

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 • April 14, 2009



Stocks We're Buying This Month

Harvest Natural Resources
(NYSE: HNR) p. 2

Gravity Co.
(Nasdaq: GRVY) p. 4

Also Inside

Downside Protection Screens

Top 10 companies
trading below net cash p. 6
trading below tangible book ... p. 7
buying back their own stock ... p. 7

Scorecard

See how we're doing p. 8

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	7%	0%
...net cash	7%	2%
...tangible book value	30%	15%
...5x trailing EPS	6%	5%

Data as of April 10, 2009.

Dear Fellow Idea Seekers,

Last month, we discussed investors' tendency to look for perfection in their investments. We argued that perfection was not achievable, as a perfect business does not come at a perfect price. As investors, we are forced to compromise, weighing the *price* we pay against the *value* we get.

The compromises we struck in the March issue appear to have been good ones, at least so far: **K-Swiss (Nasdaq: KSWS)** and **Sierra Wireless (Nasdaq: SWIR)** are up 19% and 66%, respectively, since we recommended them, while the S&P 500 Index has gained 9%.

In this issue, we highlight two more imperfect candidates—**Harvest Natural Resources (NYSE: HNR)** and **Gravity Co. (Nasdaq: GRVY)**. Once again, we like the compromises we are making, as it seems Mr. Market is compensating us handsomely for what's wrong with these companies while extracting hardly any price for what's right.

In the case of Harvest, investors appear to be focused on the fact that the company's primary producing assets are in Chavez-ruled Venezuela, while ignoring the fact that 84% of Harvest's market value is accounted for by cash deposited in domestic banks, with additional value tied up in several high-potential exploration projects outside of Venezuela. We show that the current valuation provides a robust margin of safety, at the same time providing us with enviable upside potential.

The case for Korean online games developer Gravity is even clearer. After repeatedly disappointing investors with operating losses and poor execution on new games, Gravity brought in a new CEO last August. While much work remains to be done, initial results have been positive. The company has restored double-digit revenue growth and turned solidly profitable. The only one not noticing this inflection point seems to be Mr. Market. Gravity still sells for \$27 million, or well under five times the apparent operating income run rate. Oh, and did we mention that Gravity has more than \$40 million of cash and no debt?

We do caution that Gravity is a microcap stock with low trading volume. As a result, any purchases should be made deliberately and spread out over time. There is no need to overpay—even for a good thing.

Sincerely,



*Are you a portfolio manager? Do you want to benefit from the analysis depended on by some of the world's top value investment managers? Then don't miss another issue of **PORTFOLIO MANAGER'S REVIEW**.*

DOWNSIDE PROTECTION REPORT is published monthly by BeyondProxy LLC, P.O. Box 1375, New York, NY 10150. Website: www.manualofideas.com. Email: support@manualofideas.com. Please email or call if you have any subscription questions. Managing Editor: John Mihaljevic. Subscription \$149 per year. © Copyright 2008 by BeyondProxy LLC. All rights reserved. Photocopying, reproduction, quotation, or redistribution of any kind is strictly prohibited without written permission from the publisher. This newsletter bases recommendations and forecasts on techniques and sources believed to be reliable in the past and cannot guarantee future accuracy and results. BeyondProxy's officers, directors, employees and/or principals (collectively "Related Persons") may have positions in and may, from time to time, make purchases or sales of the securities or other investments discussed or evaluated in this newsletter. John Mihaljevic, Chairman of BeyondProxy, is also a principal of Mihaljevic Capital Management LLC ("MCM"), which serves as the general partner of a private investment partnership. MCM may purchase or sell securities and financial instruments discussed in this newsletter on behalf of the investment partnership or other accounts it manages. It is the policy of MCM and all Related Persons to allow a full trading day to elapse after the publication of this newsletter before purchases or sales of any securities or financial instruments discussed herein are made. Use of this newsletter and its content is governed by the Terms of Use described in detail at www.manualofideas.com/terms.html.

Harvest Natural Resources (NYSE: HNR)

Energy: Oil & Gas
Houston, TX, 281-899-5700
www.harvestnr.com

Fair Value Range

MOI estimate: approx. \$12-20 per share

Trading Data

Recent price: \$3.51
52-week range: \$2.61-12.89
Market value: \$116 million
Enterprise value: \$19 million
Shares outstanding: 33 million

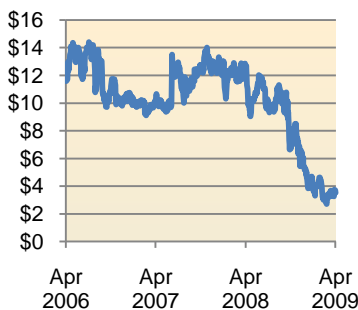
Trading Multiples

Net cash: 84% of MV
Price to tangible book: 0.4x
EV to proved reserves: \$0.43 per boe¹

Ownership Data

Insider ownership: 7%
Insider buys / sales: 3 / 0²
Institutional ownership: 71%³

Three-Year Stock Price Performance



¹ boe = barrel of oil equivalents. Represents proved reserves based in Venezuela.

² Number of transactions in past six months. Excludes transactions by 17% shareholder Mohnish Pabrai.

³ Includes 5%+ shareholders.



Harvest Links:

- [Website](#)
- [Investor presentation](#)
- [Q4 earnings release](#)
- [Earnings call transcript](#)
- [10-K for 2008](#)
- [Proxy statement](#)
- [All SEC filings](#)

MONTHLY PICK

Harvest Natural Resources (NYSE: HNR): Dirt-Cheap Oil Company with Lots of Cash

Harvest Natural Resources is an oil production and exploration company based in Houston, Texas, with producing assets in Venezuela and exploration properties worldwide. Harvest is one of those stocks that are a bit uncomfortable to own because shareholders are seemingly at the mercy of a higher power—in this case the government of Hugo Chavez. Paradoxically, therein lies the opportunity for those “brave” enough to invest in Harvest. We put “brave” in quotation marks because we do not consider Harvest a particularly risky investment at the current price, as investors appear to be mistakenly associating discomfort with risk (we could, of course, be wrong and, as always, do your own work prior to investing).

More Discomfort Than Risk

While the specter of Hugo Chavez is an uneasy one for us American capitalists, 84% of Harvest’s recent market value sits in cold, hard cash deposited with U.S. banks—out of Chavez’s reach. In addition, Harvest has a world-class engineering team and exploration properties in the U.S., Indonesia and Gabon. If Harvest owned no assets in Venezuela, one could still justify the company’s current stock price. As a result, Chavez may spoil the *upside* for Harvest investors, but there is not much he can do to create fundamental *downside* from the current stock price.

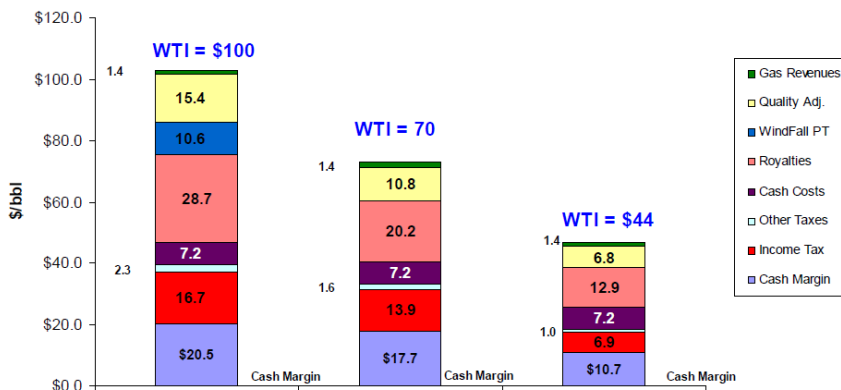
Chavez Wants Money, Too—and Harvest Can Help

We’ve shown why the downside risk for Harvest investors is lower than one might assume initially. Now we will argue that the upside is actually quite large, and that the Venezuelan government is unlikely to stand in the way.

For one, there is no nationalization risk because—you guessed it—Harvest’s Venezuelan operations *have already been nationalized*. Over the past year, the government forced Harvest into restructuring the operations to give state-owned oil company PDVSA a majority stake in the operating assets. Harvest has essentially become a service provider to PDVSA. However, instead of being paid by the hour, Harvest owns 32% of the operating assets. This gives Harvest net proved reserves of 43 million barrels of oil equivalents (“2P” reserves of 70 million boe).

Harvest Natural Resources — Cash Margin of Production Operations

The company has a low-cost production base in Venezuela and is profitable even at low oil prices



Source: Company, March 26, 2009.

Q&A on Harvest

Q: Having nationalized Harvest's Venezuelan operations, why does the Chavez government keep Harvest around at all?

A: Harvest's engineering teams have shown that they can boost reserves and production significantly beyond levels achievable by the government-owned company PDVSA. It makes economic sense for the Chavez government to compensate Harvest for delivering incremental value. The fact that Venezuela recently awarded Harvest additional fields bodes well for the company's future role in Venezuelan oil production.

Q: Harvest's GAAP financials look scary, with no revenue and large losses. What is going on?

A: Since Harvest owns only 32% of the Venezuelan company that owns the Petrodelta oil-producing assets, GAAP requires Harvest to record Petrodelta income on one line of the income statement as "net income from unconsolidated equity affiliates." As a result, Harvest shows no revenue from oil sales. The GAAP income statement makes Harvest look like an oil exploration company even though Harvest owns highly profitable producing assets.

Q: OPEC recently announced reductions in producing quotas for its member states, and Harvest was forced to limit production as a result. What impact will this have on results going forward?

A: Harvest's Q4 production increased slightly from Q3 levels despite the OPEC quota cuts, so it does not appear that the impact will be significant. Harvest may have to wait before ramping up production from new oil fields in a big way.

Q: Paint a scenario that would result in significant downside for Harvest shareholders.

A: Shareholders would likely suffer permanent impairment of capital if both of the following events came to pass: (1) Venezuela strips Harvest of its 32% stake in the Petrodelta operating assets; and (2) Harvest's exploration projects burn cash but ultimately fail. We consider the likelihood of both of these scenarios playing out at the same time as extremely unlikely.

Harvest has a history of using its world-class engineering resources to increase the amount of oil that can be recovered from Venezuelan oil fields. This is probably why the government awarded Harvest new fields during the recent conversion to majority ownership by PDVSA. Hugo Chavez needs proceeds from oil sales to fund his socialist agenda, and Harvest can maximize production.

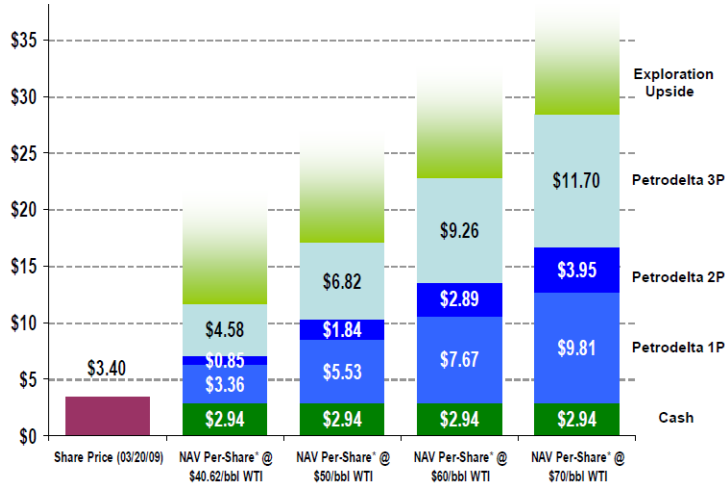
Harvest is a low-cost producer. As the chart on the previous page shows, if oil prices are \$100 per barrel, the Venezuelan operations (Petrodelta) achieve a cash margin of \$20.50 per barrel. If oil prices fall to \$44 per barrel, Petrodelta still earns a cash margin of \$10.70 per barrel. The reason is that Petrodelta has cash operating costs of only \$7.20 per barrel. Virtually all of the other costs are various taxes and royalties, which are *variable*. As a result, Petrodelta is solidly profitable even in the current environment of low oil prices.

Quantifying the Upside

A Ryder Scott report as of yearend 2008 values Harvest's share of Petrodelta's proved reserves at \$111 million, based on a world oil price of \$41 per barrel and a Venezuela price of \$34 per barrel. Under the same assumptions, the present value of Harvest's 70 million boe of proved and probable (2P) reserves is \$139 million, while the proved, probable and possible (3P) reserves are worth \$290 million. Obviously, these figures rise accordingly with increasing oil price assumptions. Finally, there is some value to Harvest's worldwide exploration properties, though the number is impossible to quantify.

Harvest Natural Resources — What Is The Company Worth?

Net asset value per share exceeds recent stock price at various assumed crude oil prices



Source: Company, March 26, 2009.

We judge Harvest shares to have strong downside protection due to (1) net cash equal to 84% of market value, (2) demonstrated willingness and ability to repurchase stock at depressed prices, (3) capable management and skilled engineering teams, (4) low-cost Venezuelan producing assets that are profitable even at low oil prices, and (5) proven ability to boost reserves and production in Venezuela, thereby delivering strong value to its government partner PDVSA.

Gravity Co.
(Nasdaq: GRVY)

Internet-based Games: MMORPGs
Seoul, South Korea, 82 2 2132 7000
<http://www.gravity.co.kr>

Fair Value Range

MOI estimate (page 5): \$2-6 per share

Trading Data

Recent price: \$0.95
52-week range: \$0.36-2.00
Market value: \$27 million
Enterprise value: negative
Shares outstanding: 28 million

Trading Multiples

Net cash: >155% of MV
Price to tangible book: 0.4x

Ownership Data

Insider ownership: 59%
Insider buys / sales: 0 / 0¹
Institutional ownership: 25%

Three-Year Stock Price Performance



¹ Number of transactions in past six months.



Gravity Links:

- [Financial model](#)
- [Gravity website](#)
- [Investor presentation](#)
- [Ragnarok on YouTube](#)
- [2008 results \(6-K\)](#)
- [2007 results \(20-F\)](#)
- [All SEC filings](#)

MONTHLY PICK

**Gravity Co. (Nasdaq: GRVY):
Microcap Gem Ready to Shine**

The Hard-to-Believe Reality

Gravity is one of Asia’s top developers of Internet-based games. Results have turned solidly profitable following the appointment of a new CEO in June 2008. Based on our analysis, the company may have earned more than \$3 million dollars of adjusted operating income in Q4 2008, suggesting an operating income run-rate of approximately \$14 million (more on this later). The company has more than \$40 million of cash, no debt, and is once again growing revenue in the double-digits on the back of new game releases. Could a growing company with high returns on capital command a valuation of 10x estimated operating income, i.e., \$140 million? Adding \$40+ million of cash, might Gravity be worth \$180 million?

Mr. Market, recently under the tremendous stress of what some have termed a stock market “meltdown,” appears not to have found the time to reevaluate his harsh opinion of Gravity. You see, Mr. Market had punished Gravity for delaying repeatedly the release of a much-anticipated game—and for the resulting operating losses. Now that Gravity has turned the corner in a big way, has Mr. Market revised his opinion? Not one bit, judging by the dismal multiple he is still putting on our estimate of Gravity’s adjusted operating income: *minus* one. That’s right, forget about arguing what multiple Mr. Market should pay for Gravity. The company still trades for less than net cash!*

Some Background on the Hard-to-Believe Reality

Gravity went public on Nasdaq on the back of the hugely successful game Ragnarok Online, one of Asia’s first and most popular massively multiplayer online role-playing games (MMORPGs). The company raised \$71 million at \$13.50 per share in 2005. The same year, a Japanese company affiliated with the large tech company Softbank bought out Gravity’s founder, paying close to \$25 per share, or roughly \$350 million, for his 52% stake in the company. In 2008, the majority holder bought another 7% of Gravity, bringing the stake to 59%.

Gravity wouldn’t be on the pages of *Downside Protection Report* if everything had gone smoothly since the company’s IPO in 2005. Fortunately for us, the highly anticipated release of Ragnarok Online 2, the sequel to the company’s best-selling game, has been delayed repeatedly, causing revenue to decline and development costs to increase, producing operating losses. The deteriorating fundamentals led investors to scrutinize several other aspects of Gravity, including the company’s lacking corporate governance and even fraud committed by former officers (now long resolved). U.S. activist hedge funds Ramius Capital and Moon Capital sued the company in South Korean courts and won certain concessions on governance matters. It appears that the company’s responsiveness to U.S. investors has improved recently. Ramius and Moon own 10% and 9% of Gravity, respectively, giving them a continued interest in seeing shareholder value maximized.

* Forgive our sarcasm, but situations like Gravity bring out the best in us!

Q&A on Gravity

Q: Gravity's valuation seems too good to be true. Is there anything you worry about here?

A: We have two primary concerns. First, we worry that Gravity may be delisted from Nasdaq, opening the door for the majority shareholder to try to buy out the minority holders on the cheap. Gravity does not currently meet Nasdaq's \$1 minimum bid requirement, nor does the company have three independent directors on the Board's compensation committee (two of the three members are currently "independent"). While Gravity is in discussions with Nasdaq to remedy this deficiency, and while the stock price appears likely to surpass the \$1 bid requirement, there is no guarantee that the shares will remain listed on Nasdaq.

Second, we worry that recent profitability might be a fluke. Gravity does not have a history of consistent profitability, and it is impossible to know whether the recent positive trend will persist. If the company reverts to operating losses, the cash balance could be eroded over time.

Q: Ragnarok Online 2 still has not been released. Do you have any idea when this might happen?

A: It's impossible to predict when RO2 might be released—and in what form. Thankfully, the company's other games have already propelled it to profitability and growth. As a result, we view the future release of RO2 as an added bonus rather than a necessity. It appears likely that RO2 will be commercialized in 2009.

Q: How do we know that Gravity really has \$40+ million of cash in the bank? Could it be a fraud?

A: We are usually highly skeptical of Asian microcap companies listed in the U.S. However, in Gravity's case, we know that the games are "real" because they are available online. In addition, two large U.S. hedge funds have known the company for years and even litigated against it in Korean courts. We also know that the company raised \$71 million in an IPO on Nasdaq in 2005. Finally, the financial statements are audited by a Hong Kong-based member firm of PricewaterhouseCoopers.

Today, Gravity's stock price of roughly \$1 per share, does not appropriately reflect recent positive developments. The positives include the release of new games, including Emil Chronicle and Requiem, even as Ragnarok Online 2 remains in open beta testing and has yet to be commercialized. Most of all, however, Gravity's value has been enhanced by the cost-cutting actions taken by new CEO Yoon Seok Kang. Together with resurgent revenue growth, the cost reductions have led to sharp increases in operating income.

Why Investors May Have Missed Gravity's Solid Profitability

A quirk in Gravity's reporting schedule makes it difficult to appreciate the extent of the company's recent profitability. Gravity does not report consolidated results for the year ended December 31st until it files Form 20-F in June. The company files *non-consolidated* results in a 6-K filing in early April, but those results are based on Korean GAAP and do not correspond to the quarterly reports filed by the company. Long story short, we still don't know for sure what Gravity's Q4 results looked like. However, we have pieced together an estimate of the Q4 results based on historical consolidated and non-consolidated financials.

The bottom line: It appears that Gravity earned adjusted operating income of 4.5 billion Korean Won, or \$3.4 million, in Q4. For a reconciliation of consolidated and non-consolidated results and our estimate of Q4 results, [log into the members-only area](#) of the *Manual of Ideas* site and download our Gravity financial model.

A Look at the Potential Upside

To get a sense of the upside once Mr. Market awakens to the fact that the Gravity enterprise has some value, let's look at what the company might be worth:

	Low Estimate	High Estimate
Excess Cash Value		
Non-consolidated net cash at yearend 2008	\$41 million	\$41 million
Cash required to run business	-\$10 million	-\$1 million
Excess cash	\$31 million	\$40 million
	\$1.12 per share	\$1.44 per share
Earning Power Value		
Estimated normalized EBIT	\$4 million	\$14 million
Fair value multiple of normalized EBIT	8x	10x
Value of Gravity enterprise	\$32 million	\$136 million
	\$1.15 per share	\$4.89 per share
Total Equity Value		
Estimated fair value	\$63 million	\$176 million
	\$2.27 per share	\$6.34 per share

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

We judge Gravity to have strong downside protection due to (1) \$40+ million of net cash, exceeding market value; (2) a business that has turned profitable and cash flow positive; (3) significant stock ownership by activist hedge funds Ramius and Moon, who have taken action to protect shareholders in the past; (4) the possibility of a bid by the majority shareholder to buy out the minority holders; and (5) a high return-on-capital business with favorable long-term growth prospects.

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	
									Buy	Sell
Actions Semiconductor / ACTS	1.66	141	266	17	17	189%	>999%	2%	-	-
KHD Humboldt Wedag / KHD	7.44	227	401	504	56	176%	141%	22%	-	-
QLT / QLTI	2.06	113	165	149	27	147%	272%	0%	52	29
Linktone / LTON	1.56	66	96	15	3	146%	836%	20%	-	-
Comverse Technology / CMVT	6.75	1,364	1,809	1,193	89	133%	238%	0%	-	-
Clarus / CLRS	4.00	70	86	1	-5	124%	>999%	14%	3	-
Calamos Asset Mgmt / CLMS	6.33	124	150	325	122	121%	102%	1%	10	-
iPass / IPAS	0.96	59	68	36	-93	116%	308%	19%	-	-
AuthenTec / AUTH	1.91	55	63	9	-2	116%	786%	0%	3	1
Syneron Medical / ELOS	6.02	165	190	39	0	115%	618%	10%	-	-
Webzen / WZEN	2.60	108	116	10	9	108%	>999%	19%	-	-

[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 latest 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/

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	EV	Net Debt/ Equity	TBV/ MV	LTM EBIT	Insider Own.	# of Insider	
								Buy	Sell
Kaiser Aluminum / KALU	28.08	563	574	1%	140%	-91	2%	10	-
Calamos Asset Mgmt / CLMS	6.33	124	-26	-100%	121%	122	1%	10	-
CDI / CDI	10.16	192	132	-21%	121%	25	10%	7	-
Intevac / IVAC	5.89	129	92	-21%	125%	-31	4%	7	-
Haynes International / HAYN	22.82	274	270	-1%	120%	83	2%	5	-
Stage Stores / SSI	11.41	433	464	7%	101%	-44	1%	4	-
Zoltek Companies / ZOLT	7.98	275	276	0%	117%	19	19%	4	-
Spherion / SFN	3.11	163	195	9%	178%	-136	1%	4	-
THQ / THQI	4.06	272	154	-29%	130%	-358	1%	3	-
Vishay Intertechnology / VSH	4.18	780	814	2%	175%	-1,662	8%	2	-

[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	EV	LTM EBIT	TBV/ MV	Forward P/E	Insider Own.	# of Insider	
								Buy	Sell
Canon / CAJ	31.54	38,926	32,162	4,945	69%	40x	11%	-	-
Reed Elsevier / RUK	27.99	7,717	7,717	685	10%	9x	1%	-	-
Lufthansa / DLAKY	12.40	5,678	6,468	1,827	138%	40x	1%	-	-
Fairfax Financial / FFH	258.00	4,718	4,963	2,444	101%	n/a	9%	-	-
Garmin / GRMN	22.21	4,451	3,742	862	45%	9x	46%	8	-
Makita / MKTAY	24.19	3,332	2,665	615	84%	n/a	17%	-	-
Kinder Morgan Mgmt / KMR	41.14	3,209	3,209		73%	24x	15%	3	-
Allegheny Tech / ATI	28.30	2,774	2,814	869	64%	9x	1%	-	-
Foster Wheeler / FWLT	20.68	2,614	2,056	604	11%	9x	0%	1	-
KBR / KBR	15.13	2,434	1,289	541	53%	9x	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
Greenlight Capital Re / GLRE <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	\$15.71	+44.8%	-3.9%
EchoStar / SATS <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	\$15.93	+7.3%	-1.0%
Microsoft / MSFT <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	\$19.35	-1.8%	-1.0%
Capital Southwest / CSWC <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	\$78.64	-10.3%	-0.5%
Crawford & Co. <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 \$8.42	2/9/09 2/9/09	\$4.13 \$6.46	-\$1.40 -\$1.96	-0.5%
Profit per Crawford share				+\$0.56	
K-Swiss / KSWK <i>BUY – No major change to thesis or valuation</i> Shares continue to trade roughly at tangible book value, despite good normalized economics and strong management	\$7.80	3/20/09	\$9.28	+19.0%	+9.5%
Sierra Wireless / SWIR <i>HOLD – The gap to fair value has narrowed somewhat. While the upside remains large, the downside risk has increased.</i>	\$2.89	3/20/09	\$4.81	+66.4%	+9.5%

Correction: In the January issue of *Downside Protection Report*, we presented a valuation analysis of Microsoft. When valuing the Server & Tools business, the table incorrectly showed total LTM operating profit instead of Server/Tools operating profit. When corrected, fair value changes from the published range to a range of \$23-30 per share.

Want to turn academic insight into investment performance?

The Manual of Ideas has partnered with Empirical Finance to bring you

Empirical Finance Research Newsletter

Read the current issue FREE
www.manualofideas.com/empirical



Enter your email and click "go" to join our Ideas & Wisdom list

We will alert you when future issues of Empirical Finance Research Newsletter become available.

What Can Investors Learn From The Latest Academic Studies?

Find out in:

Empirical Finance Research Newsletter: Turning Academic Insight Into Investment Performance

Wesley R. Gray, University of Chicago
Andrew E. Kern, University of Missouri

A Monthly Newsletter Published By Empirical Finance, LLC.
Brought To You By *The Manual of Ideas*



FREE Research Paper: *Fundamental Value Investors*, a study of ValueInvestorsClub.com performance, by Wesley R. Gray and Andrew E. Kern

Read the Empirical Finance Research Newsletter for FREE:



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.

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.”

—MOHNISH PABRAI, MANAGING PARTNER,
PABRAI INVESTMENT FUNDS

“The thoroughness of the product coupled with the quality of the content makes it an invaluable tool for the serious investor.”

—TIM DAVIS, MANAGING DIRECTOR,
BLUESTEM ASSET MANAGEMENT

“We do similar work ourselves.”

—GLENN GREENBERG, MANAGING
DIRECTOR, CHIEFTAIN CAPITAL MGMT

“Outstanding.”

—JONATHAN HELLER,
EDITOR, *CHEAP STOCKS*

“The best institutional-quality equity research to come along in a long time.”

—PAVEL SAVOR, ASSISTANT PROFESSOR
OF FINANCE, THE WHARTON SCHOOL

FIND OUT WHAT THE BUZZ IS ABOUT.

THE MANUAL OF
Ideas

WWW.MANUALOFIDEAS.COM