from this point forward*. It is quite unlikely that we would have recommended the same stock a year ago, as it may not have passed our stringent downside protection criteria. At higher prices, the shares most likely did not offer the “margin of safety” they provide today. The price decline has *lowered* investment risk rather than increased it.

Are you saying that the stock price will not decline from this point forward?

No. While we expect the stock to exhibit below-average downside, almost anything is possible in the stock market in the short term. As a result, you should never lever up to buy a stock, even if we judge it to have strong downside protection. We use the latter term to refer primarily to the risk that your capital will be *permanently* impaired. While our analysis gives us high conviction that you will not suffer permanent loss, our judgment will not always be correct.

What criteria do you use to determine that a stock has “superior downside protection”?

First and foremost, we want the stock to trade at a large discount to our appraisal of fair value. Such appraisal can be based either on the value of the company’s assets, including cash and real estate, or on the present value of estimated future cash flows, or both. Each situation is different—how we arrive at an estimate of fair value will reflect the peculiarities of each situation. Once we estimate fair value, we ask a number of questions that help us build conviction that current value will be safeguarded and, in fact, increased over time. For example, we want management that is capable, properly incentivized and likely to treat fellow shareholders fairly. We also favor companies that have authorized a plan to repurchase their own shares when they are available at a discount to fair value. Repurchases not only provide short-term support for the stock price but, more importantly, boost per-share intrinsic value and signal management’s willingness to return cash to shareholders. Finally, we want companies with strong and liquid balance sheets, enabling their executives to steer through—and take advantage of—difficult economic conditions.

You include some stock screens in this report. Are you saying that the companies passing those screens are also good investment opportunities?

Not necessarily. We provide three downside protection stock screens in order to identify companies that may represent good investments. We provide the screen results as a starting point from which you may do more research into specific companies.

What are the other benefits of subscription in addition to receiving this report?

As a subscriber, you have access to the members-only section of manualofideas.com. The section includes an archive of past reports and access to other subscriber-only content.

WE’VE BEEN CALLED MANY THINGS.

BUT WE’RE NOT COMPLAINING.

**“INVALUABLE.” “IMPRESSIVE.” “INCREDIBLE.”
“TREASURE TROVE.” “WINNER.”**

“The Manual of Ideas is a tremendous effort and very well put together.”

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