

# 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 • March 23, 2009



With  
**John Mihaljevic, CFA**  
Managing Editor,  
*The Manual of Ideas*  
john@manualofideas.com

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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	8%	0%
...net cash	8%	2%
...tangible book value	35%	18%
...5x trailing EPS	8%	7%

Data as of March 20, 2009.

## Dear Fellow Idea Seekers,

As investors, we often seek perfection in our investments. We want a wide-moat business with high returns on capital and recurring revenue streams, a fast-growing and fragmented market that offers plenty of opportunity for share gains, a rock-solid balance sheet, and a capable, shareholder-friendly management team. Unfortunately, perfection almost always comes at a price.

In the stock market, paying a high price for perfection is usually inconsistent with protecting the downside. As a result, we have to resolve a key dilemma—how to balance the quality and the price of an investment in a way that minimizes the downside and still leaves plenty of upside?

In this issue, we highlight two ideas, neither of which is perfect but each meets our criteria for strong downside protection and above-average upside potential. Athletic footwear maker **K-Swiss (Nasdaq: KSWW)** is going through the most pronounced fashion slump in the company's history, with no turnaround in sight. However, the company has successfully managed through tough periods twice before since current CEO Nichols took over. We believe the recognized brand, liquid balance sheet and excellent management make K-Swiss an attractive long-term investment.

Our other monthly pick, **Sierra Wireless (Nasdaq: SWIR)**, also has a muddled near-term outlook. In Sierra's case, the main culprit has been management's decision to acquire French competitor **Wavecom (Nasdaq: WVCM)** in a large all-cash deal that weakens Sierra's balance sheet but nonetheless leaves it with more net cash than the entire market value of the combined company. While we fault management for going ahead with the Wavecom deal, our analysis suggests that investors have overreacted to the acquisition, setting up an opportunity with a compelling risk-reward profile.

As managing editor of *The Manual of Ideas*, I am pleased to announce the launch of a new bi-weekly stock screening report. As a *DPR* subscriber, you'll receive the new *10x45 Bargain Hunter*, a \$99 value, for free. This unique screening service is designed to complement *DPR* and make it even easier for you to branch out beyond the stocks discussed in each monthly newsletter. We have worked hard to overcome some of the drawbacks of other screening tools, and we hope you'll find *10x45 Bargain Hunter* an ally as you search for hidden values in the stock market. To learn more, visit [manualofideas.com/bargainhunter.html](http://manualofideas.com/bargainhunter.html)

Sincerely,

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**K-Swiss  
(Nasdaq: KSW)**

Consumer: Footwear  
Westlake Village, CA, 818-706-5100  
[www.kswiss.com](http://www.kswiss.com)

**Fair Value Range**

MOI estimate (page 3): \$12–23 / share

**Trading Data**

Recent price: \$7.80  
52-week range: \$6.44–20.76  
Market value: \$272 million  
Enterprise value: \$74 million  
Shares outstanding: 35 million

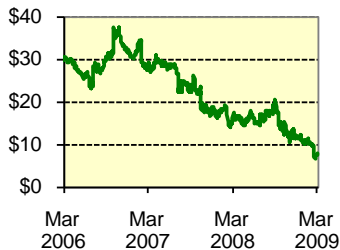
**Trading Multiples**

Net cash: 73% of MV  
Net net current assets: 97% of MV  
Price to tangible book: 0.9x  
EV to trailing revenue: 0.2x

**Ownership Data**

Insider ownership: 24%  
Insider buys / sales: 0 / 1<sup>1</sup>  
Institutional ownership: 77%<sup>2</sup>

**Three-Year Stock Price Performance**



<sup>1</sup> Number of transactions in past six months.  
<sup>2</sup> Includes 5%+ shareholders.



**K-Swiss Links:**

- [Website](#)
- [Q4 earnings release](#)
- [Earnings call transcript](#)
- [10-K for 2008](#)
- [Proxy statement](#)
- [Buffett's past interest?](#)

**MONTHLY PICK**

**K-Swiss (Nasdaq: KSW):  
Footwear Brand Selling at Price Ben Graham Would Like**

Investing in an unfashionable footwear company posting large revenue declines is a scary prospect in any environment, but especially so today. However, at recent market prices, K-Swiss shares should deliver strong appreciation with low risk of permanent capital impairment over the next few years.

**Background**

K-Swiss is a global athletic footwear company, with a majority of sales now coming from international markets. The company is mostly known for the “Classic” K-Swiss-branded shoe, created in 1966 as the first mass-produced leather tennis shoe. The Classic still accounts for roughly 70% of revenue.

Chairman and CEO Steven Nichols took control of K-Swiss in an LBO in 1987 and has built a strong track record of value creation for shareholders. He owns 21% of the company and has voting control. Despite the dual-class share structure, we view Nichols’s leadership as a big positive for K-Swiss shareholders.

**A Company Ben Graham Would Like—and Warren Buffett Did Like**

At \$7.80 per share, K-Swiss should outperform the market at lower risk. The low quotation makes K-Swiss a borderline Ben Graham “net net,” as market value approximates the carrying value of current assets minus all liabilities:

Cash and equivalents	\$207 million
Other current assets	\$127 million
Total current assets	\$334 million
Subtract: Total liabilities	–\$70 million
<b>“Net net” current assets</b>	<b>\$264 million</b>
...as % of market value	97%

Current assets net of total liabilities, as of December 31<sup>st</sup>, roughly equaled the recent market value of K-Swiss.

Even in the current depressed market environment, so-called “net nets” account for only 8% of all U.S. public companies. Among those net nets, it is quite rare to find a company that is as shareholder-friendly as K-Swiss and operates a business that can generate high returns on capital on a normalized basis.

Interestingly, Warren Buffett expressed an interest in acquiring K-Swiss in the mid-1990s, apparently making an offer that was rejected by the company.\*

**Key Sources of Shareholder Value**

- Solid balance sheet, with net cash of \$198 million or \$5.69 per share, equal to 73% of market value. Assuming cash needed to run the business of \$30 million, excess cash is \$168 million or **\$4.83 per share**.
- While K-Swiss will likely post a loss in 2009, we estimate normalized earning power (excluding interest income) at \$1.50-2.00 per share (K-Swiss earned more than \$2 per share in each of 2005 and 2006).

\* Martinez, Carlos, “A step ahead of the pack: Steven Nichols says K-Swiss survived a glut in the shoe market by being choosy about its retailers,” *San Fernando Valley Business Journal*, August 19, 2002.

**Q&A on K-Swiss**

**Q: Has K-Swiss become too small to compete against footwear makers such as Nike or Adidas?**

**A:** Probably not. K-Swiss has had a niche strategy for a long time, and it has managed to avoid going head-to-head against brands like Nike. Rather than target shelf space at mass merchants, K-Swiss has focused on higher-end, specialized stores. It has historically delivered strong ROI to such retailers.

**Q: Is there a specific product that may revive K-Swiss' fortunes?**

**A:** No product has emerged as the definitive driver of a revival for K-Swiss. In fact, no signs of a turnaround are evident at this time. It appears likely that the Classic, which still accounts for 70% of revenue, will have to regain popularity for K-Swiss to start growing again. Aside from the Classic, K-Swiss is increasingly emphasizing performance footwear, including running shoes. In 2008, K-Swiss acquired 57% of footwear company Palladium for €5 million.

**Q: Why is K-Swiss not buying back shares at current prices?**

**A:** At yearend 2008, K-Swiss had a remaining Board authorization to repurchase 3.9 million shares. However, the company did not buy back any stock in the fourth quarter. It appears that management not only demands a low purchase price but also wants to see at least some signs of a turnaround in the business before reengaging in aggressive share repurchases.

**Q: Do you think it's likely that K-Swiss will be acquired?**

**A:** A sale of the company appears unlikely in the near future. CEO and 21% shareholder Steven Nichols seems to believe that the company can turn around the business over the next few years. If it is successful, the company will be able to demand a much higher acquisition price than it could do today.

- Assuming an 8-12x P/E multiple range, the company has estimated future earning power value of \$12-24 per share.
- If we assume that K-Swiss will restore normalized earning power within 3-5 years, and we apply a 10% discount rate to translate future value to current value, the earnings stream is worth **\$7-18 per share**.
- For the sake of simplicity and conservatism, we also assume that the company will generate no cash over the next 3-5 years.
- The following intangible sources of value are already reflected in our estimate of normalized earnings. As a result, we assign no incremental value to the following positives:
  - *Shareholder-friendly management with a demonstrated ability to allocate capital*, including share repurchases. To get a sense of Steven Nichols's candid communications, we encourage you to read past earnings call transcripts.
  - *Brand with premium reputation*. Whenever demand for K-Swiss shoes has dropped off, the company has cut down on supply rather than resorted to deep discounting. This has allowed K-Swiss to rebound more strongly in good times.
  - *Prior success emerging from fashion slumps*. K-Swiss has gone through two prior periods of sharply declining sales, in 1995-96 and 2000. Each time, the company took steps that enabled it to go on to generating record profits.

**K-Swiss — Fair Value Estimate**

Excess Cash Value	
Net cash	\$198 million
Subtract: Estimated cash needed to run business	-\$30 million
<b>Excess cash</b>	<b>\$168 million or \$5 per share</b>
Earning Power Value	
Estimated normalized earning power per share	\$1.50-2.00
Shares outstanding	35 million
Estimated normalized earning power	\$52-70 million
Assumed earnings multiple range	8x-12x
Assumed discount rate and discount period	10% for 3-5 years
<b>Discounted earning power value</b>	<b>\$258-631 million or \$7-18 per share</b>
Total Equity Value	
<b>Estimated fair value</b>	<b>\$430-800 million or \$12-23 per share</b>

Source: Company data, *The Manual of Ideas* estimates and analysis.

**We judge K-Swiss shares to have strong downside protection** due to (1) more than \$5 per share of net cash, (2) a history of skilled management execution and shareholder-friendly actions, (3) a resilient brand that has endured two prior fashion slumps and rebounded strongly, (4) a globally diversified business, with more than 50% of revenue from outside the U.S., and (5) an ability and willingness to buy back stock at far below intrinsic value, thereby mitigating the stock price downside and boosting eventual upside for the remaining shareholders.

**Sierra Wireless  
(Nasdaq: SWIR)**

Technology: Wireless Devices and Software  
Richmond, BC, Canada, 604-231-1100  
<http://www.sierrawireless.com>

**Fair Value Range**

MOI estimate (page 5): \$6–23 per share

**Trading Data**

Recent price: \$2.89  
52-week range: \$2.64–21.18  
Market value: \$90 million  
Enterprise value: negative  
Shares outstanding: 31 million

**Post-Wavecom Trading Multiples**

Net cash: >100% of MV  
Price to tangible book: 0.5x

**Ownership Data**

Insider ownership: 1%  
Insider buys / sales: 0 / 0<sup>1</sup>  
Institutional ownership: 52%<sup>2</sup>

**Three-Year Stock Price Performance**



<sup>1</sup> Number of transactions in past six months.

<sup>2</sup> Includes 5%+ shareholders.



**Sierra Wireless Links:**

- [Sierra website](#)
- [Wavecom website](#)
- [Investor presentation](#)
- [Q4 earnings release](#)
- [SEC filings](#)
- [SEDAR filings](#)
- [Wavecom acquisition](#)

**MONTHLY PICK**

**Sierra Wireless (Nasdaq: SWIR):  
Market Overreacts to Ill-Timed Acquisition of Wavecom**

**Has Mr. Market Gone Mad?**

On December 1<sup>st</sup>, 2008, wireless technology company Sierra was worth \$243 million in the stock market. A day later, Sierra offered to buy French competitor Wavecom (Nasdaq: WVCM) for €18 million, or roughly \$300 million, in cash. In the recently completed acquisition, Sierra not only bought the Wavecom operating business but also received net cash of €18 million, or roughly \$160 million. As a result, Sierra paid about \$140 million for the Wavecom enterprise.

In a highly pessimistic scenario, if investors believed that Wavecom had an enterprise value of zero, they might conclude that Sierra was suddenly worth only about \$100 million, i.e., \$243 million (the market value on December 1<sup>st</sup>) minus \$140 million (the enterprise value paid for Wavecom). Meanwhile, Sierra shares closed this past Friday, March 20<sup>th</sup>, at a market value of \$90 million.

The market's apparent overreaction to Sierra's recently completed acquisition of Wavecom would be even more striking if Sierra shares had already been undervalued on December 1<sup>st</sup> and the Wavecom enterprise had at least some value. Our analysis suggests that Sierra was indeed undervalued going into the takeover of Wavecom, and that Wavecom represents a potentially valuable complement to Sierra's existing wireless technology business.

**Post-Acquisition Financial Position of Sierra Wireless**

The above snapshot of Sierra's recent history merely shows that the shares *might* be a good investment. To determine if this is actually the case, let's look at Sierra's balance sheet as if Wavecom had been acquired as of December 31<sup>st</sup>, 2008:

	Sierra Wireless	Wavecom	Acquisition Adjustments	Sierra Wireless <i>pro forma</i>
Cash and securities	\$273 million	\$161 million	–\$296 million	\$138 million
Other current assets	\$112 million	\$38 million		\$150 million
Current assets	\$385 million	\$199 million		\$288 million
Intangible assets	\$48 million	\$41 million	\$103 million	\$192 million
Other assets	\$29 million	\$33 million		\$63 million
Total assets	\$462 million	\$273 million		\$542 million
Short-term debt	–	\$2 million	–\$2 million	<\$1 million
Other current liabilities	\$96 million	\$59 million		\$156 million
Current liabilities	\$96 million	\$61 million		\$156 million
Long-term debt	–	\$110 million	–\$109 million	<\$1 million
Other liabilities	\$8 million	\$20 million		\$28 million
Shareholders' equity	\$357 million	\$82 million	–\$82 million	\$357 million
Tangible equity	\$309 million	\$41 million		\$166 million
Shares outstanding	31 million	16 million	–16 million	31 million
<b>Net cash / share</b>	<b>\$8.79</b>	<b>\$3.07</b>		<b>\$4.41</b>
<b>Tangible book / share</b>	<b>\$9.96</b>	<b>\$2.58</b>		<b>\$5.33</b>

Source: Company data, *The Manual of Ideas* estimates and analysis.

Even after paying \$296 million for Wavecom, Sierra would have been left with net cash of more than \$135 million, or more than \$4 per share, as of December 31<sup>st</sup>, significantly above the recent market value of \$90 million, or \$2.89 per share.

**Q&A on Sierra Wireless**

**Q: Your discussion of Sierra focuses on the financial picture post-Wavecom acquisition. What about Sierra's competitive position and growth prospects?**

**A:** Sierra Wireless is a leading provider of modems and software to connect to mobile broadband networks. More than two-thirds of revenue comes from PC adapter products called AirCards. The company sells primarily through wireless carriers, who account for 60% of revenue. While it seems that Sierra has carved out a strong position in the growing markets for wide area wireless and machine-to-machine (M2M) communications, it is unclear whether the company enjoys a sustainable competitive moat.

**Q: What was the strategic rationale behind the Wavecom acquisition?**

**A:** The purchase of Wavecom, a leader in embedded wireless for M2M, complements Sierra's product portfolio and geographic coverage. Wavecom had previously received a takeover bid from Gemalto (Euronext Paris: GTO), a €2 billion provider of security solutions. Sierra essentially outbid Gemalto for the Wavecom business. Sierra management sees "opportunities to capture significant revenue and cost synergies."

**Q: How can you trust a management team that overpaid for Wavecom at a time when it should have been preserving cash?**

**A:** We question management's judgment and believe the Wavecom deal should not have been consummated. However, the current opportunity to invest in Sierra shares at a steep discount would probably not exist had it not been for management's misstep. We find Sierra shares attractive today because our analysis suggests that the market has punished the company excessively for management's poor judgment.

Even if we assume that weak results and acquisition-related costs have depleted net cash to \$100 million, it's clear we are paying "nothing" to buy the combined Sierra and Wavecom operating businesses. The \$100+ million of net cash and additional tangible assets provide strong protection on the downside, assuming that the combined company doesn't become a money-burning machine.

While Wavecom lost roughly \$42 million from operations on a GAAP basis on a 36% revenue decline in 2008, it generated a small amount of cash from operations last year. More importantly, Sierra Wireless earned \$45 million from operations on a GAAP basis on a 29% revenue increase in 2008. Sierra generated free cash flow of \$66 million last year, with Q4 FCF of \$27 million. Sierra has guided for breakeven earnings in Q1 and Wavecom appears likely to lose money in the foreseeable future. Nonetheless, the combined company can pursue cost synergies that should keep cash burn low even in an extremely difficult demand environment.

**A Look at the Potential Upside**

To get a sense of the upside once the economy turns and the market starts valuing Sierra close to fair value, let's look at what the company might be worth:

	Low Estimate	High Estimate
<b>Excess Cash Value</b>		
Pro forma net cash as of December 31, 2008	\$137 million	\$137 million
Assumed cash burn through March 22, 2009	-\$37 million	-\$20 million
Cash required to run business	-\$50 million	-\$25 million
Excess cash	\$50 million	\$92 million
	\$2 per share	\$3 per share
<b>Earning Power Value – Standalone Sierra Wireless</b>		
Estimated normalized EBIT	\$25 million	\$50 million
Fair value multiple of normalized EBIT	5x	8x
Value of standalone Sierra	\$125 million	\$400 million
	\$4 per share	\$13 per share
<b>Enterprise Value – Standalone Wavecom</b>		
Estimated annual revenue	\$100 million	\$150 million
Fair value multiple of revenue	0x	1x
Value of standalone Wavecom	\$0 million	\$150 million
	\$0 per share	\$5 per share
<b>Value of Acquisition Synergies</b>		
Δ EBIT from cost cutting and revenue growth	\$0 million	\$10 million
Fair value multiple of incremental EBIT	n/m	8x
Value of acquisition synergies	\$0 million	\$80 million
	\$0 per share	\$3 per share
<b>Total Equity Value</b>		
<b>Estimated fair value</b>	<b>\$175 million</b>	<b>\$722 million</b>
	<b>\$6 per share</b>	<b>\$23 per share</b>

Source: Company data, *The Manual of Ideas* estimates and analysis.

**We judge Sierra Wireless to have strong downside protection** due to (1) \$100+ million of post-acquisition net cash, exceeding recent market value; (2) a fundamentally sound Sierra business, with strong normalized cash generation; and (3) the potential for meaningful synergies from the Wavecom acquisition.

## SCREENING FOR STOCKS WITH DOWNSIDE PROTECTION

In this section, we present three of our favorite stock screens. We have designed the screens with downside protection in mind, but we note that even the best screens sometimes turn up companies with little investment merit. As a result, the following screens should be used as a starting point for additional research rather than as a ready-made list of stocks to buy.

### DOWNSIDE PROTECTION SCREEN #1 Companies Trading For Less Than Cash

This screen looks for companies trading close to liquidation value. Such companies are likely to have strong downside protection because investors may get their money back even if the companies are forced to shut down operations.

When searching for stocks in this category, we avoid companies losing large amounts of money because such businesses may burn through their cash before it can be distributed to shareholders.

We also avoid companies controlled by insiders. We want shareholders to be able to change the Board if the incumbent directors are unwilling or unable to maximize value.

Sorted by: Net cash to market value | Units: U.S. dollars in millions, except as otherwise stated

Company / Ticker	Price (\$)	Market Value	Net Cash	Total Liab.	LTM EBIT	Cash/MV	ST Assets/Total Liab.	Insider Own.	# of Insider	
									Buys	Sells
Actions Semi / ACTS	1.43	121	266	17	17	220%	>999%	2%	-	-
Calamos Asset Mgmt / CLMS	3.93	77	150	325	122	195%	102%	1%	10	-
Linktone / LTON	1.25	53	96	15	3	183%	836%	20%	-	-
KHD Humboldt Wedag / KHD	7.94	242	395	496	86	163%	143%	22%	-	-
Comverse Technology / CMVT	5.65	1,141	1,809	1,193	89	159%	238%	0%	-	-
Webzen / WZEN	1.80	75	103	9	8	138%	>999%	19%	-	-
Adaptec / ADPT	2.38	290	369	48	-21	127%	878%	1%	20	-
Syneron Medical / ELOS	5.46	157	197	39	0	125%	636%	10%	-	-
Clarus / CLRS	3.95	69	86	1	-5	125%	>999%	14%	3	-
ORBCOMM / ORBC	1.40	59	74	30	-5	125%	291%	23%	5	-

[DownsideProtection1 • DownsideProtection • downside\_protection.xls • dp1]

**Screening criteria:** ► Market value less than net cash and investments ► Current assets greater than total liabilities ► At least as much insider buying as selling in past six months (both shares and transactions) ► Insider ownership less than 25% ► Positive LTM EBIT, or LTM loss equal to less than 10% of net cash balance, or estimated forward EPS not negative ► Market value greater than \$50 million

Read the inaugural issue of

***10x45 BARGAIN HUNTER,***

our new bi-weekly stock screening service,  
a \$99 value, FREE for *Downside Protection Report* subscribers:

[www.manualofideas.com/members/bargainhunter/](http://www.manualofideas.com/members/bargainhunter/)

## DOWNSIDE PROTECTION SCREEN #2

### Companies Trading For Less Than Tangible Book Value

This screen looks for companies trading below book value, adjusted for goodwill and other intangibles. As such companies are frequently in distress, we only consider firms that have little or no debt and have either made money in the past twelve months or are expected to turn profitable this year.

**Sorted by:** Number of insider buys in past six months | **Units:** U.S. dollars in millions, except as otherwise stated

Company / Ticker	Price (\$)	MV		Net Debt/ Equity	TBV/ MV	LTM EBIT	Insider Own.	# of Insider	
		MV	EV					Buys	Sells
FutureFuel / FFL	4.95	140	66	-41%	130%	32	43%	60	-
Agilysys / AGYS	4.74	108	35	-23%	127%	-194	4%	28	-
Kenexa / KNXA	4.60	104	78	-17%	107%	-144	6%	25	-
Titanium Metals / TIE	5.37	972	927	-4%	111%	220	53%	18	-
Kaiser Aluminum / KALU	20.74	416	426	1%	190%	-91	2%	10	-
TriQuint Semiconductor / TQNT	2.24	330	244	-16%	149%	-16	1%	8	-
CDI / CDI	8.84	167	107	-21%	139%	25	10%	7	-
Intevac / IVAC	5.16	113	76	-21%	142%	-31	4%	7	-
Haynes International / HAYN	14.88	178	175	-1%	184%	83	2%	5	-
Zoltek / ZOLT	6.97	240	241	0%	134%	19	19%	4	-

[DownsideProtection2 • DownsideProtection • downside\_protection.xls • dp2]

**Screening criteria:** ► Market value less than tangible book value ► Current assets greater than total liabilities ► At least as much insider buying as selling in past six months (both shares and transactions) ► Net debt to equity of less than 10% ► Positive trailing operating income or non-negative estimated forward EPS ► Market value greater than \$100 million

## DOWNSIDE PROTECTION SCREEN #3

### Cheap Companies Buying Back Their Own Stock

This screen looks for companies that are cheap on a price-to-book or price-to-earnings basis. We focus on firms actively buying back stock, thereby providing some downside protection and increasing intrinsic value per share.

**Sorted by:** Market value | **Units:** U.S. dollars in millions, except as otherwise stated

Company / Ticker	Price (\$)	MV		LTM EBIT	TBV/ MV	Forward P/E	Insider Own.	# of Insider	
		MV	EV					Buys	Sells
Canon / CAJ	27.04	33,368	26,484	5,157	82%	35x	12%	-	-
Stryker / SYK	31.53	12,507	10,332	1,519	36%	9x	15%	-	-
United Overseas / UOVEY	12.18	9,169	13	1,787	80%	11x	41%	-	-
Deutsche Lufthansa / DLAKY	10.83	4,960	5,710	1,876	150%	35x	1%	-	-
Fairfax Financial / FFH	249.90	4,570	4,815	2,444	104%	n/a	9%	-	-
Garmin / GRMN	20.05	4,018	3,309	862	50%	8x	46%	8	-
CF Industries / CF	67.68	3,276	2,655	1,150	41%	10x	1%	5	5
Kinder Morgan / KMR	40.58	3,165	3,165		74%	24x	15%	3	-
Makita / MKTAY	22.09	3,042	2,375	642	92%	n/a	17%	-	-
Foster Wheeler / FWLT	18.26	2,308	1,750	604	12%	8x	1%	-	-

[DownsideProtection3 • DownsideProtection • downside\_protection.xls • dp3]

**Screening criteria:** ► Shares outstanding down more than 2.5% sequentially in latest quarter ► Market value less than 1.5x tangible book or forward P/E of less than 10x ► At least as much insider buying as selling in past six months (both shares and transactions) ► Net debt to equity of less than 10% ► Positive LTM EBIT or non-negative 2009E EPS ► Market value greater than \$100 million

## A Look at Our Past Monthly Picks

On this page, we track the performance of our monthly picks versus the S&P 500 Index. We also provide a quick update on past recommendations and let you know if it's time to sell.

	Recommended		Latest Price	Price	S&P 500
	Price	Date	as of 3/20/09	Change	Change
<b>Greenlight Capital Re / GLRE</b> <i>HOLD – The gap to fair value has narrowed, but we continue to like Einhorn's investment strategy and portfolio</i>	\$10.85	12/5/08	\$16.07	+48.1%	-12.3%
<b>EchoStar / SATS</b> <i>BUY – No major change to thesis or valuation</i> We like Ergen's recent pursuit of Sirius; weak quarterly results were largely expected in light of the weak economy	\$14.84	1/16/09	\$14.64	-1.3%	-9.6%
<b>Microsoft / MSFT</b> <i>BUY – No major change to thesis or valuation</i> Shares remain unjustifiably cheap, despite management's cautious outlook for CY 2009	\$19.71	1/16/09	\$17.06	-13.4%	-9.6%
<b>Capital Southwest / CSWC</b> <i>BUY – No major change to thesis or valuation</i> Shares continue to trade at a discount to the fair value of the investment portfolio	\$87.69	2/9/09	\$81.63	-6.9%	-9.1%
<b>Crawford &amp; Co.</b> <i>Buy CRD-A, Sell Short CRD-B – No major change to thesis</i> Dollar spread per share has narrowed slightly but remains unjustifiably wide	\$5.53	2/9/09	\$4.00	-\$1.53	-9.1%
	\$8.42	2/9/09	\$6.70	-\$1.72	
	Profit per Crawford share			+0.19	

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December 31, 2008 (current issue) — Empirical Finance Research Newsletter on Pension Plan Funding and Stock Market Efficiency, a paper by Francesco A. Franzoni and Jose M. Marin

Abstract: The paper argues that the market significantly overvalues firms with severely underfunded pension plans. These companies earn lower stock returns than firms with healthier pension plans for at least 5 years after the first

## 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 downloadable Excel models included in this report as well as links to other useful information. You will also other subscriber-only content.

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