

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."

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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 research team has extensive experience in industry and security analysis, equity valuation, and investment management. We bring a "buy side" mindset to the idea generation process, cutting across industries and market capitalization ranges in our search for compelling equity investment opportunities.

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- ▶ Snapshot of 100 "cheap" and "good" companies
 - ▶ 20+ companies profiled by MOI research team
- ▶ Proprietary selection of Top 5 candidates for investment
 - ▶ Plus: Superinvestor holdings update
 - ▶ Plus: Exclusive interview with Michael van Biema

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Inside:

**Exclusive Interview with
Michael van Biema,
founding partner of
van Biema Value Partners**

*With compliments of
The Manual of Ideas*

Exclusive Interview with Michael van Biema

We recently visited the offices of van Biema Value Partners in New York, where we spoke with the firm’s members, including Michael van Biema, Chris Kehoe and Sam Klier. van Biema Value Partners specializes in investing in funds managed by value-oriented investors, many of whom are managers investing relatively small amounts of capital. van Biema’s firm manages portfolios of hedge funds in the U.S., Europe and Asia. Michael van Biema is co-author of *Value Investing: From Graham to Buffett and Beyond*.

The Manual of Ideas: Tell us about your investment approach and the genesis of your firm.

Chris Kehoe: Michael started the firm five plus years ago after teaching at Columbia for twelve years. It was there that he developed a value philosophy and a great network of up-and-coming and established money managers. Michael thought he could create an investment vehicle that took advantage of the best niche value managers. His thinking was to find managers of smaller size, but not necessarily managers that lacked experience. He realized that there are some managers that have been managing money for many years that purposely want to stay small. Michael gathered some of the current board members [of van Biema Value Partners] and brought them the idea. They liked it and decided to put their own capital to work as an experiment. That experiment was successful and they decided to launch the firm. The first fund launched in the U.S. in 2004 and concentrated on domestic fund managers. In 2008 an international fund was launched and, most recently, an Asia-focused fund.

So the basic investment thesis was to invest in smaller managers that can be flexible, can invest across different capital structures, are willing to short on an opportunistic basis, with the ability to provide diversified exposure to the value style of investing.

Michael van Biema: The funds have a relative simple concept. The concept came from reading Warren Buffett’s “[The Superinvestors of Graham-and-Doddsville](#),” where he wrote that the great value investor of his generation had a couple of things in common. The first one was that they produced terrific long-term track records. The second was that they all had periods of big drawdowns (somewhat less attractive). Finally, and one of the key things for us, was that when he looked at the historical performance, their performance didn’t correlate strongly.

A thought occurred to me that there were a number of small value shops out there that I was aware of, and that it would be interesting to see if what Buffett had observed in his generation of value managers held true for the current small value managers of today. So we pooled some of our own money — my own and from our board — and ran the fund for awhile as, more or less, a social experiment to see if Buffett’s theory still held true.

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One of our first big concerns was whether we could find enough high-quality small managers to populate a reasonably sized fund. That question was answered quickly as I went around to the members of the board to ask for names. I got over one hundred names of small value shops that had been around for awhile or in which our board members had already invested. We had a list of managers among whom many had already closed their funds. From my perspective this was a good sign because it meant that the board was picking out guys that were disciplined, controlled and closed their funds with relative modest sizes. Of the ones that were not closed, which was somewhere between 35 and 45 managers, we picked 20 managers to start the portfolio.

We discovered the exact same thing Buffett mentioned: the managers' performance didn't correlate strongly. We didn't know if they were going to produce above-average long-term returns, but there was a decent amount of evidence that suggested they would. The other big hypothesis we had was that the portfolio would provide significant downside protection. We really had to wait until 2008 to see if our hypothesis was correct.

Basically, when I watched the fund from a quasi-theoretical point of view, it was my belief that the fund would be able to capture about 75% of strong upside markets and less than 25% of strong downside markets. To date the fund has captured 75% or more of strong upside markets and has captured less than 50% of strong downside markets. So it hasn't done as well as I thought it would in down markets. However, the statistics may be slightly skewed by the events of 2008.

What's extremely reassuring to me is that these funds — at least the ones that were in existence at the beginning of 2008 — showed the same pattern, which was a pattern I had predicted: They followed the market down at the beginning of the drawdown, but leveled out long before the market leveled out, which makes sense intuitively. If you're buying stuff that's already cheap, there is a certain point where it becomes absurdly cheap, and even guys who are panicked will quit selling, because they're just going to say, "I might as well hold onto this." And that's exactly what happened. So in the beginning of 2008 we followed the market down and then we leveled off nicely.

MOI: The fact that value portfolios tend to be more concentrated and more volatile in the short term seems to fit well with what you are doing as opposed to other funds of hedge funds, which look through to vehicles that themselves are trying to have low volatility. It seems that what you're essentially doing is grouping guys who are going to be volatile and, hopefully, not very correlated, and therefore there's a value created in the process...

van Biema: If you care about volatility, and certainly a number of our investors do, this strategy takes small, highly concentrated managers, and puts them together in a portfolio where you get, to a certain extent, the best of all worlds, because you have a group of highly focused managers without getting the risk and volatility that comes with investing in a highly concentrated manager.

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MOI: Do your managers employ short selling as part of their investment strategy?

van Biema: They do, but our underlying managers are strongly long biased, as you would expect for true value managers. Yet, they all are allowed to short securities. Some of them choose to short, while some seem to do it infrequently, but they all seem to do it if opportunities arise. Their short positions are generally not for hedging purposes or insurance on their portfolios, but are opportunistic — what we would call moneymaking shorts. They may come across a short idea when they're searching for new long ideas, where some obscene comparative values don't make sense and shorting the company makes sense.

Shorting is not a huge component of our returns, and we don't expect it to be a big component of returns. We don't expect shorting to protect us significantly on the downside. What protects us is that these guys are buying cheap stocks; we do expect that shorting will add a little extra return.

Our managers are very opportunistic. To give you an example, at the beginning of 2009 they moved dramatically out of equities and into fixed income securities. They were ahead of or leading the curve. In talking to some institutional investors, the lament I got was they started to understand that this was a huge opportunity in March or April of 2009 when it really began in October 2008. It took them several months to figure out there was money laying in the street. Then it took them another two or three months to implement the strategy, and by the time they got around to it, it was the fall and the greater part of the opportunity had disappeared. Our guys started to get there at the end of 2008, and for them it was a no brainer. The managers were out there buying fixed income securities generating “equity-plus” returns, 30% to 40% in some cases, and at a minimum 20%. The fixed income securities were short-term money good, these were companies that had many, many times coverage, if you picked the right one. At the beginning of 2009, no really knew how to predict anyone's earnings, and so why were you going to buy equity in the company if you thought it was a good company, and even if you thought it was cheap. If you could go out and buy debt and get a guaranteed return, you didn't really need to be concerned about earnings over the next year.

MOI: You also didn't need to worry about catalysts. As Seth Klarman has discussed with regard to fixed income, you have a time table, so if you're right, you're going to be proven right on a specific date. Meanwhile, with equities, you're a little more dependent on the market...

van Biema: One of the things that we think a lot about is how we can generate returns for our investors with the lowest possible risk. I'll give you a wonderful example from our global fund. We have a Dutchman, who is one of our managers and lives in England. The only things he invests in are English “net net” securities — that's his niche. He has a tiny little fund and has been running it for 14 years and has produced high-teen returns over the period. There are times when he doesn't find a lot of net nets, and he may have 60% cash. There are other times, like in 2008 or the beginning of 2009, where he finds a ton of net nets, and he's close to fully invested. He made a 65-70% return in 2009. You can sit around and twiddle your thumbs for a few years if you get a return like

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that every once in awhile. We like these small niche managers that have a specialized investment strategy. It helps our fund in terms of our manager correlation.

Our domestic fund has been running at a 7% positional overlap — very low, if you consider that you are hiring a set of guys who are focused on the same universe of stocks. They're small, dedicated value managers picking U.S. equities, which for the most part are small- and mid-cap U.S. equities. You would think there would be substantial overlap in holdings, and it was one of our fears when setting up the business. But in reality we have consistently run in the 7-8% positional overlap range. This is partially because value managers in general are idiosyncratic in nature, but it is also in part because we try to pick managers who are in the Graham-Buffett spectrum of managers. Some of our guys are much closer to being more Buffett-like, while others have investment styles that follow Graham.

MOI: Can you tell us what information you receive from your managers, and how you track them?

van Biema: We basically have full positional transparency with our managers. It comes in slightly different flavors, but we will not keep a manager over the long term who won't open his positions to us. The reason for that is very simple. Our investment team, Chris Kehoe and Alan Kahn and myself, could be practicing fund managers themselves, and they know how to pick and analyze stocks — it's a check to make sure that our managers are investing in the "real thing." If we discover that one of our managers is investing in stuff we don't understand, and we call him to have it explained, and if we still don't understand, then we usually have a problem with the manager. We'll then call the manager in front of the board to help point the manager in a more fruitful direction. Sometimes this works, sometimes it doesn't.

MOI: Are you typically one of the biggest investors in the funds you invest in?

van Biema: Yes, we are. Unlike many institutional investors, we don't have a problem with being a large percentage of a particular fund. To some extent, it makes for a strong relationship. Our managers have relatively low operational risk even though they're small businesses. The reason is that our managers have either been doing this for a long time and demonstrated that fact, or that they have come out of shops like Klarman's [Baupost Group], which are "grade A"-type shops. They've been seen a shop running properly, and if we're hiring them, they're smart. We made a mistake early on and hired a manager outside the mold — he had worked for a large institution. He was a pretty good investor, but once you took the large institution out of the picture, he just wasn't able to function well.

Now we exclusively invest in two types of managers. We either invest in a class of managers I call the "Wizard of Oz" managers or the "apprentice" managers. The "Wizard of Oz" managers are guys who like to stay behind the curtain. They don't really like to talk to investors very much and would prefer to stay behind the curtain and pull all the levers — they are really obsessed with running the investment business. They'll grow to reasonable size — a few hundred million dollars — and then they'll stop. If you ask them why they stopped, they say, "I'm making more money than I ever thought I would make. I know all my investors by first name. If I took on another billion dollars, I'd be

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richer, but it wouldn't really change my lifestyle, except that it might make it a little worse because I'd have to deal with all these people who run funds of funds and are a pain." That's one class, and the operational risk is very low. I used to say that the reputational risk was very low, but Bernie [Madoff] has given me a pause. The value investing community is a community that is very tight, and it is I believe less likely that you would have a rogue trader in the community.

The other types of managers that we invest in are what I call the "apprentice managers." Basically, the model is from the European guild system, whereby the managers have been trained by a "grandmaster," be it Seth Klarman, Marty Whitman, Chuck Royce or whoever it might be, and they're smart enough to stay in those shops for a good period of time — at least four years, in many cases eight to ten years. One of our managers worked for Seth Klarman for about ten years. He was a full partner, and then decided to go out on his own. Usually, when they leave, they leave with the blessing of the grandmaster, or at least in a graceful way. The guy that tutors them may give them some money to run; obviously, that is a positive sign. Luckily for us, we have a strong network, and if there's someone that leaves one of these shops, they'll call me up and say, "So-and-so is leaving," and then tell me whether or not they're giving the manager money or not. That's a strong indication of the quality of manager.

"We basically ask the managers we interview how they want to be remembered and what their goal is in running their business. The primary thing we want to hear is something along the lines of, 'I want to have a thirty-year track record I'm proud of.' If they say anything other than that, and in particular anything like being the biggest, it's usually a huge red flag."

So we think that by sticking to these two profiles we greatly reduce the overall risk of our managers, and we think that we get guys who are terrific investors.

MOI: This approach seems quite differentiated, especially in the fund-of-funds world, so it's no wonder you have found there to be a good opportunity for your approach...

van Biema: And it's a lot of fun, too. Our managers are almost always a real pleasure to deal with. They're all smart guys, they may be relatively young or relatively old, they're passionate about investing, and most importantly, they're passionate about generating a good return for themselves and their investors. Unfortunately, in our industry this has become more and more rare. It's shouldn't be about making money by raising huge amounts of assets, but about making money because you have your own money invested alongside that of your investors, and you're looking to a 20-to-30-year career generating mid- to high-teen returns. If you can do that, you don't have to worry about your finances.

MOI: In addition to having managers in the two buckets you described, are there other things you insist upon, perhaps in terms of having a big piece of the managers' net worth in the fund, in terms of the fee structure, or other aspects of the fund?

van Biema: It's almost natural for our managers to have a huge percentage of their net worth invested in their funds. If that's not the case, then it's definitely a source of concern to us.

We basically ask the managers we interview how they want to be remembered and what their goal is in running their business. The primary thing we want to hear is something along the lines of, "I want to have a thirty-year

track record I'm proud of." If they say anything other than that, and in particular anything like being the biggest, it's usually a huge red flag.

The other thing is that value outperforms over the long term, we don't need to convince you of that. But many people don't realize how true it is that "small is beautiful." We want our managers small. It is a lot easier to make a great return with a few hundred million dollars than it is to make a great return with a few billion dollars. That's why guys like Royce are so remarkable, because he has managed to continue to generate great returns with \$20-30 billion, and that is rare. And frankly, we don't even pretend that we'll be able to pick a bunch of Chuck Royces or Marty Whitmans or Seth Klarman. The probability of us picking a manager that is that good is probably relatively small. It would be great if all of our managers were that good, but it's not likely to happen. But since they are managing modest amounts of money, we think they will be able to generate attractive returns for us. They have a large universe of stocks to pick from. The thing that the big guys will tell you is how much more difficult business gets if you're successful. It's a curse of our industry: If you are good and successful, you naturally tend to increase the size of your asset base, unless you're disciplined. For those guys that are comfortable in growing a larger business, you also have to be comfortable with the fact that that your universe of stocks in the U.S. is going to shrink from 8,000 to a few hundred. And adding value on a few hundred stocks, each of which has 10 or 20 analysts — and one or two of them may actually be very competent — makes things much more difficult, than adding value on a stock that no one covers or few people have heard of.

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Kehoe: The other thing we look for [in managers], as an overall theme, is being opportunistic. This includes managers who view cash as a strategic alternative, don't look at being fully invested, are market cap agnostic, and focus on absolute returns.

MOI: Can you talk about your global and Asia funds and the similarities between the managers. How are they implementing the value strategy, and what differences do you see between your U.S. managers and your foreign managers?

van Biema: There's definitely a difference. Value in the U.S. is a well-known flavor, whereas in Asia a lot of our managers don't even know they're value managers, or certainly didn't know it before they met us. It's a funny thing because you'll walk into a manager's office in Hong Kong or Singapore, and there on his shelf is a copy of Ben Graham's *Security Analysis* or *The Intelligent Investor*, or even in a couple of cases a copy of my own book, *Value Investing: From Graham to Buffett and Beyond*. I don't know whether they did a Google search and went out and bought a copy, and prominently displayed it where I could see it when I walked in, or it was just a coincidence.

In certain countries like India, Warren Buffett is a national hero, so in India value investing is extremely well known. For many parts of Asia, no one has really heard of him or paid that much attention to him.

What you'll find in Asia is that you have these old families that have been in business for many generations and have accumulated a lot of wealth. They have a lot of different businesses; they're basically small conglomerates. Typically there's one scion of the family with a bunch of sons, and he will delegate one son to run the shipping business, another son to run the

construction business and there will be one son that will be in charge of managing the assets. And what happens is that if this person is particularly talented, other friends of the family have taken note and asked if they can add to the family's portfolio. Some of our money is with such organically grown money management businesses. The family may be half or more of a fund, there is some friends-of-the-family money, and in most cases we are the only investor from the U.S.

We find these people through our network, and would not have found them if we didn't have such a strong network across the globe. These guys are value investors, not because they went to Columbia or they were trained or read Security Analysis, but they grew up running one of the family businesses from a fundamental perspective. They understand how to run a good business, they understand the capital structure and the management of cash flows. When they start investing, they look for the things that U.S. value investors look for as well. It's kind of reassuring and neat to find these people because they have organically grown into being value investors.

The other thing about Asia, and why we think it is such a wonderful opportunity, is that the entire world focuses on Asia as a growth opportunity, including most Asian-based managers. So everyone is out there screening for companies that growing at 15-20% or more. If a company is not growing at 15-20% percent or more, it doesn't even show up on people's radar screens. What we see with our managers is that there are these strong franchise-type businesses growing at a miserable eight, ten or twelve percent — not bad if you're sitting in Europe or the U.S. Usually, those companies are the more established and better managed companies. It is open territory for our managers. Last year those companies were selling at 1x, 2x or 3x free cash flow; now they are selling around 5x or 6x free cash flow. So they're still great investments today.

MOI: What kinds of allocations are you targeting in your funds, for example in terms of equity versus fixed income exposure? Do you seek out managers who may apply a value mindset to other asset classes, such as real estate?

van Biema: Our managers invest in all publicly tradable securities, but their focus is on equity and fixed income securities. There are certainly a lot of opportunities out there, and there will be a opportunities to grow our business in some of those niche areas. But at the moment we've chosen to diversify across different geographies.

The next thing we'll probably do is look at different asset classes and interesting ways of putting small managers together in portfolios that are not differentiated by geography alone. We have some other ideas on how to find managers that would generate good returns, not just on a geographic basis. At this point we still have a lot of geography to cover. Currently, we covering Asia, the U.S. and developed Europe. We have been seriously looking at South America. There is interest in some emerging markets as well.

We don't want to have the same problem we try to avoid with our current managers — we don't want our funds to grow too big. We want to have small managers, with reasonably sized funds. We don't want to flood our managers with capital because that's self-defeating. So rather than building bigger funds, we'll close our funds and hopefully try to find other interesting ways to invest our client money.

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MOI: Do you ever take an equity stake in your managers?

van Biema: No, we don't. We carefully examined going into the "seed" business when we started. It might look like an attractive business, it's exciting, and a good marketing ploy, but if you're trying to sell people on the concept of "small," then it's a contradiction. The only way you make money with a seed fund is by growing the managers' asset size. The other problem is it takes a lot of time and effort, and there are a lot of issues if the manager is successful. We decided our way was a clean way to do things and not complicate the business with seeding funds. We are frequently approached by individuals that want us to seed them, which we don't do.

MOI: Do you ever lend a hand to your managers who may not have the infrastructure or may have questions about how they should comply with regulations?

Sam Klier: It's not so much compliance they are asking about, as most of their operations are relatively small. We do insist on best practices when we do operational due diligence calls or meetings. Our managers understand that we have exposure to the way many other managers operate, and can therefore offer valuable guidance. Couple this with the fact that we are typically a large part of their investor base, these managers are very receptive to our ideas and suggestions.

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Kehoe: I think there's one point that hasn't been stressed enough — it's importance of the board [of advisors]. We have a board that consists of the most successful and, perhaps, most long-standing value managers on the planet. They're not a titular board; they are fairly active. In the beginning they certainly provided manager ideas — and still do in the vetting process and the ongoing due diligence process.

MOI: Your view into the managers probably gives you insight into where value guys are finding opportunities at any given time. About 30% of the "look-through" portfolio was in financials at yearend 2009. Can you give us any insight into what your managers are seeing and where they are finding value?

Kehoe: The opportunity set has certainly thinned. The exposure to financials is one where in the first quarter of 2009 and the last quarter of 2008, there were some amazing opportunities, particularly on the fixed income side. Those opportunities, in many respects, are still ongoing, perhaps toward the tail end, but still ongoing. So that's where some of the exposure is. There is also some exposure to the equities of those financials. The opportunity set in general has narrowed significantly since the first quarter.

van Biema: Your question is a good one because you have to be very careful when you look at the sector charts. The financials number is typically one of the most misleading numbers in terms of exposure. For example, we used to have even more exposure to financials going into 2008, but most of those financials were actually SPACs [special purpose acquisition vehicles]. So it looks like they were in financials, but in reality they were in a cash-equivalent type of vehicle.

MOI: More recently there has been talk about a bubble in China. How do your Asia managers view this risk and what steps are they taking to protect their portfolios on the downside?

van Biema: One of the big concerns I've heard from our Asian managers is about inflation throughout a number of the Asian economies. One issue when trying to predict bubbles and understand the macroeconomics of the larger countries — China certainly falls into this group — is that you have so much government intervention, you can't really make any fundamental judgment. To the extent macroeconomics provided much insight in the past, it provides less insight today. In terms of the way we approach these markets is very simple. We watch carefully how invested our managers are and what they tell us in terms of how easy or hard it is to find value opportunities. When value opportunities start drying up, as they did at the end of 2007, it's usually a pretty good indicator that the market is overvalued. I don't think that has happened quite yet in China, but it is certainly moving in that direction.

We make regular trips over there, and that will certainly be something that we'll be talking to our managers about as we make our circuit through Asia. We're fortunate to have several extremely experienced investors in Hong Kong and Singapore who have spent a lot of time investing in those markets. We don't currently have any interest in the A share market. We don't have any managers on the ground in mainland China. All of the managers that provide us with Chinese exposure are either in Hong Kong or Singapore.

MOI: You've talked about the fact that you have the skill set in-house to actually add value to your managers. Do you ever develop a macro view and then ask your managers how they are positioning their portfolios?

van Biema: We're mostly observers and would comment more on individual positions. We actually look to our managers to give us local market intelligence. In Asian markets, you have to be more cognizant of the macro environment than you might in the U.S. It's important to keep good information flow in local markets. We have some country managers and some regional managers, and it gives us two different perspectives on what's going on within local markets. Typically, if a market is overvalued, the regional managers will be moving out of that market. The local managers will also be moving to either more of a hedged or cash position. If we see those two things not lining up, then we'll start talking to the managers, trying to figure out why one manager might be moving into Thailand while the other is moving out of Thailand. It's a terrific source of regional and local intelligence. And that's one of the things we can bring to our clients — give them insight into some of those markets, which are pretty difficult for an outsider to understand.

MOI: Thank you very much for your time and insight.

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