PORTFOLIO MANAGER'S REVIEW

THE MANUAL OF **Ideas** SERIOUS IDEAS FOR SERIOUS INVESTORS™

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

Edited by the *Manual of Ideas* Research Team

"If our efforts can further the goals of our members by giving them a discernible edge over other market participants, we have succeeded."

Top Ideas In This Report

Contango Oil & Gas (NYSE: MCF) .... p. 54

Exterran Holdings (NYSE: EXH) .... p. 57

Pfizer (NYSE: PFE) ....p. 60

Also Inside

Editor's Commentary .... p. 5

Portfolios with "Signal Value" .... p. 6

Interview with Brian Bares ....p. 29

100 Superinvestor Stocks .... p. 34

Value Investing Seminar Notes p. 116

About Portfolio Manager's Review

Our goal is to bring you equity 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 screening methodology to identify opportunities that are not yet widely followed by institutional investors.

John Mihaljevic, managing 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.

THE SUPERINVESTOR ISSUE

- ► **Snapshot of 100 companies owned by superinvestors**
- ► **22 companies profiled and analyzed**
- ► **Proprietary selection of Top 3 candidates for investment**
- ► **Plus: Latest holdings of top investors**
- ► **Plus: Exclusive Interview with Brian Bares**
- ► **Plus: Exclusive Notes from Value Investing Seminar, Italy**

Superinvestor companies mentioned in this issue include Abbott Labs, Abercrombie & Fitch, Alleghany, Allegheny Energy, Allergan, Alliance One, Allied Healthcare, Allstate, AmeriCredit, Apollo Group, Aspen Insurance, Automatic Data, AutoNation, Bank of America, Becton, Dickinson, Bel Fuse, BioFuel Energy, Brookfield Prop., Burlington Northern, Campbell Soup, Capital Southwest, CapitalSource, Cardinal Health, CF Industries, Coca-Cola Company, Comcast, Contango Oil & Gas, Coventry Health, Crosstex Energy, Dell, DIRECTV Group, Discovery Comms, DreamWorks Animation, EMC Corp., Exterran Holdings, Fairfax Financial, Forest City, General Electric, Genworth Financial, Health Net, Hertz Global, Hewlett-Packard, Humana, Intelligent Systems, International Assets, International Coal, Jefferies Group, Johnson & Johnson, Leucadia National, Level 3 Comms, Liberty Acquisition, Liberty Entertain., Lockheed Martin, Magna International, Market Leader, McDonald's, MI Developments, Microsoft, ModusLink Global, Monsanto Company, Nabors Industries, News Corp., Northrop Grumman, Odyssey Re, Omnicom Group, Overstock.com, Pfizer, Philip Morris, POSCO, Potash Corp., Procter & Gamble, Republic Airways, SAP, Sears Holdings, Smithfield Foods, Spirit AeroSystems, St. Joe, Stanley Furniture, Strayer Education, Sun Microsystems, Sycamore Networks, TAL International, Target, Tejon Ranch, Theravance, Transatlantic, TravelCenters, tw telecom, U.S. Bancorp, United Am. Indemnity, Varian Medical, Visa, VistaPrint, Wal-Mart, Walt Disney, WellCare Health, Wells Fargo, Wyeth, Yahoo!, Yum! Brands, and more.

(profiled companies are underlined)

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Exclusive Interview with Brian Bares

We are pleased to bring you an interview with Austin, Texas-based investor Brian Bares this month. Bares started his investment firm, Bares Capital Management, in 2000, focusing initially on micro-cap public companies. The firm launched a small-cap institutional strategy in 2001 and now manages assets in two value-oriented strategies. Bares Capital Management is quite unique in the institutional asset management world, as it has adhered to a disciplined business strategy, limiting the growth of assets under management to benefit investment performance. Both of Bares's institutional strategies have beaten their respective benchmark indices by wide margins since inception.

Brian Bares
Bares Capital Management, Inc.

"Our competitors have a difficult time running a strategy like ours because success creates profit motives that tend to move them up the market cap spectrum or into excessively diversified portfolios..."

MOI: **Since starting your firm nearly ten years ago, you have focused on investing in small public companies. What prompted this focus, and has your approach changed at all in light of the fact that many large companies have looked inefficiently priced recently?**

Brian Bares: There are really two reasons for our focus on small companies. The first is that small companies are more likely to be inefficiently priced. Our investment process mandates a comprehensive understanding of our portfolio companies. It is much more likely that we can profit from this understanding in small caps, where information scarcity allows for opportunity. We also cap assets to maintain our focus on small companies. Our competitors have a difficult time running a strategy like ours because success creates profit motives that tend to move them up the market cap spectrum or into excessively diversified portfolios in order to accommodate a larger asset base.

The second reason is structural. Our firm manages money in replicated separate accounts, and our relationships are largely direct with foundation and endowment clients. These clients employ many specialist managers in a number of different niche areas. They understand that our value to them is our area of competence — small-company common stocks. And they pay for our best ideas as we typically hold between 10 and 20 positions. Our clients allow us to do this because they have other managers looking at mid- and large-caps, international, commodities, real estate, etc. So we have really absolved ourselves of making many difficult macro and asset allocation decisions. Instead, we simply hunker down and focus on our little corner of the market. Our success is judged against small company benchmarks. The only time we think about what is happening with large-caps, international stocks, and other asset classes is when factors affecting these could affect the underlying business performance of the companies we own.

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MOI: **When it comes to stock selection, what are the key criteria you look for? Is there a price at which you would buy into a bad business, or do you weed out such companies before valuation even enters the picture?**

Bares: We are unique in that we start with qualitative analysis. Our research process begins with company-level information. We want to understand on a very detailed level exactly what a company does, who it competes against, and the forces affecting its ability to earn sustained economic profits over long periods of time. We also want to understand the motivation of the people running the company. Are there incentives in place to align management's success with the success of passive shareholders? Is management doing what they said they would do? What is their history? Questions like these and many other qualitative factors are examined before we allow a company to be considered for the portfolio.

Only after a company meets our internal qualitative criteria, and only after the idea has gone through an internal presentation and discussion, will we do valuation work. We understand that this process is the reverse of many managers, but we want to prevent ourselves from being drawn into seductively cheap subpar businesses. Our process is built specifically to guard against this. We understand that it is hard for resource-constrained small-cap managers to look at the thousands of companies in their universe. Most of our competitors compensate by using a multi-factor screening tool to help whittle down their investable universe. The problem with doing this is that backward looking accounting data tells you very little about a company's current competitive position, management, strategy, and all of the things key to the internal compounding that will determine your success or failure as a stockholder.

"…this [investment selection] process is the reverse of many managers, but we want to prevent ourselves from being drawn into seductively cheap subpar businesses."

MOI: **High returns on capital are generally of little value if they can't be replicated with reinvested capital for a long period of time. Many businesses with apparent sustainable competitive advantage — such as Polaroid or The New York Times — actually had no such advantage. How do you determine the sustainability of competitive advantage?**

Bares: That is a great point, and one that debunks multi-factor screening as a useful tool, in my opinion. A screen for high returns on invested capital may provide you with a list of companies that did well in the past, but tells you nothing about what will happen going forward. And for the going concern, value is 100% driven by what happens in the future. Our process is shaped by the premise that stock returns will follow the value created by internal business compounding over time, and that above average-business compounding will inevitably decline through competitive forces absent a durable advantage. Not to beat a dead horse, but this is why we spend so much time on the qualitative issues that influence internal compounding.

As you illustrate, competitive advantage is most often temporary. Even though we think of ourselves as long-term investors, we have the luxury of a liquid portfolio. This allows us to be decisive and sell out of a position if we perceive deterioration in a company's competitive position.

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To determine the sustainability of a company's advantage, we must look at all of the factors that make the company unique, and understand how their positioning fits within their industry. We walk through a Porter's "five forces" analysis of each of our ideas before they make it into the portfolio. We try to assess management's competitive strategy. Each idea is very different; some companies have natural network effects that create huge barriers to entry, some have IP or trade secret protections, some lock-in their customers through complexity and contracts, some have locked-in superior distribution, and so on. We're not perfect in our analysis, but we usually have a good handle on the competitive threats facing our businesses. In the case of The New York Times, their historical advantage was real, but certainly not permanent. And this may be presumptuous, but we feel like we would have sold Polaroid long before the mass adoption of digital photography had we been investors. We have gotten it wrong in our portfolio before, and we will again. The keys for us are to get it right a lot more than we get it wrong — which in our opinion is easier with a concentrated portfolio — and to be decisive in our selling when we recognize deterioration in competitive position. I think our track record over the last nine years illustrates above-average execution in these two areas.

"…experience has taught us that personalities vary widely, and we are very careful not to let likability or other traits bias our assessment of their capability as managers."

MOI: **Do you insist on meeting the senior management of your investee companies? If so, what do you focus on in such meetings?**

Bares: Yes, with perhaps one or two exceptions where phone conversations give us the information we need. After meeting with hundreds of managers over the last nine years, we have developed a baseline for comparison. We can usually spot exceptional managerial talent. But experience has also taught us that personalities vary widely, and we are very careful not to let likability or other traits bias our assessment of their capability as managers.

Our focus in these meetings is on better understanding the business, products, and competitive dynamics. Once we feel like we have a good handle on the business, we move on to discussions about incentives, and how management has executed against what they said they would do. We also like to focus on how managers think about capital allocation. Will they invest internally or use capital for acquisitions? Asking management about their Board's thinking on dividends versus buybacks is often a very insightful conversation.

MOI: **Some have argued that value investors can no longer ignore macroeconomic forecasting in investment decisions. How do you incorporate the macro outlook in investment selection, if at all?**

Bares: As I mentioned previously, we attempt to understand how various macroeconomic conditions would affect the portfolio of businesses that we hold, but we do not spend an inordinate amount of time on digesting macro data.

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One key point that we do debate internally is the extent to which poor macroeconomic conditions would affect not only the earnings of our portfolio companies, but their earnings power. A competitively advantaged company can consolidate power within an industry as weaker competitors become casualties of a poor economy. The survivors stand to gain share and, ideally, an improved competitive position that will allow for much higher earnings down the road.

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

Bares: We do exactly one computer screen on market cap that identifies our constituent investment universe. From that point it is old-fashioned hard work. Our research analysts are free to follow their intellectual curiosities. I want to foster a collegial environment where people are constantly exchanging ideas. If I constrain people to specific sectors, or task them to write up a specific idea, they may not go the extra mile to get an idea as polished as it can be. We have had ideas come to the table from researching competitors. Others have materialized by visiting management simply because we are in the area. And some have come to our attention through shared board members or founders.

"We have a very important discussion about what our advantage is in researching a specific idea. We love it when there are behavioral reasons for pervasive contrary opinions."

Anytime one of our research analysts comes up with an idea, it is presented in a formal process internally. The idea needs to meet our qualitative criteria for competitiveness and management capability. We also have a very important discussion about what our advantage is in researching a specific idea. We love it when there are behavioral reasons for pervasive contrary opinions. We also take pride in knowing that our research is better than what is out there, both from the sell and buy sides.

***MOI:* What is the single biggest mistake that keeps investors from reaching their goals?**

Bares: My experience tells me that individual investors run into the most trouble with the simple things: saving habits, proper diversification, and sticking to their investment policies. My peers in institutional investing probably run into the most trouble when they mistake familiarity with excellence. You may know everything there is to know about an idea, but that doesn't necessarily make it a good idea. Also knowing when you have an edge is very difficult, but in my experience it is the critical factor that allows us to stand out in the ultra competitive world of institutional money management.

***MOI:* What insights have you gained from the market turbulence of '08-09?**

Bares: It reinforced our belief that conservative capitalization benefits strong firms over the long-term. Leverage may marginally improve ROE in good economic times, but it can kill a company in poor economic times. We obviously witnessed this in the last two years.

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***MOI:* When it comes to the business of investment management, have you found it difficult to grow your firm while managing a concentrated portfolio invested in small companies? How do you identify investors who have the right mindset and time horizon?**

Bares: We have stayed relatively small by structure, as capping assets early in anticipation of portfolio growth was our main objective. We view this as a competitive hurdle that we have been able to jump. Our flat asset-based fee structure without associated performance fees has limited our economics somewhat, but we have been fortunate to partner with long-term foundation and endowment clients who have made, and kept, a commitment to us. We have not had any institutional clients leave us in the history of our firm. As we grow our firm, we will continue to do so slowly and deliberately. We have no marketing people on staff, and the extent of our proactive marketing efforts will simply be my visits with foundation and endowment offices when I am out researching companies. We have also received some inbound interest as our name becomes better known in the industry.

"I think all investors would be well served to read Pat Dorsey's 'The Little Book that Builds Wealth.'"

***MOI:* What books have you read in recent years that have stood out as valuable additions to your investment library?**

Bares: I think all investors would be well served to read Pat Dorsey's *The Little Book that Builds Wealth*. I also liked *Creating Shareholder Value* by Alfred Rappaport.

My favorite reads are usually business biographies. I just finished Stacy Perman's *In-n-Out Burger, A Behind the Counter Look at the Fast Food Chain That Breaks All the Rules*. I loved it. It shows what kind of personality, commitment, intelligence, and drive it takes to create an enduring business. I think reading like this helps us in our identification of individuals and business models with the right recipe to grow meaningfully larger.

***MOI:* Brian, thank you very much for taking the time to interview with us.**

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