

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 • December 27, 2009



With
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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	2%	0%
...net cash	5%	1%
...tangible book value	19%	6%
...5x trailing EPS	2%	0%

Data as of December 25, 2009.

Dear Fellow Idea Seekers,

As we usher in the New Year, it may be time to reflect on the past year as well as ponder what lies ahead. Only nine months ago, few investors envisioned the Dow at 10,500 today. Back in early March, most commentators asked, "How low can stocks go?" Only the brave (or imprudent) wondered, "How high, how fast?"

We certainly had no idea which way the market as a whole was headed in the short term. We did, however, see many bargain opportunities—stocks that offered downside protection while affording the patient investor large upside. We reasoned that when many companies with valuable operating businesses and no debt were offered for less than the cash on their books, why hold cash on *our* books? Why not get an operating business for "free" and let good management invest the cash for us? After all, strong companies often get stronger during downturns, as they snap up assets and competitors on the cheap. We have featured several companies with large cash piles over the past year, including **EchoStar** (33% gain so far), **KHD Humboldt Wedag** (40% realized gain), **Gravity** (50% gain so far), **WellCare** (100% realized gain), and **Sierra Wireless** (192% realized gain).*

Even companies with long-term track records of outperformance and superior business models were suddenly on sale in late 2008 and early 2009. **Microsoft**, which we described as "the world's best large business" was available for less than ten times earnings (the shares are up 57% since the write-up). **Greenlight Capital Re**, an investment vehicle run by David Einhorn, one of the world's most talented investors, was available for less than book value. Greenlight Re was featured in the inaugural *Downside Protection Report* last December. We are now closing out the position and moving on with a long-term capital gain of 123%.

We are gratified that most of the stocks featured here have outperformed the indices by a wide margin, and we are especially happy to have fulfilled the mission of this report—to bring you ideas with *strong downside protection*. Out of 23 stocks featured since, not one has "blown up." The worst performer in the group has suffered a 12% decline. Two other stocks are down, giving us an 87% batting average. While we will keep doing our best, we should warn you that this batting average probably won't be sustained—and we'll have the occasional blow-up, too.

As we look ahead, it seems tough to justify stocks going much higher while big problems remain in the private and public sectors. We would not be surprised to see a meaningful pullback in the stock market in the near future. Still, we view market timing as a "fool's game." We'll keep digging up the best ideas we possibly can and bringing them to you each month. Stay tuned!

Wishing you a happy, healthy and prosperous 2010,

* For detailed performance data, see the scorecard on page 8.

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SCORECARD *

Closed Out Positions	Featured		Closed Out		Price Change		S&P 500 Change	
	Price	Date	Price	Date	Absolute	Ann.	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)	\$2.89	3/20/09	\$8.45	8/28/09	+192%	+1,039%	+35%	+97%
PDL BioPharma (PDLI)	\$7.88	7/13/09	\$9.06	8/28/09	+15%	+203%	+15%	+198%
KHD Humboldt Wedag / KHD	\$8.28	6/26/09	\$11.61	11/27/09	+40%	+123%	+19%	+52%
Greenlight Capital Re / GLRE	\$10.85	12/5/08	\$24.15	12/24/09	+123%	+114%	+28%	+26%
SELL <i>We like Einhorn's investment style but the valuation gap has narrowed significantly. We are moving on with a long-term capital gain.</i>								
WellCare Health Plans / WCG	\$19.04	5/21/09	\$38.15	12/24/09	+100%	+222%	+26%	+48%
SELL <i>Few would have believed in May that WellCare would double if healthcare reform passed in Congress. The gain shows the virtues of buying out-of-favor companies on the cheap. We move on as the downside has risen.</i>								

* 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. *** Annualized.

Open Positions <i>(sorted by date of initial write-up)</i>	Featured		Latest Price	Price	S&P 500
	Price	Date	Dec. 24 th	Change	Change
EchoStar / SATS BUY <i>Shares too cheap to ignore; look for more buybacks.</i>	\$14.84	1/16/09	\$19.70	+32.7%	+32.2%
Microsoft / MSFT HOLD <i>Trades at discount to sum-of-the-parts valuation.</i>	\$19.71	1/16/09	\$31.00	+57.3%	+32.2%
Capital Southwest / CSWC BUY <i>Trades at discount to value of investment portfolio.</i>	\$87.69	2/9/09	\$79.08	-9.8%	+29.3%
K-Swiss / KSWS BUY <i>Good management and normalized economics.</i>	\$7.80	3/20/09	\$10.10	+29.5%	+46.6%
Harvest Natural Resources / HNR BUY <i>Trades at material discount to estimated fair value.</i>	\$3.51	4/14/09	\$5.40	+53.8%	+33.3%
Gravity Co. / GRVY BUY <i>Trades below net cash despite profitable operations.</i>	\$0.95	4/14/09	\$1.43	+50.5%	+33.3%
MI Developments / MIM BUY <i>Trades at steep discount to fair value of real estate.</i>	\$8.64	5/21/09	\$12.52	+44.9%	+26.1%
Kenneth Cole Productions / KCP BUY <i>Trades at discount to estimated fair value.</i>	\$7.00	6/26/09	\$9.24	+32.0%	+22.5%
Contango Oil & Gas / MCF BUY <i>Trades at big discount to PV-10 using strip pricing.</i>	\$40.80	7/13/09	\$47.09	+15.4%	+24.8%
Cowen Group / COWN BUY <i>Trades close to net cash, adjusted for Ramius deal.</i>	\$6.59	8/30/09	\$5.80	-12.0%	+8.8%
Premier Exhibitions / PRXI HOLD <i>Trades at discount to value of Titanic assets.</i>	\$0.72	8/30/09	\$1.41	+97.2%	+8.8%
Tejon Ranch / TRC BUY <i>Clean balance sheet; discount to land value.</i>	\$25.72	9/25/09	\$30.16	+17.3%	+7.7%
Imation / IMN BUY <i>Trades in line with "net net" current assets.</i>	\$9.52	9/25/09	\$9.12	-4.2%	+7.7%
Syms Corp. / SYMS BUY <i>Retail operations "free" when adjusted for real estate value.</i>	\$7.03	10/31/09	\$7.33	+4.3%	+8.6%
MVC Capital / MVC BUY <i>Trades at material discount to fair value of investment portfolio.</i>	\$9.18	10/31/09	\$12.05	+31.3%	+8.6%
Global Access / GAXC BUY <i>Trades at less than 10x earnings despite fundamental inflection point.</i>	\$0.64	11/30/09	\$0.87	+35.2%	+2.7%
Dundee Precious Metals / DPM.TO BUY <i>Materially undervalued at recent gold and copper prices.</i>	C\$3.14	11/30/09	C\$3.70	+17.8%	+2.7%

Member question: Why did you change your view of Premier to HOLD?

Premier's share price has increased faster than intrinsic value since our write-up, narrowing the valuation discount. We still view Premier as undervalued, and a resolution of the Titanic court case might be a positive catalyst. Nonetheless, we would not buy new shares at this time.

Member question: Why would Cowen do a secondary so soon after the Ramius deal? Any thoughts on why equity instead of debt? It seems to be questionable judgment and doesn't show much regard for shareholders, which was one of your initial concerns.

It is not encouraging to see Cowen issue shares at a big discount to intrinsic value, particularly when such issuance appears unnecessary. We do note, however, that Cowen executives participated in the offering, signaling their confidence in the company. While on balance we consider the equity raise a negative from a corporate governance standpoint, we continue to like the risk-reward in Cowen.

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.

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