

Value Judgment

Market values diverge from intrinsic values often, if unpredictably. Ric Dillon's Diamond Hill Investment Group excels in its readiness to take advantage.

Ric Dillon has a ready answer when asked about conflicts of interest in running publicly traded Diamond Hill Investment Group: "In our minds there isn't a conflict, clients come first, shareholders second. That ends up being best for shareholders anyway."

Dillon's client-first mentality at the \$9.4 billion (assets) firm has produced enviable returns. Its small-cap strategy has earned a net annualized 11.6% since the end of 2000, vs. 6.2% for the Russell 2000. Its large-cap strategy over the same period has beaten the Russell 1000, 8.0% vs. 2.8%.

Finding relatively more to go long than to short, Dillon and co-CIOs Chris Bingaman and Chris Welch are finding value today in such areas as airlines, energy, bond insurance, routers and real estate. [See page 2](#)

INVESTOR INSIGHT



Diamond Hill Investment Group

(l to r) Ric Dillon, Chris Welch, Chris Bingaman

Investment Focus: Seek companies – to buy or short – whose market prices most diverge from the risk-adjusted values justified by their estimated future cash flows.

Asset-Backed Security

There can be good reasons why companies trade for less than their marked-to-market net assets. When there aren't, Ari Levy has proven ready to capitalize.

INVESTOR INSIGHT



Ari Levy

Lakeview Investment Group

Investment Focus: Seeks companies that combine a significant margin of safety from net asset value with a sustained ability to increase that asset value over time.

The seeds of Ari Levy's interest in investing were firmly planted as an undergraduate at Stanford, where he parlayed a facility for numbers and probabilities into heading a blackjack team and earning excellent returns betting on sports. "I'd like to believe I've moved on to a higher calling," he says.

His Lakeview Investment Group investors would certainly agree he has. Since starting his long/short hedge fund in early 2005, he's earned a net annualized 12.8%, vs. 5.2% for the Russell 2000.

Focused first on the tangible asset value backing any potential investment, Levy is finding opportunity today in such areas restaurants, industrial services, trade finance and retirement real estate. [See page 10](#)

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Investor Insight: Diamond Hill

Ric Dillon, Chris Bingaman and Chris Welch of Diamond Hill Investment describe why a return to “normal” is often a variant perception, how they try to learn the right lessons from mistakes, where they’re active on the short side, and why they see upside in Southwest Airlines, Assured Guaranty, Juniper Networks, Occidental Petroleum and iStar Financial.

Your focus on intrinsic value in assessing potential investments is both straightforward and refined. Describe how it drives your strategy.

Chris Welch: While we may not always be able to estimate it with great confidence, every stock has an intrinsic value that is independent of its current market price and tends to be far less volatile than that market price. That’s because market prices partly reflect investor emotions, while intrinsic values reflect business fundamentals. Given that over sufficiently long periods of time market prices tend to revert to intrinsic values, we’re simply looking to go long when the price is at a discount to a value we believe we can estimate, and to go short when it’s at a premium to that value.

What that typically means on the long side is that we’re assuming things remain more or less normal or get back to normal when the implicit assumption reflected in the stock price is that things are going to fall off or never recover. If you look at the big drug companies like Merck [MRK] and Pfizer [PFE], which we own, their current valuations imply earnings growth is going to be negligible indefinitely, while they’re currently growing better than that and are generating tons of cash flow to reinvest in the business or return to shareholders. Even assuming a steady state for their businesses, we think investors at today’s valuations will be well rewarded.

We don’t interpret meaning in how stocks are priced. People tend to think if a stock falls 30-40%, that must mean things are worse than they realize. We don’t think that way and just stay focused on our estimate of intrinsic value. It can happen that a stock falls 30% but we think the business value is down 50%, so we sell. More often the stock price falls 30% and we think the business value may have fallen only 5-10%, giving us an opportunity.

Explain the mechanics of how you estimate intrinsic value.

Chris Bingaman: Our research is predominantly bottom-up, beginning with a fundamental analysis of a company’s financial and competitive position, profitability, growth potential, capital needs and management quality. We’ll also look top-down on the competitive industry dynamics, secular trends, long-term capital flows and regulatory environment. The goal is to create a detailed financial model that estimates cash flow available to shareholders over the next five years. We tend to think about businesses in a normalized way – especially in the out years – where growth is competed away absent a wide moat, where excess returns on capital are difficult to sustain, and where the macroeconomic and capital-market environments are more or less normal.

With that model we’re able to calculate the present value of both the five-year cash flows and a terminal share value, calculated by applying an estimated terminal multiple to our year-five cash flow estimate. We discount both those values back to the present using a required rate of return, which reflects the riskiness of the cash flows due to things like industry cyclicality, competitive threats and the rate of technological change. In today’s interest-rate environment, required rates of return for most companies we analyze are from 8% to 12%. At the low end would be companies like Pfizer and Procter & Gamble; at the higher end would be firms like Juniper Networks and Assured Guaranty, which we’ll discuss later.

Is there a hurdle discount (to buy) or premium (to short)?

Ric Dillon: No. We won’t buy a stock above current intrinsic value or short one below, but we have rarely had trouble



Ric Dillon

Cultural Horizon

Value investors almost universally cite their long-term investment horizon as a competitive edge. If many investors are trying to bet where a stock will trade this quarter, this week or this afternoon, they may misprice stocks relative to where they’re more likely to trade in a “normal” environment years in the future. It’s on that mispricing that value investors seek to capitalize.

Ric Dillon has used a variety of methods to ingrain such a long-term focus in his Diamond Hill Investment Group’s culture. Employees can’t invest in equities for their own account, but only in Diamond Hill strategies. All analysts and portfolio managers are compensated primarily based on the performance of their specific ideas or funds, the power of which was enhanced three years ago by the funding of a limited partnership, now a mutual fund, for which there is not a single manager – each of the firm’s analysts has full discretion over one or more sector “sleeves.” Most importantly, performance is measured not on a calendar year or quarter, but based on five-year rolling periods. “In isolation, combining any of this with a value-investing discipline may not be unique,” says Dillon. “When you roll it all together, we think it can give us an edge.”

finding discounts or premiums. Remember, even if we bought something at our estimate of intrinsic value, embedded in that is a required rate of return that in most market environments would be fully satisfactory. How much better we can do than that depends on the market. In 2007 there was nothing selling at a 20% discount. In March 2009 we didn't take anything seriously that wasn't at a discount of at least 50%.

Can you generalize about situations companies find themselves in when they pique your interest?

CW: There's often no specific negative event. Most frequently we're finding high-quality companies that are plugging along with modest revenue growth, generating a lot of free cash and deploying that cash well, but they sell at no better than average prices when we believe they deserve a premium for the consistency and quality of their results. With short time horizons, people are looking for obvious catalysts, but that isn't overly important to us. If our analysis is correct and a company is meaningfully undervalued, that valuation will eventually serve as a catalyst.

A recent example would be medical diagnostics company Alere [ALR]. The company has been acquisitive and that seems to make the market nervous, but we believe it's well positioned as a provider of products that can help control rather than escalate health-care costs, and that as it focuses more on internal operating effectiveness and paying down debt, profitability will improve. There's no big news, just a solid company that we think the market isn't appropriately valuing.

CB: We also frequently find lesser-quality companies selling at extremely low valuations. This gets back to the idea that the market's short-term focus means it's slow to recognize that things can ever improve when they haven't gone well. We've added in the last quarter or two to our holdings in Hartford Financial Services [HIG], for example. What's changing for the better is that pricing on the property/casualty side of the business is clearly improving,

and management is actively pursuing opportunities to shrink or dispose of underperforming life insurance businesses. As the share price gets to a 25% discount or more to our fair value estimate of around \$29 – which reflects the assumption that the life insurance businesses are essentially worthless – we've used it as an opportunity to buy. [Note: HIG shares currently trade at just under \$17.]

Another example would be Popular [BPOP], Puerto Rico's largest bank. The company was hit hard during the mortgage crisis, but it has since acquired an-

ON SHORTING TODAY:

One focus has been on traditional retailers weighted down by a lot of fixed assets that are less necessary.

other large bank on the island in an FDIC-assisted deal and now has a commanding deposit market share that bodes well for deposit pricing. We think its loan-loss reserves are sufficient, capital levels are high, and it has some fee-income and payment businesses that are more valuable than the market seems to acknowledge. The stock rallied earlier this year, but as it has sold back off we've been back in. [Note: BPOP shares currently trade at \$15.60.]

What's attracting your attention on the short side today?

RD: More than half our short positions are in the consumer area. Although household debt levels have come down from the peak, consumer balance sheets are still stretched and are significantly supported by government transfer payments and low interest rates that won't be maintained indefinitely. Looking forward, we're still not optimistic about consumers' ability to increase spending.

One particular focus for shorts has been traditional retailers and department stores that are weighted down by a lot of fixed assets in a world where those as-

sets are less necessary. Macy's [M], for instance, has performed well fundamentally and that has been reflected in its stock-price performance. But as we look out at the secular challenges facing department stores, Macy's would appear especially vulnerable to decelerating sales trends over time, which to our mind doesn't justify the current share price [of around \$38].

Have you taken a position in fellow retailer J.C. Penney [JCP]?

RD: We have a high regard for [Pershing Square Capital's] Bill Ackman so his involvement was one of the few things that gave us pause, but we shorted the shares as they started going up late last year and early this year on the promise that the new CEO's various initiatives would work. The market seemed willing to give him a tremendous amount of credit immediately for ideas that will be difficult to execute in an extremely competitive space. That combination made it an attractive short.

Has the latest hit to the share price prompted you to cover?

RD: Not yet. We are mindful, in general, on the short side that time is often not on our side. Companies are in business to increase their value, so if you're short a company with an intrinsic value you believe is down here because the stock price is up there, growth in value over time will dissipate your short return. Even though we don't at all think it is now, there's a decent chance J.C. Penney will ultimately be worth \$40 per share. In the meantime, if our view continues to become the consensus view and the stock [now at \$27] fully reflects it, that's when we'll look to cover.

Describe your current investment case for Southwest Airlines [LUV].

RD: With the bankruptcy filing of American Airlines, Southwest is now the only airline that existed prior to industry deregulation in the late 1970s that has not gone through bankruptcy. It has been consistently disciplined and rational in an industry that has been plagued by competition

that hasn't been either for 35 years. The latest confirmation of that came earlier this month, when Southwest announced it was delaying the delivery of new Boeing jets in order to more tightly manage capacity with an eye toward increasing returns on invested capital.

As bad as the industry has been, we do believe that the dramatic consolidation and restructuring of the competitive set – with the American bankruptcy the final shoe to drop – is finally resulting in a more rational dynamic that will benefit all players. Plane manufacturers have also stopped their own mindless grab for market share in pushing new planes on air-

lines. Across the board, airline profitability and plane load factors are better than they've ever been and there are plenty of reasons to be optimistic those trends will continue.

Won't better competitors make things tougher for Southwest?

RD: Its cost leadership will be tougher to maintain, but the company still retains several operating advantages. The exclusive use of Boeing 737s saves money on maintenance and labor and facilitates faster turnaround times. The point-to-point route structure allows for more non-stop

destinations than anyone else offers and helps improve capacity utilization. Labor relations are still the envy of the industry, which is reflected in the service quality offered. Southwest actually pays people more, but because it has its planes in the air longer every day, labor cost per revenue mile is lower.

Given its relationship with customers – enhanced by things like not charging new baggage fees – the company doesn't use any of the online travel portals to sell tickets. That not only saves on commissions, but it cuts down on fare comparison shopping – because they buy directly through Southwest, most customers don't bother finding out whether they could save \$20 by flying with someone else. That type of brand loyalty is valuable.

You mentioned an effort to increase returns on invested capital. How do they plan to do that?

RD: Management is targeting a 15% return on invested capital within five years, up from around 10% today. There are probably another couple hundred million dollars of savings to be realized over the next twelve months from the acquisition of AirTran, which closed last year. The two airlines have recently been approved to operate interchangeably across routes and landing slots, which should allow better rationalization of the route structure and improved capacity management. Available seat capacity – reinforced by the delay in buying the new 737s – is flat-lining, which should bode well for pricing in a stable demand environment. Getting revenue per available seat mile up is a key way to increase ROIC.

With the shares at around \$8.90, how are you looking at valuation?

RD: The current share price approximates tangible book value and trades at about 10x our estimate of current normalized earnings.

If we build into our models a 12% ROIC within five years and discount future cash flows and terminal value back at 10%, we arrive at a current intrinsic value

INVESTMENT SNAPSHOT

Southwest Airlines
(NYSE: LUV)

Business: Largest U.S. airline based on number of originating passengers, providing primarily short-haul, high-frequency, point-to-point service to more than 70 cities.

Share Information
(@5/30/12):

Price	8.87
52-Week Range	7.15 - 11.92
Dividend Yield	0.5%
Market Cap	\$6.81 billion

Financials (TTM):

Revenue	\$16.55 billion
Operating Profit Margin	4.4%
Net Profit Margin	1.6%

Valuation Metrics
(@5/30/12):

	LUV	S&P 500
Trailing P/E	25.6	14.8
Forward P/E Est.	12.7	12.5

Largest Institutional Owners
(@3/31/12):

Company	% Owned
Capital Research Global Inv	12.1%
Primecap Mgmt	10.4%
T. Rowe Price	6.2%
Vanguard Group	5.5%
Manning & Napier Adv	4.6%

Short Interest (as of 5/15/12):

Shares Short/Float	3.7%
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LUV PRICE HISTORY



THE BOTTOM LINE

A more rational competitive set and ongoing integration benefits from its AirTran acquisition should allow the company to improve returns on invested capital, says Ric Dillon. Assuming a 20% increase in ROIC within five years, he pegs current intrinsic value at \$12. Assuming a 50% increase – the company's goal – fair value is \$15 today, he says.

Sources: Company reports, other publicly available information

of around \$12 per share. Given expected growth in the intrinsic value, that means the share price would roughly double within five years.

If we assume they hit their ROIC goal, the intrinsic value today is closer to \$15 and we believe the stock would triple, or better, in five years. We don't need to believe that to find the shares attractive, but instead it's icing on the cake.

Your position in bond-insurer Assured Guaranty [AGO] would indicate you don't shy away from controversy. Why is that well considered in this case?

CB: Assured Guaranty is sort of the only game left in town in the municipal-bond insurance business, having bought out one competitor in 2009 and watched the other two, MBIA and Ambac, essentially succumb to the financial crisis. While that's a nice competitive position to be in, there are still some big issues making life difficult for the company.

One is the future demand for municipal bond insurance, which represents about 80% of the company's in-force book of business. Assured has a double-A rating from Standard & Poor's, but its rating is currently under review at Moody's and we're assuming it's going to be downgraded by them all the way to the single-A category. Uncertainty around the rating is a big reason why Assured only "wrapped" 15% of single-A and triple-B rated municipal issues in the latest quarter – a low level of penetration considering Assured's monopoly position – and if the downgrade happens, that will further diminish the addressable market.

A second big issue is an ongoing exposure to structured-finance products insured prior to the housing crisis. It didn't insure the most toxic CDOs [collateralized debt obligations], but it has paid out nearly \$4 billion in losses on residential mortgage-backed securities [RMBS] it insured. That's been offset – with more likely to come – by \$2.5 billion recovered from deal underwriters through the enforcement of representation and warranty rights. There's still risk, however, that the loss levels in RMBS could go higher.

Finally, there is concern that defaults by issuers of tax-free bonds are likely to increase as states, counties and municipalities face continued financial pressure. With \$270 billion of par exposure to municipal issuers rated single-A or lower, a meaningful change in default rates would obviously be bad news for Assured.

Where's the good news?

CB: Part of it is that we're not expecting loss rates to get materially worse for either the insured RMBS or munis. Prospects for the RMBS issues are tied to the health of the housing market, which we believe has

essentially bottomed, so we consider the risks there to be both well understood and contained. It helps that we believe Assured should continue to recover losses from additional counterparties such as Credit Suisse and UBS.

On the muni side, loss rates may remain elevated, but we don't expect a major structural change in default experience. If you look at the details behind most such debt issues in terms of how onerous the debt service actually is and how stable tax revenues are, we don't see anything that would indicate a major structural change.

As for the ongoing muni-insurance business, the fact is that we can assume

INVESTMENT SNAPSHOT

Assured Guaranty
(NYSE: AGO)

Business: Bermuda-based provider of financial guaranty insurance and reinsurance, primarily to the municipal finance, structured finance and mortgage markets.

Share Information
(@5/30/12):

Price	12.17
52-Week Range	9.16 - 19.04
Dividend Yield	2.9%
Market Cap	\$2.22 billion

Financials (TTM):

Revenue	\$1.19 billion
Operating Profit Margin	19.5%
Net Profit Margin	12.9%

Valuation Metrics

(@5/30/12):

	AGO	Russell 2000
Trailing P/E	14.6	33.1
Forward P/E Est.	4.5	17.4

Largest Institutional Owners

(@3/31/12):

Company	% Owned
Invesco	10.8%
Wellington Mgmt	9.5%
Fidelity Mgmt & Research	6.8%
Vanguard Group	4.1%
Fine Capital Partners	3.6%

Short Interest (as of 5/15/12):

Shares Short/Float	2.9%
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AGO PRICE HISTORY



THE BOTTOM LINE

While several concerns make life difficult for the company, says Chris Bingaman, its shares are so beaten down that they have considerable upside just if losses on existing books of business don't get materially worse. Assuming zero new business and discounting future cash flows and terminal value at 11%, he pegs today's per-share intrinsic value at \$19.

Sources: Company reports, other publicly available information

they book zero new business in the future and we still arrive at an intrinsic value for the company much higher than today's share price.

What is your intrinsic value estimate against today's price of around \$12.20?

CB: Assured gets paid up front for its wrap and earns profits over the life of the bonds it insures, so there is a very predictable pattern of earnings over the next 20-plus years. Assuming no major surprises with respect to losses on the structured and muni sides, a pure run-off of the existing book of business, and an 11% required rate of return, we arrive at a current intrinsic value of around \$19.

And there are ways it might turn out even better. If Moody's doesn't downgrade to single-A and/or new-issue penetration stays at even 5%, our estimate of intrinsic value increases to \$21. In addition, the reps and warranty settlements could come in at an additional \$800 million to \$1 billion, significantly more than we've assumed in our models. Finally, as the company's exposures naturally expire, it should generate excess capital, which if used to buy back shares at a discount would be accretive to intrinsic value as well.

What's behind your more-cyclical bet on Juniper Networks [JNPR]?

CW: The company is a leading IP networking company with a strong position in the service-provider router market, which accounts for about 60% of sales. That market segment is a near duopoly, with Juniper and Cisco maintaining very high market shares over time and regularly leap-frogging one another with each new generation of products. Juniper just started shipping its T4000 router, which offers better performance than Cisco's competing product that was introduced in mid-2010. Market shares follow the product cycles to some extent, but the two companies have controlled around 80% of this segment for the past decade. For Juniper, routers are the clear value driver for the company over a smaller and less-profitable IP-switch business.

The opportunity here has been created for two primary reasons. One has to do with the router product cycle. New-product introductions often take a few quarters to produce results as service providers assess the new technology and how best to use it, and in the short term can lead to share loss as existing customers stop buying the existing product while waiting for the new one to be available. We're currently in that lull period with the T4000, which has made investors nervous.

The other factor is a pronounced decline in capital spending by global telecom carriers that are the biggest router buyers. That has hit Juniper hard – sales early last

year were growing at 20%-plus annual rates, while they've declined at mid-single digit rates in the last couple of quarters.

The question then is whether the lost share in the routing business and the decline in telecom-industry capital spending are permanent. If they are, this probably isn't a good time to invest in Juniper.

We'll guess you think otherwise.

CW: We do. In terms of market share, Juniper spends 20% of revenues on research and development efforts, which have traditionally been productive and innovative. We've seen nothing in our work

INVESTMENT SNAPSHOT

Juniper Networks
(NYSE: JNPR)

Business: Designs and sells infrastructure products and services used to create, manage and maintain private and public-access information-technology networks.

Share Information
(@5/30/12):

Price	17.26
52-Week Range	16.67 - 36.87
Dividend Yield	0.0%
Market Cap	\$9.14 billion

Financials (TTM):

Revenue	\$4.38 billion
Operating Profit Margin	12.0%
Net Profit Margin	7.1%

Valuation Metrics
(@5/30/12):

	JNPR	S&P 500
Trailing P/E	29.8	14.8
Forward P/E Est.	20.3	12.5

Largest Institutional Owners
(@3/31/12):

Company	% Owned
T. Rowe Price	16.2%
Vanguard Group	4.1%
Oppenheimer Funds	3.7%
Jennison Assoc	3.7%
State Street	3.6%

Short Interest (as of 5/15/12):
Shares Short/Float

3.3%

JNPR PRICE HISTORY



THE BOTTOM LINE

While the market seems to think otherwise, the loss in router market share and the decline in customer capital spending that are currently afflicting the company are likely to prove temporary rather than permanent, says Chris Welch. Reflecting that view, his estimate of current intrinsic value, assuming an 11% discount rate, is \$26-27 per share.

Sources: Company reports, other publicly available information

that would indicate that has changed or that the T4000, which we believe is going through typical growing pains, will turn out to be anything but a success.

Service-provider capex is driven largely by Internet traffic, the growth of which has slowed but is still likely to drive faster-than-GDP increases in carrier spending. We're expecting Juniper to be able to grow its top line at a high-single digit percentage rate over the next five years.

What do you think the shares, currently trading at \$17.25, are worth?

CW: Given the cyclical nature in the business, we apply the growth we expect to a normalized revenue base, which happens to be relatively close to today's run rate. We assume a normalized operating margin of around 20%, higher than today's level, which is cyclically low due to where the T4000 is in the product cycle and the pause in service-provider spending. Using an 11% discount rate and a terminal multiple in the mid-teens, we estimate today's intrinsic value at \$26-27 per share.

What are the biggest risks?

CW: One constant one is missing a product cycle and losing share to Cisco. Another would be if a brand-new technology in Internet-protocol networking came along. Through our own research and working with consulting firms like Gartner, we want to stay on top of new technologies that could disrupt an industry like this. That's always a risk, but we don't see anything today that causes us great concern.

Juniper's stock peaked at \$44 in early 2011. The fact that it's down 60% in 15 months suggests many investors here are investing on the latest quarter's growth rate. It's clear to us that the value of the underlying business did not go down by 60% in the past 15 months – that's the kind of disconnect we try to capitalize on.

What makes Occidental Petroleum [OXY] stand out to you among energy stocks?

CW: For several years we've believed that in a higher-oil-price environment, the ex-

ploration and production companies that had long-lived reserves and were best able to expand production were the most likely in the sector to create value over time. Oxy, which is the third-largest U.S. E&P company, fits that model very well.

The company has an impressive set of assets, anchored by massive reserves in California and in the Permian basin of Texas. The California assets have particularly long reserve lives, which assuming Oxy can consistently get the drilling permits it needs will support significant production levels for decades. In the Permian basin it owns prime acreage and is using technology expertise it has developed over

many years in horizontal drilling and enhanced oil-recovery techniques to significantly step up production there as well. Unique for a company its size, we expect Oxy to grow production overall by 7-8% per year for at least the next five years.

I'd emphasize the advantage that comes not only from the ability to produce faster, but also longer. There's always a risk with E&P companies when they have to replace reserves that they won't be able to do so economically. The fact that Oxy has locked in so many long-term opportunities makes it to our mind a higher-quality bet – which deserves a premium from the market that it's not getting.

INVESTMENT SNAPSHOT

Occidental Petroleum
(NYSE: OXY)

Business: Global exploration and production of crude oil and natural gas; also produces chemicals and operates midstream energy assets such as pipelines.

Share Information
(@5/30/12):

Price	80.29
52-Week Range	66.36 - 109.08
Dividend Yield	2.7%
Market Cap	\$65.12 billion

Financials (TTM):

Revenue	\$24.48 billion
Operating Profit Margin	43.4%
Net Profit Margin	27.7%

Valuation Metrics
(@5/30/12):

	OXY	S&P 500
Trailing P/E	9.6	14.8
Forward P/E Est.	9.6	12.5

Largest Institutional Owners
(@3/31/12):

Company	% Owned
Fidelity Mgmt & Research	4.5%
Vanguard Group	4.2%
State Street	3.9%
Wellington Mgmt	3.8%
BlackRock	2.5%

Short Interest (as of 5/15/12):

Shares Short/Float	0.8%
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OXY PRICE HISTORY



THE BOTTOM LINE

Chris Welch believes the company's well-located and productive reserves should allow it to grow production at a faster rate and for a longer period than peers. Assuming 7-8% annual increases in production, energy prices that match strip-futures prices and stable finding and development costs, he estimates the shares' fair value today at around \$115.

Sources: Company reports, other publicly available information

Do the company's non-E&P assets factor into your thesis at all?

CW: The chemicals business and mid-stream assets over their average industry cycles have had satisfactory returns, and the two businesses today account for about 10% of normalized company earnings. There's really nothing we expect to happen in either business, however, that would move the value needle one way or the other.

In estimating intrinsic value, what assumptions are you making about oil and gas prices?

CW: We're generally going with the strip futures prices over time, which five years out are around \$90 for oil and \$4.30 per Mcf for Henry Hub natural gas. With those prices, we estimate cash flows by assuming 8-10% annual production growth for oil and natural gas liquids, basically flat natural gas production, and finding and development costs that are more or less in line with current levels. For the terminal value we apply a 6x EV/EBITDA multiple to our year-five estimates. Discounting it all back with a required rate of return of 9%, our estimate of current intrinsic value is around \$115 per share. [Note: OXY shares currently trade at just over \$80.]

Are there political risks of note here?

CW: About 60% of the company's production and two-thirds of its total reserves are based in the U.S. That is not without political risk – tax rates can go up and the regulatory environment can blow hot and cold – but we generally prefer having more activity take place in North America than less.

Most of the rest of the production and reserves are in the Middle East and North Africa. Much of that is in relatively more stable countries like Abu Dhabi, Qatar and Oman, but roughly 9% of total reserves and 4% of production are in Libya, Iraq and Yemen. As oil companies go, we'd say Oxy's geographic risk profile is better than most.

What upside do you see in commercial mortgage REIT iStar Financial [SFI]?

CB: This is a broad-based commercial real estate lender and investor that was hit by a nearly perfect storm in 2008. Quite simply, it found itself as the crisis hit with liabilities that were almost entirely whole-sale-funded and assets that were entirely in real estate. We believe management has done an excellent job of preserving value at all levels of the capital structure, but that was a toxic combination and the past few years have been extremely difficult.

The analysis here rests almost entirely on what you believe the company's net

assets are worth. On a GAAP basis, total assets are \$7.6 billion, against which there are \$6.6 billion in liabilities, including bank lines, public debt and some preferred equity. That leaves common equity of about \$1 billion, which with 84 million shares outstanding translates to nearly \$12 per share in tangible book value. That's twice the current stock price [of around \$5.70].

We actually think the \$12 is low. Part of that is due to the fact that iStar's core \$3.1 billion gross loan portfolio appears to be conservatively marked. The company currently carries loss reserves of \$570 million against that portfolio. To put

INVESTMENT SNAPSHOT

iStar Financial
(NYSE: SFI)

Business: Real Estate Investment Trust that owns, operates and offers a wide variety of financing on commercial real estate, the majority of which is located in the U.S.

Share Information
(@5/30/12):

Price	5.67
52-Week Range	4.51 - 8.64
Dividend Yield	0.0%
Market Cap	\$478.3 million

Financials (TTM):

Revenue	\$433 million
Operating Profit Margin	n/a
Net Profit Margin	n/a

Valuation Metrics
(@5/30/12):

	SFI	Russell 2000
Trailing P/E	n/a	33.1
Forward P/E Est.	n/a	17.4

Largest Institutional Owners
(@3/31/12):

Company	% Owned
Valinor Mgmt	6.3%
Diamond Hill Inv	6.2%
Vanguard Group	4.8%
Centerbridge Partners	4.7%
Goldman Sachs	3.8%

Short Interest (as of 5/15/12):

Shares Short/Float	22.3%
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SFI PRICE HISTORY



THE BOTTOM LINE

Having been hit by a nearly perfect storm in 2008, the company has done an excellent job of preserving value and now has a conservative balance sheet that doesn't fully reflect net asset value, says Chris Bingaman. Correcting for what he believes are excess reserves and undervalued net leases, he estimates current NAV at closer to \$15 per share.

Sources: Company reports, other publicly available information

that in perspective, gross non-performing loans in the portfolio are currently at \$1.1 billion. If the loss content after netting out any recoveries on those NPLs comes in at 30-35% – which would be high – that would still leave \$185-240 million in reserves against the performing \$2 billion balance of loans. So to wipe out the remaining reserve would require 10% loss content on those performing loans. We think that's highly unlikely to happen in a portfolio with a weighted-average loan-to-value ratio of 76%.

We also think the \$1.7 billion net lease portfolio – properties owned by iStar and leased long term mostly to single, high-quality tenants – is undervalued on the balance sheet. Here we're going through the portfolio in detail and applying current-market cap rates to reported net operating income levels to derive estimates of market value.

The most difficult assets to value are the \$2 billion in combined real estate held for investment and "other real estate owned," which are properties acquired through foreclosure or in partial satisfaction of non-performing loans. The values will best surface when those properties are sold, but we're comfortable basically assuming the carrying values currently on the balance sheet. If management proves to be as conservative with these as we think it is elsewhere, all the better.

All told, we believe the true net asset value today is closer to \$15 per share.

How would you characterize the macro view on commercial real estate that's informing your analysis?

CB: It's fair to say we're basically assuming things muddle through and don't get worse from here. If commercial real estate values were to materially decline, our estimate of today's net asset value is almost certainly too high.

The short interest in the stock is more than 20% of the float. Do you imagine the bears have a less sanguine macro view?

CB: The bear case is likely a deterioration in commercial real estate values. They also

might assume the processing and disposition of the other real estate owned takes longer and yields lower sale prices than expected.

Value investors inevitably will come across situations with lots of shorts. As long as we're comfortable with our own independent assessment of value, it doesn't dissuade us.

Describe your ex-post analysis of positions.

CW: At the end of every quarter we get a report showing the holdings we had in each portfolio five years ago and how

ON MISTAKES:

We've learned that we often don't give companies enough credit for their fundamental strengths or weaknesses.

those stocks have performed over the ensuing five years. The goal is to assess the decisions we made and whether the estimates of intrinsic value upon which those decisions were based were properly done. We're looking for any tendencies – say, to overestimate revenue growth rates for a particular type of company, or to underestimate margins for another – that should be corrected in order to make better estimates of intrinsic value going forward.

One thing we've learned is that we often don't give companies enough credit for the fundamental strength or weakness of their competitive positions and business models. That has resulted in selling winners too soon, and in holding losers too long because we haven't had the imagination to see how bad things could get. You can never eradicate those kinds of mistakes completely, but it has made us more sensitive to both best-case and worst-case scenarios in our valuation analysis.

We also don't want to learn the wrong lessons from decisions we've made. We would be quite concerned, for example, if we sold a stock that hit our intrinsic value estimate and then it proceeded to tank.

That decision may have worked out well, but we likely got the fundamentals wrong about the business if it was about ready to turn down.

A few years ago we were short shares of Foundry Networks, the #3 player in the networking business behind Cisco and Juniper, when it got taken out by Brocade Communications at a significant premium. Clearly a bad outcome for us, but if it turned out Brocade overpaid and the acquisition results were highly disappointing, our analysis of Foundry may have been fine but we just got unlucky. In our view, that has turned out to be the case.

RD: Adding to Chris's point about recognizing fundamental strength, we have on the short side become much quicker to cut our losses – irrespective of valuation – when the fundamentals are coming in better than we expected. It's one thing if the fundamentals are deteriorating and in line with what we expect – that, we're more likely to wait out. But when things like revenues, margins and market shares are stronger than we forecast, that likely means we've underestimated the quality of the business and should step out.

Ric, you said two years ago that you planned to step down as Diamond Hill's CEO at the end of 2015. Why?

RD: As the largest shareholder, I want the best for the company and just felt it was time for the next generation to get increasingly involved in management. I'm no longer the CIO. I've stepped back from running small-cap and now I'm only the co-portfolio manager on the long/short strategy.

My employment agreement was redone so that the vast majority of my incentive compensation is in stock that only vests at the end of 2015 – if I leave before then, I get none of it. After that, I can only sell one-fifth of the shares over each of the next five years. My goal is to stay on as the PM of the long/short portfolios. I still love investing and as I get older I'll be happy to focus entirely on that one strategy, where I have most of my own personal investments. It all just seemed to fit. vii

Investor Insight: Ari Levy

Lakeview Investment Group's Ari Levy, Mike Nicolas and Tim Won explain how they marry old- and new-school value investing, which balance-sheet anomalies attract their attention, how they ferret out frauds, and why they believe Layne Christensen, Ruby Tuesday, Banco Latinoamericano de Comercio Exterior and Assisted Living Concepts are mispriced.

You launched your firm in 2004 with only three years of experience under your belt. How did you arrive at an initial strategy?

Ari Levy: The most direct influence was my time working for Advisory Research [VII, October 31, 2011], where the first emphasis is on marking assets and liabilities to market and determining the true net asset value supporting any potential investment. But behind that is a great deal of empirical research from people like Graham and Dodd, Roger Ibbotson and Fama and French showing the long-term outperformance of value strategies focused on smaller-cap companies that trade cheaply versus book value. The idea that as a starting point as an investor you look to pay no more – and ideally a lot less – than what you could realize if you sold all the assets and paid back all the liabilities has always been a powerful concept to me.

What we've tried to do is marry that Graham-and-Dodd type emphasis on margin of safety with the more modern version of value investing that focuses on a company's sustainable ability to generate returns on invested capital that exceed its cost of capital. For ROIC we use earnings before interest and taxes, divided by the sum of net working capital and property, plant and equipment, less cash. That measure consistently exceeding the cost of capital means the net asset value is likely to grow and the business can be worth considerably more than the net value of those assets.

We assume your best ideas typically have assets and liabilities that are not well represented by financial statements. Where are you most likely to find discrepancies?

AL: We do spend a lot of time accounting for the inefficiencies of generally accepted accounting principles, which are most prominent in longer-term assets.

That could be land held on the books at cost, which over time is worth something very different than cost. For example, there are four or five public companies that collectively own a healthy share of all the private land in Hawaii. So a company like Alexander & Baldwin [ALEX], which we own, that has been acquiring land there since the 1800s, reports land values that bear no relation to what they're worth today. When the company sells something, it can earn high-90% gross margins because the land is held at a minimal cost. The fact that this happens doesn't mean the stock is mispriced, but it can increase the odds that it is.

Any asset that can be depreciated is potentially valued at something materially different than current market value. When a company buys equipment or builds a building, it sets depreciation schedules based on useful lives and other accounting conventions, but those schedules know nothing about the future supply and demand for that equipment, or the occupancy levels and cap rates for that building. Over time as that asset is depreciated, there can be major discrepancies between book value and true market value. We'll speak later about Ruby Tuesday [RT] and Assisted Living Concepts [ALC], both of which have real estate asset values that we believe are significantly undervalued on their books and by the market.

We're always finding new types of assets that may be mispriced. We bought shares in Madison Square Garden [MSG] on a when-issued basis as it was being spun off from Cablevision at the beginning of 2010. In that case, the sports franchises it owns – the Knicks in pro basketball and the Rangers in pro hockey – were on the books at close to zero, when they were obviously worth much more than that. We built our position at a \$17-18 price when we thought the private market value of the entire company was above



Ari Levy

Home Schooling

His undergraduate degree is in International Relations and he spent time working for respected Chicago investment firms Mesirow Financial and Advisory Research, but Ari Levy's business education started very much at home. His father Larry founded and ran a highly successful real estate development company as well as an international restaurant and food-services firm. His mother Carol co-founded and still actively manages two home-décor retail stores. "You could say it was a very entrepreneurial household," says Levy, who in late 2005 – at age 26 – started his own firm, Lakeview Investment Group.

Levy says the evolution of his father's restaurant business provided a particularly relevant lesson to his work today: "Very few restaurants earn a decent return on invested capital over time because the capital-spending requirements are so high. As the company evolved more to sports and other venue catering – where little capital was required, demand was predictable and customers tended to be less price-conscious – it really started to fire on all cylinders. That was my first real exposure to the compounding power of generating returns in excess of capital costs, an important element of what we look for today."

\$40. That included no expectation that the Knicks and Rangers would actually start winning, but we considered that upside if they did.

Digressing a bit, with both teams having made their post-season playoffs and the stock having doubled, have you moved on?

AL: Our estimate of private market value has increased, but the stock price has increased faster. We still own a small, less-than-2% position.

Where else do you look for balance-sheet anomalies?

Mike Nicolas: One area is around joint ventures, typically when a company uses the equity method of accounting and carries only the pro-rata share of the JV's book value on its balance sheet. For instance, a company like Layne Christensen [LAYN], which we'll discuss in more detail later, has a Latin American mineral-drilling joint venture held on its books at \$88 million. Layne's share of the EBIT from that JV on a trailing 12-month basis is \$35 million and, based on publicly traded comps, we believe it's worth literally three to four times the stated book value.

We also from time to time find mis-priced liabilities. If you screen OfficeMax [OMX], for example, it comes up as a heavily levered retailer of office products. But it has on its balance sheet what are called timber installment notes that are non-recourse – and an accounting anomaly more than anything else – that inflate liabilities by around \$1.4 billion. If you adjust for that, the stock today [at around \$4.80] trades for one-third of tangible net asset value and less than 2x EBITDA.

Are computer screens your primary method for generating ideas?

AL: That's probably our #1 source, where we're typically looking for some combination of cheapness relative to tangible book value and to EBIT, with asset coverage and cash flows that are high relative to liabilities. But screens don't help much in uncovering misvalued assets and liabilities,

so we're also constantly in touch with a network of our own investors, executives of companies we invest in, industry experts we've gotten to know, and other like-minded investors we respect. I've been active in Joel Greenblatt's Value Investors Club, for example, which I find to be a great source of under-the-radar ideas and research that is much less biased than what comes out of Wall Street. In general, there is no bad way to get a good idea.

ON LIQUIDITY:

Since we invest in a lot of small caps, we're particularly mindful of liquidity risk, more so since the 2008 crisis.

Where is your focus in terms of cap size?

AL: Our weighted-average market cap is typically between \$1.5 and \$2 billion on the long side, with the median closer to \$1 billion. We have the flexibility to look at just about anything, but recognize that our edge is most likely to come from researching companies that aren't widely covered and therefore are more apt to be misunderstood. I'd say roughly one-third of our longs have no coverage, one-third have coverage from boutique sell-side firms, and one-third are larger and fairly well followed.

Not everything we own has to have hidden asset value or be completely under the radar. We own Ingram Micro [IM], a large distributor of IT products, which we consider just a straightforward inexpensive stock trading at 85% of tangible book value and 5x EBIT on an enterprise value basis. If you run a screen for companies of this size that are this well capitalized – it has net cash of \$600 million – you'll find very few names trading below book value and even fewer trading for no more than 5x EBIT. Were they to auction this business off to the highest bidder, we believe it would go for a significant premium to tangible book.

Given your predilection for hard assets, we were curious what was behind your investment in exchange operator CBOE Holdings [CBOE].

AL: In assessing potential opportunities we do focus more on hard asset values today than on more difficult-to-predict future cash-flow streams. CBOE is somewhat atypical for us, in that the value we think the market is missing is less tangible, primarily in the trading of proprietary products like VIX options and futures. VIX previously was just an input to options-pricing models and not tradeable on its own, but now the futures and options are an asset class and generate nearly 20% of the company's trading revenues. If you back out this business, it trades at nowhere near the multiple we think it should given its growth prospects and very high profitability. On top of that, we think CBOE is an excellent buyout candidate. The global industry continues to consolidate and a strategic buyer could realize cost synergies on the order of \$100 million, not insignificant when you're talking about a \$2.2 billion market cap company.

How concentrated is your portfolio?

AL: There is credible portfolio math that shows that 10 equally weighted holdings give you roughly the same level of diversification as an infinite number. In our highest-conviction, cheapest names with the greatest downside protection, we'll go up to a 12% position at inception. We typically hold 25-30 longs, with 40% in the top five and 60% or so in the top ten. On the short side we are more concerned with concentration risk, keeping position sizes to 3% or less, and in no case going above 5%.

Since we invest in a lot of small caps, we are particularly mindful of liquidity risk, more so since the 2008 crisis. Assuming we trade in each position at 30% of the 3-month average daily volume, we could exit 78% of our portfolio within one trading day and 91% within five days. We watch those metrics carefully and wouldn't, for example, want the 5-day metric to get below 75% or so.

Explain your broader investment case for industrial services firm Layne Christensen.

MN: The company is best-known for its presence in the water-infrastructure market, where it provides services including well drilling, aquifer sourcing, pipeline installation and the design, construction, and maintenance of wastewater systems and water-treatment facilities. That business accounts for nearly 75% of total revenues and has been struggling due to problems in its Heavy Construction division, which has been dealing with cut-backs in municipal spending and a raft of unprofitable contracts priced in 2010 and 2011 under prior management. Those bad deals prompted in March a \$94 million pre-tax impairment charge – shocking for a company with roughly \$400 million in enterprise value – and will continue to depress overall water-infrastructure margins this year.

Our view is that management under new CEO Rene Robichaud is doing the right thing by owning up to the problems in the water business and has set the stage for a return to normalized profitability in calendar 2013. On top of that, while the cyclicity of this business caught some investors off guard, there are long-term drivers underpinning growth that remain intact. The EPA and states have over \$6 billion in water infrastructure funding that is expected to be deployed this year. There is near-universal agreement in the industry that spending on wastewater infrastructure has to increase even to maintain the current level of functionality. Layne's cured-in-place pipe business – in which new water piping is placed without digging trenches to get at the old pipe – is running at full capacity. Any recovery in North American residential housing would be an added positive overall.

The company's expertise in both water management and mineral drilling also positions it well to become the go-to water-solutions provider to the unconventional natural gas exploration and production industry. There are significant water-management issues with new drilling techniques, and the company believes that it can take advantage of the highly

fragmented nature of the competitive set to generate as much as \$200 million in additional revenue from this area at 30-40% EBITDA margins within five years.

Describe what you think the market is missing in the mineral-exploration business you mentioned earlier.

MN: Layne is the world's third-largest provider of drilling-rig services to miners, focused on exploratory and definitional drilling in order to extract samples and/or define the size of an ore body prior to further investment in development. Gold and copper miners account for 85% of

the business, with customers including the biggest players in the industry, including Barrick, Rio Tinto and BHP Billiton. The company's reputation is such that it was called in to drill the bore holes used to rescue the Chilean miners who were trapped in 2010.

It's clearly a cyclical business, but given high copper and gold prices, mineral exploration budgets are larger than ever. On the supply side of the equation, rig utilization rates are at or near effective full utilization of 80-85% for the three largest global competitors, which in addition to Layne are Australia's Boart Longyear [BLY: AU] and Canada's Major Drilling

INVESTMENT SNAPSHOT

Layne Christensen
(Nasdaq: LAYN)

Business: Provider of a variety of drilling, treatment and construction products and services used by operators in the water-infrastructure and mineral-exploration markets.

Share Information
(@5/30/12):

Price	19.00
52-Week Range	18.82 - 32.43
Dividend Yield	0.0%
Market Cap	\$370.0 million

Financials (TTM):

Revenue	\$1.13 billion
Operating Profit Margin	2.3%
Net Profit Margin	(-4.9%)

Valuation Metrics

(@5/30/12):

	LAYN	Russell 2000
Trailing P/E	n/a	33.1
Forward P/E Est.	11.0	17.4

Largest Institutional Owners

(@3/31/12):

Company	% Owned
Tradewinds Global Inv	14.3%
Dimensional Fund Adv	7.4%
Vanguard Group	4.7%
C.S. McKee	4.5%
Keeley Asset Mgmt	4.4%

Short Interest (as of 5/15/12):

Shares Short/Float	4.6%
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LAYN PRICE HISTORY



THE BOTTOM LINE

The market isn't adequately recognizing either the operating improvements in the company's water-related businesses or the true value of its mining-services assets, says Mike Nicolas. Adjusting reported tangible book value to better reflect just the worth of one Latin American joint venture, he believes the current NAV is at least \$30 per share.

Sources: Company reports, other publicly available information

[MDI: CN]. The primary constraint to rig growth is a lack of skilled labor to man the rigs, which we expect to continue to restrain supply. Overall, we expect pricing increases of 10-15% in 2012.

To fully evaluate this business you have to incorporate the results of both Layne's wholly owned operation and its proportional ownership in its Latin American affiliates, which is carried on the balance sheet using the equity method of accounting. The affiliates, of which Layne owns some 45%, own a total of 250 rigs and operate exclusively in Central and South America. Using the publicly traded peers as a guide, we believe the mineral-exploration group alone is worth more than the current entire-company enterprise value.

Walk through how you're looking at valuation with the share price today at \$19?

MN: If we adjust trailing-twelve-month numbers for non-recurring items and include the proportional share from the JV, consolidated pro forma EBIT comes to around \$74 million and EBITDA is nearly \$150 million. So just looking at historical numbers, the EV/EBITDA multiple is around 3x.

Tangible book value is \$21 per share, but if we value the JV at the peer multiple of 8x EBIT, the adjusted net asset value is in excess of \$30 per share. If we take into account our expectations for things like water-infrastructure margins normalizing and mineral-exploration pricing increasing, we believe the upside in the stock price within the next couple of years is 100%-plus. Given that we think the company could liquidate for much more than the current stock price, the risk/reward is heavily skewed in our favor.

How concerning is the ongoing review by the SEC and Department of Justice over company payments made in Africa that might have violated the Foreign Corrupt Practices Act?

MN: Any undefined liability is a concern, but we've looked closely at prior similar violations and the resulting liabilities, as well as Layne's profit history in Africa,

and concluded the worst-case result would be fines of \$40 million or so. But in none of those previous cases had the companies self-reported, as Layne did, and been as aggressive in remedying the issues through management and operational changes. In its latest earnings announcement, management created an initial accrual against this of \$3.7 million, which gives us confidence our worst-case scenario – which is likely already more than reflected in the share price – won't be close to the final result. It gives us added comfort that both Rene Robichaud and the company's COO have

ON TYPICAL IDEAS:

The business isn't firing on all cylinders, that's not permanent, and there's asset value underlying the stock.

bought stock on the open market well after the issue was first reported, indicating they don't see it as particularly value-destroying.

Describe what you believe the market is missing in restaurateur Ruby Tuesday?

AL: This is an excellent example of the type of situation we often find attractive: the stock is cheap because the business isn't currently firing on all cylinders, there are reasons to believe that isn't a permanent condition, and there's significant asset value underlying the market price.

The headline problem is the performance of Ruby Tuesday's flagship restaurants, which have continued to show same-store sales weakness even while the casual-dining business overall is coming back somewhat from the recession. That's particularly troubling because the company went through a \$500 million-plus capital-spending facelift a few years ago to improve and modernize both the design of the restaurants and the food quality. We believe the money was mostly well spent and should result in higher average tickets, but that the company hasn't yet effectively

let its market know about the changes. Going beyond typical coupon-based marketing, they're planning to spend more than \$20 million on TV advertising this year – from nearly nothing last year – and more than \$40 million next year. We're optimistic that will drive traffic and revenue growth, and we like that the incremental spending is being funded by some \$40 million in estimated annual cost savings that have been identified in working with consulting firm Alix Partners.

MN: It's not central to our thesis, but the company also recently acquired a nice growth concept in Florida-based Lime Fresh Mexican Grill. It's sort of a Chipotle, with more service and higher ticket prices. The plan is to roll out 20 new stores this fiscal year and 30 next year. Management expects to spend \$750,000 to open each Lime Fresh store, which will then earn at least \$1.5 million in annual revenue and 20% unit-level EBITDA margins. Those economics are superior to those of a big-box Ruby Tuesday store, and the company thinks this new unit could generate \$30 million of incremental EBITDA in just a few years.

What downside protection do you see in the real estate?

AL: The company owns the land and building for 355 stores. There are a number of data points from recent sale lease-backs and repurchases of franchised locations that indicate a fair market value per restaurant of approximately \$2.1 million. Assuming a 35% corporate income tax rate, the after-tax market value of that owned real estate comes to \$665 million.

The current enterprise value, including nearly \$300 million in net debt, is around \$760 million. Subtracting the after-tax value of the owned real estate results in an adjusted enterprise value of only \$94 million. Against that, you've got trailing 12-month EBITDA of \$117 million, which adjusted for the incremental rental expense necessary if the company sold the owned stores, would be around \$65 million. So adjusted EV/EBITDA on a trailing basis is only 1.5x.

INVESTMENT SNAPSHOT

Ruby Tuesday
(NYSE: RT)

Business: Owns, operates and franchises more than 800 Ruby Tuesday-branded casual-dining restaurants, 95% of which are located in the United States.

Share Information
(@5/30/12):

Price	7.17
52-Week Range	6.35 - 11.33
Dividend Yield	0.0%
Market Cap	\$457.4 million

Financials (TTM):

Revenue	\$1.32 billion
Operating Profit Margin	3.9%
Net Profit Margin	1.5%

Valuation Metrics
(@5/30/12):

	RT	Russell 2000
Trailing P/E	23.7	33.1
Forward P/E Est.	13.3	17.4

Largest Institutional Owners
(@3/31/12):

Company	% Owned
Fidelity Mgmt & Research	14.8%
Carlson Capital	6.9%
Dimensional Fund Adv	6.3%
Vanguard Group	4.8%
BlackRock	4.3%

Short Interest (as of 5/15/12):

Shares Short/Float	10.3%
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RT PRICE HISTORY



THE BOTTOM LINE

Significant value in the company's owned real estate provides excellent share-price protection as a credible plan to turn around its flagship restaurants is executed, says Ari Levy. Using what he considers a reasonable 7x EV/EBITDA multiple on his estimated adjusted numbers, he believes the fair value of the shares today is just under \$13.

Sources: Company reports, other publicly available information

With the stock today around \$7.20, what's a more appropriate valuation?

AL: Using a realistic 7x multiple on adjusted EBITDA and adding back the after-tax proceeds from the assumed real estate sales less net debt, we estimate the fair market value of Ruby Tuesday's equity to be just under \$13 per share. That ascribes no value to Lime Fresh or to an additional 250 properties for which the company owns the buildings but not the land.

The biggest risk is that the turnaround doesn't happen and the decline in the franchise is more permanent than temporary, ultimately impacting the value of the real

estate as well. We don't believe that will turn out to be the case, but in any event find the margin of safety more than sufficient relative to the risk. Also, the company has generated nearly \$350 million in free cash flow over the past four years, so there should still be a nice cash-flow cushion even if the turnaround takes time.

Turning to an industry we haven't yet discussed, what's behind your interest in Banco Latinoamericano de Comercio Exterior [BLX]?

AL: Bladex, as its commonly known, is the only bank we own, but due to its heritage

operates with a much different business model than the typical commercial bank. It was originally established in 1979 by a group of Latin American central banks to promote trade finance in the region. It went public in 1992 and today its public shareholders include 23 Latin American central and state-owned banks, which own Class A and Class B supermajority shares. Class E shares, which we own, make up three-quarters of the total share count.

As a trade bank, Bladex specializes in asset-backed, short-term loans (with an average duration of 15 months) and letters of credit that finance international trade transactions. The loan portfolio is well-diversified by geography and industry, and has proven to be considerably less risky than the typical bank's, with total write-offs since inception of just 0.2% of all loans. The company has no retail branch network, relying instead for funding primarily on deposits from central banks, wholesale deposits from other banks, and bond issuances. It's based in Panama, where it pays no income tax under a special exemption granted at the founding.

Are you particularly bullish on Latin America?

AL: We didn't buy this because we were getting macro exposure to Latin America, but it does make sense from a macro perspective. It's an excellent way to play the low double-digit growth in trade expected in the region, in no small part attributable to the expansion of the Panama Canal, which will double its cargo capacity by 2014. In addition to benefitting in its traditional businesses as trade expands, the company is also looking to diversify into new businesses like factoring – buying accounts receivables from companies at a slight discount to face value in exchange for immediate liquidity for the seller – which is a greenfield business in Latin America, but has the potential to grow quickly and earn 30% or better returns on equity.

The primary opportunity we saw when we first bought shares in mid-2010 was for the company to recast its balance sheet with an amount of leverage consistent with

the quality of its assets. Its Tier-1 capital ratio was well above 20% two years ago, and as they're moving that down to a still conservative mid-teens level, that has a direct impact on returns. Return on equity, in the single digits in 2010, is now approaching management's target of 15%.

At a recent \$19.45, the shares are up 50% from two years ago. Is the story out?

AL: The stock still trades at a discount to tangible book value of \$20.60 per share, which we believe is somewhat understated because it excludes what we think is an extremely conservative reserve for bad loans

of \$2.40 per share. The shares also trade at less than 8x the \$2.50 in EPS we're estimating for this year. The dividend yield is above 5%.

We believe a low-risk, 15%-ROE bank should trade for something more like 1.5x tangible book and 15x earnings. Were that to happen, that would mean there's still significant upside in the shares.

The market has at times expressed concern with the company's small hedge fund business. Does it concern you?

AL: The market doesn't like it when Bladex's main global-macro hedge fund has

a bad quarter, but the reality is that the fund has performed admirably since it was launched in 2006. They haven't been able to attract much in the way of third-party assets, but the ultimate success, change or retrenchment in this business is unlikely to have a material impact on the company one way or the other.

Is having central banks as fellow shareholders a plus or minus?

AL: The minus is that the company isn't likely to be bought out or taken private, but for the most part we like the alignment of interest between Bladex and its public owners and believe it provides preferential access to information, funding, institutional support and product-distribution channels. Management has proven so far to be independent and focused on building value for all shareholders.

Why do you believe Assisted Living Concepts is being mispriced by the market?

Tim Won: The company owns and operates residential housing properties for seniors who need more assistance – say with following medication protocols or getting dressed in the morning – than if they were living fully on their own, but less assistance than would be provided in a traditional skilled-nursing facility. Most of the properties are in the Midwest, Southeast and Texas, and while competitors typically lease the majority of the units they operate, the opposite is true for ALC, which owns more than 75% of its 9,300 units.

The company has gone through a wrenching business transformation in the past several years. It previously followed the industry playbook, which was to attract as many private-pay clients as possible and then add another 20% or so of residents whose bills were paid by Medicaid, even though the average monthly payment from government-pay clients was 30-40% lower and the assistance level required tended to be higher. ALC decided to take the hit on occupancy and get out of the Medicaid business, with the goal of improving baseline profitability

INVESTMENT SNAPSHOT

Banco Latinoamericano
(NYSE: BLX)

Business: Provider of loans and other financial services that facilitate international trade transactions for state-owned and commercial enterprises in Latin America.

Share Information
(@5/30/12):

Price	19.45
52-Week Range	14.81 - 21.99
Dividend Yield	5.2%
Market Cap	\$732.1 million

Financials (TTM):

Revenue	\$151.6 million
Operating Profit Margin	65.8%
Net Profit Margin	65.3%

Valuation Metrics

(@5/30/12):

	BLX	Russell 2000
Trailing P/E	7.3	33.1
Forward P/E Est.	7.9	17.4

Largest Institutional Owners

(@3/31/12):

Company	% Owned
LSV Asset Mgmt	5.4%
Lee, Danner & Bass	2.6%
Aronson, Johnson & Ortiz	2.1%
Renaissance Group	1.9%
Advisory Research	1.4%

Short Interest (as of 5/15/12):

Shares Short/Float	3.5%
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BLX PRICE HISTORY



THE BOTTOM LINE

The market appears to be significantly undervaluing the strength and quality of the company's current business, let alone its attractive growth prospects from increased Latin American trade, says Ari Levy. If the stock's valuation better reflected the low-risk, good-return dynamics of the business, he says, it would trade for \$30-35 per share.

Sources: Company reports, other publicly available information

while focusing on steadily adding private-pay clients. It's been a difficult transition – particularly on the public-relations front, given the need to evict elderly clients – but residency now is 99% private-pay. While occupancy fell from 85% in 2006 to 62% at the end of 2011, EBITDA over that same period increased by 40%, to nearly \$67 million. While the addition of private payers could be much faster, from a shareholder standpoint we believe the company is doing the right thing.

The latest controversy weighing on the share price is the fact that ALC is being sued by Ventas, its landlord on eight of the 211 properties it operates, which is claim-

ing ALC breached its lease obligations, is liable for accelerated rent payments and should be evicted. This caused ALC to delay its earnings release for the first quarter and the stock fell 12% on the day that was announced.

Based on conversations we've had with people in the industry, the view appears to be that Ventas is responding to issues that are usually resolved easily without litigation, primarily because it wants to re-lease the properties on more favorable terms. The most we can imagine ALC having to pony up is maybe \$15-20 million, to close out business on which it doesn't even make money. In any event, this issue

has very little impact on our valuation of the company.

How are you looking at valuation with the shares currently at \$13.30?

TW: This is a business where transactions are happening all the time – from property sales to capacity add-ons – so you can get a pretty good read on current net asset values. Taking into consideration location and quality, we think based on appraisals and precedent transactions that ALC's nearly 7,200 owned and operated units are conservatively worth \$100,000 each.

If we assume the company sells these units for \$100,000, leases them back at a 7% cap rate, and pays 35% in taxes, it would end up with after-tax proceeds of around \$615 million. If we then add the value of the operating business, at a 5x EV/EBITDA multiple and after assuming \$50 million in added rent, we arrive at an overall share value of \$27 per share.

We would not be surprised if the company attracted takeover interest. In addition to the asset-value discrepancy, it also generates \$30-40 million in annual free cash flow, now has minimal Medicaid reimbursement risk and is significantly less leveraged than its peers. For example, increasing debt to \$60,000 per unit – still much less than the leverage at many competitors – would cover today's entire enterprise value. Increasing leverage could be a catalyst to value realization, whether used by an acquirer or the company itself.

Can you generalize about the short ideas that most appeal to you?

AL: We've done some of our best work on the short side in teasing out fraud in the operation of a business or in how it's being represented in the financial statements. A classic example, among several U.S.-listed Chinese companies we've shorted, was a company called Universal Travel, which sold itself as an Orbitz or Expedia in China, but in reality had a non-functional website, implausible financial numbers and operating claims, some sketchy related-party transactions, and a revolving door for both CFOs and low-quality audi-

INVESTMENT SNAPSHOT

Assisted Living Concepts

(NYSE: ALC)

Business: Owns, operates and leases more than 200 assisted-living residence facilities for seniors, located in mid-market suburban communities throughout the U.S.

Share Information

(@5/30/12):

Price	13.28
52-Week Range	11.16 - 20.33
Dividend Yield	2.7%
Market Cap	\$307.9 million

Financials (TTM):

Revenue	\$235.0 million
Operating Profit Margin	19.1%
Net Profit Margin	10.6%

Valuation Metrics

(@5/30/12):

	ALC	Russell 2000
Trailing P/E	12.3	33.1
Forward P/E Est.	12.2	17.4

Largest Institutional Owners

(@3/31/12):

Company	% Owned
Morgan Stanley	18.6%
Advisory Research	13.3%
Bandera Partners	9.2%
Dimensional Fund Adv	5.7%
Vanguard Group	5.0%

Short Interest (as of 5/15/12):

Shares Short/Float	3.6%
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ALC PRICE HISTORY



THE BOTTOM LINE

The market is understating the benefits of the company's radical business transformation in recent years and overstating the risk of a recent legal dispute with a partner, says Tim Won. Assuming its owned and operated units are worth \$100,000 apiece, he estimates the fair value of the company's shares to be roughly twice the current market level.

Sources: Company reports, other publicly available information

tors. That's actually a pretty good checklist of what to look for generally in frauds. While it once had a market cap of around \$500 million, the stock now trades for next to nothing in the pink sheets.

Something we've been focused on more recently on the short side is leveraged ETFs. These are wildly popular and provide investors exposure to a leveraged version of the daily return of an underlying index, say 2x or 3x the return of the S&P 500. These vehicles are structurally flawed in that over time compounding creates significant tracking error from the longer-term leveraged performance of the underlying index. For example, suppose the S&P 500 index is priced at \$100 per share and a leveraged ETF meant to deliver 2x the S&P 500 daily return is also priced at \$100 per share. Say the S&P 500 index goes down 10% the first day and up 10% the second. The index would go to \$90, and then back up to \$99. That's a 1% decline, so you'd expect the 2x ETF to be

down 2%, right? But it's not. It goes down to \$80 on the first day and then back up only to \$96, a 4% decline. In most market environments, that's a structural decay mechanism that's built in.

To give an example of what can happen, ticker symbol FAS is meant to deliver 3x long the Russell 1000 Financials index, while ticker FAZ is 3x short the same index. They should be polar opposites, but in 2011 FAS was down more than 50% and FAZ was down more than 20%. So one core way we're hedging our long equity portfolio today is through shorting vehicles like FAS. We're trying to go beyond just hedging beta, with a positive alpha expectation as well.

Ari, you've spoken about your gambling exploits in college. Has that been useful preparation for what you do today?

AL: I've always been fascinated by statistics, probability and game theory and my

favorite class at Stanford was a freshman seminar called Math in Sports. The professor was a famous card counter in the 1970s and articulated very well the importance of knowing your odds and finding your edge. I founded a blackjack team and with one of the other members of the team also came up with an arbitrage strategy that took advantage of the fact that on-line sports books at the time were offering bonuses on capital put at risk, as long as the capital was risked a minimum number of times in a given period. We figured how to put the capital at risk with an expected outcome that would keep us well ahead after earning the bonuses. Over the course of the NFL season my senior year we quadrupled our money with this strategy.

Out of all that I'd say the quantitative focus and the emphasis on fully understanding your odds and only acting when they're in your favor are certainly applicable to investing. It's a far more serious game, but just as challenging and fun. **VII**

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Timing Value

Value investing titan Gabelli Funds has a new strategy that invests not only in stocks trading at deep discounts to intrinsic value, but when the discounts are also expected to go away soon. Here are five that qualify today.

It would be an exaggeration to say value investors don't care about timing – after all, who wouldn't rather buy a stock at the point at which it starts a prolonged or pronounced rise, rather than 20% too soon or too late? But most value investors count more on their long-term horizons to support the convergence on intrinsic value they expect, rather than on identifying short-term catalysts to do the same thing. As Markel Corp.'s Tom Gayner puts it: "I'm not against making money in the short term, I just don't know how to do it."

Most of Gabelli & Co.'s more than \$35 billion in assets are managed in that way: stocks are bought based on discounts to estimated private-market values and then held for as long as the discount to those updated PMVs is attractive. But Gabelli is trying to go one step further with its recently launched Focus Five strategy, emphasizing near-term catalysts along with steep discounts. Says company President Dan Miller, who co-manages the strategy: "The philosophy is that if we don't feel like we *have* to own a stock today – say because the business outlook is negative or management isn't focused on shareholder value – we don't want to own it."

The impetus for the new fund was a research report started in 2006 that reflected

the firm's five best ideas based on valuation and catalysts. This "focus five" was renewed each quarter and no company remained on the list more than twice in a row. A hypothetical portfolio investing in this strategy produced such jaw-dropping returns that Miller led the effort to turn it into a more-diversified fund, which will hold 25 to 30 positions, with up to 50% of assets in the top five holdings.

The top five today [see table, below] are an eclectic mix. Security firm **Brink's** is going great guns in emerging markets, but has been hurt in the U.S. by sluggish demand and aggressive competitor pricing. Key catalysts, says Miller, are continued U.S. economic improvement and higher margins driven by a more focused cost-cutting initiative. An increase in interest rates would also be a plus, he says, prompting merchants and others with excess cash to schedule more frequent armored-car runs. His team's estimate of private-market value is \$40 per share, versus today's price of \$23.

Economic recovery coupled with stimulus spending would bode well for cement and aggregates company **Texas Industries**. TXI expanded capacity during the downturn, particularly in Texas, which Miller expects to serve it well as infrastructure

spending increases. Another potential catalyst: the large position in the company owned by Egyptian mogul Nassef Sawiris, who has continued to buy shares since his initial stake was announced last summer.

Cyclical calls support Miller's interest in vehicle-parts supplier **Dana** and coal and natural gas producer **Consol Energy**. Dana's strides since emerging from bankruptcy in 2008 were masked by the recession, but he expects the company to be a prime beneficiary as the commercial-vehicle market continues to recover. The primary catalyst for Consol is that "natural gas prices have likely seen their lows," says Miller, but he also sees potential to unlock value through some sort of split between its coal and natural gas businesses.

The smallest member of the "focus five" by market cap, **Rochester Medical**, is poised to benefit both from superior new products and an expansion of its internal sales force, Miller says. He believes the company's operating margins, around 5% in the latest quarter, can triple over the next year or two. As that plays out, he wouldn't be surprised if a more classic catalyst arose: a takeover offer from a larger medical-products firm that could more quickly and broadly take advantage of Rochester's product lineup. **VII**

Conviction

A hypothetical portfolio of Gabelli Funds' five best ideas based on valuation and potential catalysts produced such jaw-dropping returns that the firm translated the idea into a more-diversified strategy open to investors, including through the Gabelli Focus Five Fund [GWSVX]. These stocks are the strategy's five largest holdings, the most expensive of which has a private market value estimated by Gabelli to be more than 60% above the current market price.

Company	Ticker	Price@ 5/30/12	52-Week		Est. Private Market Value	Discount to PMV
			Low	High		
Brink's	BCO	23.03	21.53	31.91	40.00	(-42%)
Texas Industries	TXI	32.40	21.89	43.09	65.00	(-50%)
Dana	DAN	13.73	9.45	19.00	25.00	(-45%)
Consol Energy	CNX	28.84	28.71	55.02	55.00	(-48%)
Rochester Medical	ROCM	9.95	6.60	10.80	16.00	(-38%)

Sources: Gabelli Funds; publicly available information

Delayed, Not Denied

After a prolonged spate of management overpromising and underdelivering, has the disconnect between Hess Corp.'s market value and the asset value underlying its shares grown too large to ignore?

As global integrated energy companies go, Hess Corp. doesn't cut a high profile. Run since 1995 by John Hess, son of larger-than-life company founder Leon Hess, the company these days seems as well known for its branded gas stations and ubiquitous toy trucks in the Northeastern U.S. than it is for its prowess as a producer of oil and natural gas. It's highest-profile public notice of late: *The Wall Street Journal* singling out John Hess in an article earlier this month as an example of a CEO delivering "the least bang for the buck."

In a difficult market for energy stocks, Hess shares have been especially disappointing, down more than 40% in the past year to a recent \$45.40. The company is spending heavily to expand exploration and production – with capital spending expected to exceed cash flow again in 2012 – but the results haven't inspired. Its oil and gas production fell 11% last year from 2010, and this year's first quarter was similarly sluggish.

Despite such shortcomings, venerable energy investor Rich Howard, the longtime manager of T. Rowe Price's Capital Appreciation Fund who joined Prospector Funds in 2005, believes the disconnect between Hess's market value and the asset values underlying its shares has gotten too wide. The crux of his argument: the company's roughly 900,000-acre stake in North Dakota's Bakken oil field. Amerada Corp., which merged with Hess in 1969, drilled the first wells on farmer Henry Bakken's land in 1951, providing it with a first-mover advantage in acquiring the best-located and most-productive reserves, and in building out the infrastructure to develop them as new drilling technology has made it feasible.

While the company's ultimate payoff from Bakken has been delayed – the original expectation for 150,000 barrels per day in production by 2015 is now down to 120,000 – Howard does not believe it has been denied, and that Hess's stake there is

potentially worth the \$20,000 to \$25,000 per acre others have paid for comparable assets in the region. At \$20,000 per acre, pre-tax, the Bakken properties alone – which accounted for only 8% of the company's total 2011 production – would be worth more than \$50 per share.

If he ignores the Bakken private-market value and just assesses the sum-of-the-parts – assuming \$85-per-barrel oil – of all the company's existing reserves and operations, Howard believes the shares are

worth \$80-85. While others criticize the diverse makeup of Hess's assets – which include gas stations, refineries and electricity-generating plants in addition to energy properties in the farthest-flung regions of the world – Howard likes it that way: "It's a cyclical and risky industry, where different assets go in and out of favor over time. When I buy something, I like to get a lot of 'stuff' that can over and above my sober assessment of value provide lottery-ticket catalysts. There's a lot of that here." VII

INVESTMENT SNAPSHOT

Hess Corp. (NYSE: HES)

Business: Exploration and production of oil and gas worldwide; Marketing and refining of petroleum products mostly in U.S.

Share Information (@5/30/12):

Price	45.38
52-Week Range	44.10 - 79.08
Dividend Yield	0.9%
Market Cap	\$15.34 billion

Financials (TTM):

Revenue	\$38.00 billion
Operating Profit Margin	10.0%
Net Profit Margin	3.5%

Valuation Metrics

(@5/30/12):

	HES	S&P 500
Trailing P/E	11.7	14.8
Forward P/E Est.	7.1	12.5

Largest Institutional Owners

(@3/31/12):

Company	% Owned
State Street	4.0%
Fidelity Mgmt & Research	3.7%
Vanguard Group	3.6%

Short Interest (as of 5/15/12):

Shares Short/Float	1.6%
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HES PRICE HISTORY



THE BOTTOM LINE

While it's true that the company's heavy spending to expand exploration and production hasn't yet delivered the results it expected, the market seems to be overreacting to that fact, says Rich Howard. Even without fully reflecting the estimated value of its prime asset, he believes the company on a sum-of-the-parts basis is worth at least \$80 per share.

Sources: Company reports, other publicly available information

Preparing for Surprise

As truly fascinating as most writing about investing is (at least in *Value Investor Insight!*), we try as often as possible to read things that don't ostensibly have anything to do with investing. Sometimes it offers insight into our work and sometimes it doesn't, but reading as widely as possible is rarely a waste of time. As no better role model than Charlie Munger puts it: "In my whole life, I have known no wise people who didn't read all the time – none, zero."


Thus we found ourselves recently making our way through a paper co-written by Jack London, the long-time CEO and now Chairman of defense contractor CACI International. Titled "Surprise, Deception, Denial, Warning and Decision: Learning the Lessons of History," the paper describes the prevalence and importance of surprise and deception as integral, enduring elements of diplomacy and warfare, adding, "They are also a basic and recurring part of everyday life. We constantly fail to anticipate events; frequently, we spring traps; more often, we fall into them."

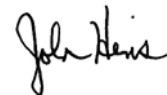
The paper goes on to offer a broad-based outline for how to better prepare

for negative surprises and mitigate their impact, much of which, not surprisingly, has great relevance for investing. Here are the set of basic rules the authors offer as useful "in remaining ever vigilant":

1. You don't know what it is you don't know, and what you don't know can be a disaster.
2. If the situation is crystal clear, and everything you see fits your expectations, hopes and plans, you are probably being deceived.
3. Surprise is the ultimate asymmetric threat because it exploits weaknesses and capitalizes on vanities.
4. Don't confuse estimates with facts. The level of classification is not a good indicator of reliability, relevance or validity of the information you receive.
5. There are no universal standards of rational behavior (or stupidity). Just because you wouldn't do something doesn't mean someone else won't.
6. Don't fall in love with your plan, policy or estimate of the situation. Expect the

unexpected and be able to imagine the worst. Hope is not a viable strategy!

7. Beware of group-think. Give a fair hearing to alternative viewpoints, even if this means admitting you might be wrong.
8. Warning is about being safe, not about being right. Trust your instincts, be ready to pay the price that goes with that, and don't punish those who "cry wolf." Sometimes the wolves are really at the gate and a threat is more than just "rhetoric."
9. Timely, unambiguous, warning is nice to have, but don't count on it. Don't assume (or expect) that appropriate political decisions and authorities would automatically follow warning. You've got a lot of latitude in your own organization. Use it and do what's right.
10. Stuff happens. So does surprise. Don't be a victim. 



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