

When asked how he became so successful, Buffett answered: "we read hundreds and hundreds of annual reports every year."



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### About Portfolio Manager's Review

Our goal is to bring you investment ideas that are compelling on the basis of value versus price. In our quest for value, we analyze the top holdings of top fund managers. We also use a proprietary methodology to identify stocks that are not widely followed by institutional investors.

Our managing editor John Mihaljevic is a member of Value Investors Club, an exclusive community of 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.

## THE SUPERINVESTOR ISSUE

- ▶ Snapshot of 100 companies owned by superinvestors
  - ▶ 24 companies profiled by MOI research team
- ▶ Proprietary selection of Top 5 candidates for investment
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*Superinvestor companies mentioned in this issue include*  
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*Inside:*

***Exclusive Interview with Paul D. Sonkin, Managing Member and Portfolio Manager, Hummingbird Management, LLC***

*With compliments of The Manual of Ideas*

## Exclusive Interview with Paul Sonkin

We recently had the pleasure of speaking with Paul Sonkin at his offices in New York. Paul is one of the most prominent value investors focused on micro cap and nano cap investing. He serves as portfolio manager of The Hummingbird Value Funds and the Tarsier Nanocap Value Fund. He is also an adjunct professor at Columbia Business School, where he teaches security analysis and value investing. He was previously a senior analyst at First Manhattan and an analyst and portfolio manager at Royce. Prior to receiving an MBA from Columbia, Paul worked at Goldman Sachs and at the SEC. He is a co-author of [Value Investing: From Graham to Buffett and Beyond](#).

### **MOI: What was the genesis of your firm, and how would you describe your investment approach?**

**Paul Sonkin:** I started in December of 1999, so we're coming up on ten years. I had worked at Royce and then I had worked at First Manhattan. First Manhattan did large cap value, and I really wanted to get back to what I had done at Royce—which was micro cap value—because that's what I really love. I met with Mario Gabelli and said I wanted to manage his micro cap fund. He had this guy who worked for him who had started a partnership, and he said, Why don't you start a hedge fund and I'll give you some money and own a piece of your management company? So that was how I really got the start at Hummingbird. It's just old-school, Graham-and-Dodd-type value investing.

We've pushed the envelope a little bit—Bruce Greenwald talks about doing an asset value based on replacement cost, and then an earnings power value and an earnings power value with growth. The asset value is really Graham's "net nets." The earnings power value would be the low P/E. The earnings power value with growth is where you may be paying a full price for the current earnings power but you are getting all the growth for free. We tend to stay in the first two categories, although we have gotten into situations where we are paying for earnings that we firmly believe will materialize, but they haven't materialized yet—and then we're getting a lot of growth on top of that for free. That's evident in a lot of the positions we have.

Our largest position now is a company called Rand Logistics (RLOG). We believe they'll do about \$0.40 in free cash flow [per share] in this fiscal year ending March [2010]. We think that will go up to \$0.75 to \$1 over time. The stock is at \$3-3.25, so we think it's a pretty good bargain.

Hummingbird was structured after the old Buffett Partnership and Graham-Newman. There are two sides to the portfolio: There is an arbitrage side, and there is a cheap stocks side. We look to keep to those roughly 50-50, although that'll change over time. In the last few years, there hasn't been a lot going on in arbitrage. There are a lot of spinoffs but none—that area is pretty well picked over. Liquidations used to be a great area to invest in, and that's become very picked over. Even in micro cap risk arbitrage, we've seen more deals breaking, so that hasn't been a great area for us.

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On the cheap stock side, it's just opportunities abound—like a kid in a candy store, because you have all these cheap companies. What we've seen in the second and third quarter, the markets have come roaring back. We had a very good second quarter. Our third quarter, though, was pretty stagnant. A lot of the market action that you've seen is in the larger, more liquid names. I was talking to someone this morning, and they said a manager would rather buy a \$500 million company that'll go up 20% than a \$100 million market cap company without any liquidity that might triple. There are a lot of people that are still very concerned about liquidity. The extremely small companies haven't really come roaring back yet. We're off the March lows, but they haven't had those huge run-ups we've seen in a lot of the larger micro caps—in the \$250-750 million market cap range.

**MOI:** You wrote in a letter late last year that you thought it was one of the best times to be investing. It sounds like you still believe it's a good time to be in the micro cap space...

**Sonkin:** One can make the argument that it's even better now than it was a year ago because there is a lot less uncertainty now, yet the stocks are still down. A lot of them haven't recovered, yet their businesses are starting to recover. What we're seeing in a lot of our portfolio companies is that during the third quarter the intrinsic value of the companies increased in our estimation, but the stock prices didn't—and that creates a great opportunity.

**MOI:** Do you feel that just as fairly low volume drove micro cap stocks down so much late last year, it would also take little volume to drive those stocks a lot higher?

**Sonkin:** Absolutely. What you're seeing is that these stocks go up on very little volume, and then they'll get to a certain level and they'll start to trade a lot more volume. But it's usually 50-100% of where they are now. We had one company that was trading at \$1.83 per share, and they got an \$85 million contract. The stock traded up to \$4.60, and we owned about 300,000 shares. It traded a lot of stock that day, and we sold about 200,000 shares or two-thirds of our position. Now the stock is back down to \$2.63. These stocks can be very volatile, and they can go up on very little volume and down on very little volume.

**MOI:** Speaking of volume, to be successful in getting in and out, you need to keep the fund to a certain size. What struck us in some of your writings was how different they are from a lot of other managers whose portfolios creep up to higher market-cap companies over time. You've actually encouraged some of your investors to take money out when you didn't see opportunity, which is pretty rare...

**Sonkin:** It's pretty rare, but some would argue that it wasn't the smartest thing to do because you have to feed the birdies when they're singing. I did the right thing by my investors by not taking in a lot of additional capital. But you get credit for the money you make your investors, not the losses that you've helped them to avoid. Now that we think it's a great time to invest money, it's very difficult, because people have been burned and they're very hesitant to put capital at risk.

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**MOI:** It sounds like a quandary you have as a value manager who wants to look out for your investors. You want them to be in with more capital at a time like this, and yet most people act in an opposite way.

**Sonkin:** There was an academic study done on Fidelity Magellan. The return of Magellan was, let's say, 15% over a 15-year period. But if you looked at the actual money flows in and out, the average holder of Magellan only made 4% because they bought and sold at the exact wrong times.

The interesting thing is that while our performance in Q3 wasn't that great, people penalize us for that. You would think that when the rest of the market has moved, you don't want to give money to people who have done well; you want to give money to people whose stocks haven't moved yet. It's a real quandary, and it takes a sophisticated investor to recognize that we have a strategy that over the long term outperforms.

There are times when value investing doesn't work. We saw in 2008 one of those times, where you had extreme dislocations in markets. You had people just puking out positions with a total disregard to price. Now what we're seeing is that people are coming back into the market, but they want to be in the more liquid names. It's a rubber band that stretches and stretches and stretches, and eventually it'll snap—and we're waiting for that snap.

**MOI:** Getting back to how you see the micro cap world, what is your definition of the space you target?

**Sonkin:** We primarily operate in the sub-\$100 million [market cap range], and we're even more focused on the sub-\$50 million. If you look at our Hummingbird fund, it probably has a median market cap of \$20 million and a weighted average of \$40 million. If you look at our Tarsier fund, which is our nano cap fund, it probably has a weighted average [market cap] of \$5-6 million and a median of \$3 million. You're getting exposure to the tiniest companies in the U.S. capital markets (the bottom 40 basis points).

**MOI:** It seems that with those kinds of companies, a lot of them may not be very sophisticated and there might be a lot of low-hanging fruit that an active shareholder could have management pick off and create value. How would you describe the rewards to activism?

**Sonkin:** We don't really consider ourselves to be activist. What we'll try to do is that if a company is making a decision, we'll offer some suggestions. Should they buy back stock? Should they pay a dividend? We'll opine a lot on capital allocation. Managements know their companies and their businesses, and they usually know how to run their businesses, but they're less sophisticated in terms of capital allocation. We'll try and guide them to make capital allocation decisions that we feel are shareholder-friendly. Usually, management owns a lot of stock, so if you suggest things that are shareholder-friendly, nine times out of ten, management is going to take your suggestion because it's also in their best interest.

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**MOI: Do you need to weight the quality of management more heavily in your decision process when dealing with micro caps than larger companies?**

**Sonkin:** Of course. When you're dealing with a larger-cap company, they have more of a bench to draw from. But one person in a large organization can still have a meaningful impact—look at the decisions George Bush made. He was running the largest organization in the world, and one man was able to have a big impact.

It's true that [with small companies] you have less delineation in the job functions. We went to meet with a company yesterday, and we met with the chairman, the CEO and the head of operations. The head of operations was operating as a COO. The CEO plays a big role in the sales functions and the operations and the finance side. With smaller companies, you have managers wear a lot of different hats.

**MOI: Do you look at their compensation very closely?**

**Sonkin:** Of course. One of the documents we spend a lot of time on is the proxy statement. It discusses the compensation, the board, and has the certain transactions section, which is where you find the insider skullduggery that's going on. With a lot of these companies, you'll find that the CEO owns the building and leases it back to the company; or what expenses are being paid for by the company. Usually, you're trying to separate the wheat from the chaff with these small companies. If you have an owner-operator, it's usually preferential to an operator. But we've seen different cases—we've seen cases where management owns a lot of stock and they still take big salaries and they treat the company like their own piggybank. What we see with a lot of our companies is that management has significant shareholdings, and they take a rather modest salary because they realize that \$100,000 to them is \$100,000 in their pocket. \$100,000 to the bottom line, if it increases earnings by \$0.01 per share, and you put a 10x multiple on it, and they own x number of shares... But it takes a rather sophisticated manager to do all that mental math.

*“One of the documents we spend a lot of time on is the proxy statement. It discusses the compensation, the board, and has the certain transactions section, which is where you find the insider skullduggery that's going on.”*

**MOI: One other danger with micro cap companies whose stock prices have come down sharply is that there is an easy argument to be made that, “Our stock is below \$1 and the expense of being a public company doesn't make sense.” Then they “go dark,” and it tends to get even worse for shareholders...**

**Sonkin:** Sometimes yes, sometimes no. We think there will be a huge resurgence in the Pink Sheets, because there are a lot of companies going dark. So we see going dark as an opportunity. We haven't had a lot of companies that we've invested in that have gone dark. If you pick the companies right, they don't have these bloated cost structures. The cost of being a public company isn't really that high. In some cases, we had a company that went dark, and they went from doing pretty detailed quarterly reporting to doing annual reporting. What it's enabled them to do—again, these are owner-operators who take modest salaries and are just trying to build the best business they can, and eventually they'll sell it. So they're still building up the intrinsic value.

**MOI: How do you generate investment ideas?**

**Sonkin:** I've seen a lot of companies [in the micro cap space]. There are companies that I'll look at for five or ten years before I even own a share. I got an email from one of my former students who said, have you looked at such and such company? It's been on the periphery of my radar for ten years. We do look at them, and I keep track of their progress. I read through their press releases, and if the stock price falls to a level that becomes extremely attractive, or there is some corporate event, then it moves to the top of the inbox. I have a very big inbox, but you have to do triage or prioritize. Then there is also maintenance research on existing companies. Sometimes we have to go back and do a lot of research if there is something that has changed, but a lot of the times nothing has really changed. And again, a lot of these companies take very long-term views in terms of their business plans, so we just want to see if they are executing against their plan.

**MOI: As they hopefully grow and become more valuable, is there a point at which those companies become too big for your fund?**

**Sonkin:** We have position limits, and we have price targets. If it hits a price target, we'll begin to sell. If it hits a position limit, we'll start to exit the position. Those two things keep the discipline.

**MOI: Your portfolio is fairly diversified...**

**Sonkin:** It's fairly diversified, though we've become more concentrated over time. From this current debacle, there are so many cheap companies. We have tended to buy more stock in companies that we knew very well. We've tried to find companies that can execute well against a tepid macroeconomic backdrop. We think we have good companies.

**MOI: We saw you discuss Steinway Musical Instruments (LVB) recently. That company looks quite interesting because you have real estate value that is pretty substantial plus a brand and a business that may not be a hugely growing business but is one that will be around for a long time...**

**Sonkin:** Steinway has been around for 150 years, and it'll be around for another 150 years. That's the kind of stock that you just buy and lock away. In five years, you double or triple your money because, even though the outlook is pretty horrific, they'll survive and prosper.

**MOI: A few years ago, there were some pretty large valuations being put on their real estate, even by the company in an SEC filing...**

**Sonkin:** Yes, there was [a filing] when they did a debt offering. They came out with a press release which laid out a liquidation analysis of the company. What it showed is that on a scorched-earth basis, the bonds were money good. When the stock traded above \$30, it hit our price target and there we saw that a lot of people were focused on the real estate values rather than on the fundamentals of the business. Now we've been buying stock back at an \$8-12 per share range. We think the stock could easily triple over the next five years.

*“Steinway [Musical Instruments (LVB)] has been around for 150 years, and it'll be around for another 150 years. That's the kind of stock that you just buy and lock away.”*

**MOI:** So it sounds like you like it for the business primarily—is it the band business that is attractive because of the demographics?

**Sonkin:** Both businesses are attractive. The band business is very attractive because they've done a lot of cost cutting on the band side of the business, and there is a lot more cost cutting that they can do. They are coming out with a lot of new products, so they have a pretty robust new product pipeline. Those new products have pretty good gross margins associated with them. Then there is the demographic trend—you just look at fourth-graders, and a certain amount will need band instruments, so there is a favorable demographic trend.

Steinway is going to be a big beneficiary of any growth in the BRIC countries. There are more children learning piano in China than there are children in the United States. So when you talk about China, the numbers are just absolutely staggering. Britain was the world leader for a hundred years. Between World War I and World War II, the transition was made to the United States, and I think that we'll probably get a hundred years where we are the top dog, and then it's going to be China.

**MOI:** Is it hard to find small U.S.-based companies that have a lot of exposure to those trends? Do you ever invest in ADRs?

**Sonkin:** The interesting thing is that there are a lot of really interesting Chinese companies that trade in the U.S. We bought a company recently called Lihua International (LIWA). They are in an interesting business—they make different types of wire. They came out at a very attractive valuation, great growth prospects. I remember going to a conference last January. We set down with a number of Chinese companies that were trading at a discount to cash and at three times earnings. A lot of those have doubled or tripled. We only took small positions—the world was a scary place in January, February and March. Then there are companies based in the United States that have good growth prospects in the emerging markets.

The company I mentioned that went dark, Kyzen (KYZN), makes different kinds of de-greasers and cleaning solvents. They're seeing a lot of growth in Europe and Asia. They just built a new facility in Malaysia, and they're building out a salesforce. Kyzen trades on the Pink Sheets. Their earnings are down this year, but they earned a dime or \$0.15 and the stock is at \$0.50. They'll get back to peak earnings and surpass those peak earnings.

**MOI:** In terms of broader investment perspective, what would you say are some of the mistakes that keep investors from reaching their goals in the stock market?

**Sonkin:** You have to find a style of investing that works. You have to find a style of investing that fits with your personality. I'm cheap and paranoid, so value investing works very well for me. And then what you have to do is that once you've decided to pick a strategy, you've got to stick to it. That's really where the discipline comes in. Where a lot of people get into trouble is when they're not disciplined and they deviate into different areas—that's when you get market cap creep and style drift, which we've never had. We've made mistakes, and I guess my goal is not to avoid making the same mistake twice, but not to make the exact same mistake the tenth time in a row. It can be very challenging, but that's what I strive for.

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**MOI:** In the last year, a lot of investors did get astray from the principle of staying disciplined. A lot of value investors now say, “We can’t ignore the macro any longer,” and they’ve almost morphed into macro investors who then look for cheap companies...

**Sonkin:** If you look at value investors that are running tens of billions of dollars, you have to have an opinion on the economy because you are not in the market, you *are* the market. But a lot of the smaller value investors didn’t pay attention to the economy. Now it’s like trying to close the barn doors after the horses are out. You’re a dime short and a day late. To do it now, I just don’t think make a lot of sense.

**MOI:** Seth Klarman put it well when he said that he invests from the bottom up but he worries from the top down...

**Sonkin:** Exactly. What Seth Klarman does is that he is always looking to overlay insurance on the portfolio and is always looking for cheap insurance. He happened to be in a lot of credit default swaps because they were really cheap. It was great disaster insurance. Inflation protection now is—or was—really cheap, so you’re able to put that on. So what he is doing is overlaying on his portfolio disaster insurance. He is worrying from the top down, and that’s he was able to have such a good year last year.

**MOI:** Lastly, are there any books you’ve read in recent years that you would recommend to other investors?

**Sonkin:** I like [Hidden Champions](#) by Hermann Simon, which is an excellent book. [The Intelligent Investor](#), of course. There is a book called [In the Shadows of Wall Street](#), which is an excellent book by three professors up at Cornell at the time.

I don’t really get much time to read... I’m too busy reading annual reports.

**MOI:** Paul, thank you very much for your time.

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