"It is extraordinary to me that the idea of buying dollar bills for 40 cents takes immediately with people or it doesn't take at all. It is like an inoculation. If it doesn't grab you right away, I find you can talk to him for years and show him records, and it doesn't make any difference."[1] –Warren Buffett, 1984

Purpose

The goal of this collaborative book and website map will be to guide you through multiple resources found at www.csinvesting.org to develop your investing skills. There is nothing new under the sun. Human beings have never changed in how they make decisions or in their emotional reactions to events in financial markets. Therein offers opportunity for reasoned investing.

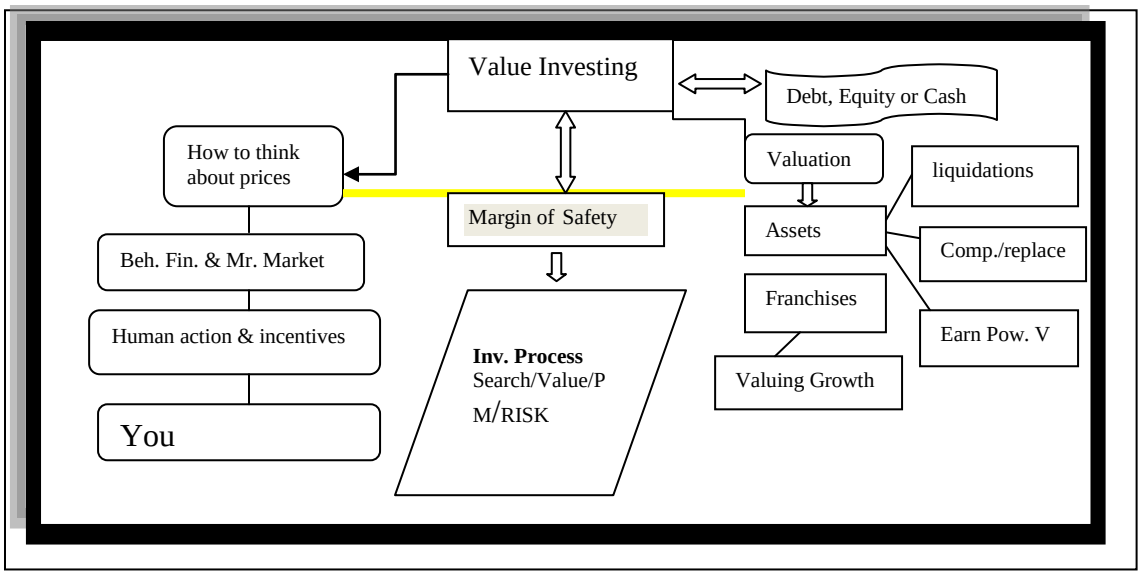
This handbook will provide extensive links to other books, case studies, lectures, and videos. For many, the resources will be overwhelming, but I prefer that you choose what you need. Jump to different sections and then return. I read Buffett's letters twenty years ago, but didn't glean their wisdom as I do today. I lacked adequate knowledge and experience to place Buffett's words into context. Another suggestion would be to hone in on the classics like the *Intelligent Investor* by Ben Graham (**Link here (ebook)** and read that classic several times to gain the **proper attitude** towards investing; then sit down with your accounting text books to help you go through 10-Ks of companies that peak your interest. Always ask how does this material help you become a better investor?

A new investor often feels like a passenger stepping into a 747 cockpit on the left. Are you ready for take-off? Overwhelmed? Once you understand the theory of flight, you understand that all you really need to fly an airplane is an air speed indicator, altimeter, and compass. With case study practice you will learn how to place information into context.

I believe in buying bargains or paying less for what you get. Value investing is just one type of pursuit. You can also be a momentum investor (go here LINK but that approach doesn't suit me. If you want to buy bargains, you have the choice of franchise companies or non-franchise companies (much more on those topics later). When you buy a franchise you must assess the strength of the company's moat or competitive advantages and how much to pay for growth. If you choose non-franchise companies, then you must buy asset value and earnings power value below enterprise value. You have the choice of investing in either the debt or the equity of the company. You must become a good business analyst. You will have no choice but to learn human action (economics), how to value growth, understanding regression to the mean, assessing competitive advantage, how to think about prices and how to track your progress. You will never completely master investing but the journey will be fascinating and perhaps even rewarding. If you are curious and

[1] The Superinvestors of Graham-and – Doddesville," Hermes, 1984

love learning then you are in the right place. The goal of these resources will be to help you **learn how to learn** about investing while encouraging you to develop mastery. The catch is that 90% of this process is up to you; you must apply yourself by using the principles and techniques to find opportunity within your **circle of competence**. We will build the circle.



Investing is simple but not easy. Whenever you buy or sell, **respect those on the other side of the trade from you** who may have an advantage. One of you will be wrong. Let's think about all that last sentence implies. Yes, you must remain humble and respect the market because although it is not perfectly efficient (are humans?) it can discount known information quickly. Entire methods of "investing" can go out the window. Ask yourself how looking at squiggles on a stock chart (technical analysis) help you predict future prices? What edge do you have? What is your variant perception? Your battle to do the right thing will be more emotional/psychological than intellectual. Character trumps intellect.

You do not need obtain an MBA, Charted Financial Analyst (CFA) https://www.cfainstitute.org, and CPA, elite education or "pedigree" to become a successful investor. Though I am a contrary iconoclast (**Link: Dangerfield in Econ Class**). I don't imply that having an MBA, CFA, etc. would be detrimental, just not sufficient. Here is a high school drop-out investing rationally (www.gannononinvesting.com). You are required to sit in a room quietly and think critically for yourself.[2] All I ask of you is to remain skeptical but open-minded. Use what you prove is beneficial for your own investing approach. Avoid experts and talking heads (CNBC). Opinions are worth what they cost to utter, nothing.

If you avoid the noise of Wall Street, focus on what a business is worth and having a margin of safety, then the rewards can be great and not just in monetary terms. You have to contribute a dollop of common sense like knowing the value of incentives,

[2] Michael Burry (links)

understanding human action, knowing your weaknesses and strengths and your opponents'.

I can provide a road map with vast resources but YOU have to apply the principles of investing to your unique personality and situation. **Investing can't be taught, it must be learned.** As Zeke Ashton of Centaur Capital Partners (WST May 27, 2013) says, "everybody is wired a little differently—everybody learns a little differently. Over time you **learn to see the patterns** that you are good at handling in terms of not only analytical capability that also in terms of what interests you in terms of what you like.

Don't expect to become an investing overnight; five to ten years of intensive reading will start you on your way. If that sounds too daunting, then learn about index funds or read Greenblatt's book on value-based ETFs here: **LINK.** Or if you want to first obtain a traditional finance MBA go here for free courses (Damodaran NYU link).

You will go through many stages of learning as you make progress, hit a plateau, become frustrated, suffer a setback, and then move forward to another level of skill. At first you will want a paint-by-numbers approach. If only just buying stocks at ½ stated book value worked all the time! You will look up to investing gurus and try to emulate them. Only when you decide that you will choose your own path. You will stop trying to become another Buffett and the best investor you can be. You have skills and aptitudes that Buffett may lack, use your unique talents and personality to find investments that suit you. You will learn about many investors and their investment philosophies.

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I will write to you as if we are at a coffee house in New York, Delhi, Australia, or London discussing investing. Yes, the conversation will be lopsided, but I prefer we converse as friends. In the room will be Seth Klarman, Warren Buffett, Charles Munger, Peter Lynch, Phil Fisher, James Grant, and many, many other investing legends who will instruct us at the appropriate times. Take a sip of your latte and let's begin……

Buffett said that there are only two subjects to master if you wish to be an investor:

1. How to think about prices
2. How to value a company.

Hollywood

Let's go to Hollywood and learn from Danny Devito in *Other People's Money* about what a value investor does….

See movie clip: http://youtu.be/gtvTY3hYYQ4. Now read the transcript below before **reviewing** the movie.

OTHER PEOPLE'S MONEY with Danny Devito and Burt Lancaster

Danny Devito ("Larry the Liquidator") drives up to visit NE Wire and Cable Company—a potential take-over target of his.

START: **Larry the Liquidator**: "Well, let's put it this way:

Back in New York, I got a computer. Her name is *Carmen*. Every morning, right after I brush my teeth, I punch out: Carmen, computer on the wall, who's the fairest of them all?" Now, most mornings, she spits out, "Garfield, you're the fairest." But three weeks ago, she said: "Garfield, Garfield, scratch your balls.

New England..." Pardon me. "***New England Wire and Cable*** is the fairest of them all."

New England Wire and Cable? I said, **"What's it worth?"** So she showed me the numbers. You got equipment here that costs $120 million. Even at *salvage*, it's worth **$30 to $35 million**. - Can I use that blackboard over there?"

- Burt Lancaster as **Jorgy**, President of NE Wire and Cable Company, "Yeah, go ahead."

Thank you.

Come with me. Carmen will educate us. Let's put down **$30 million**.

- How many acres you got? - A hundred and ten. Carmen and I figure, even as farmland, grazing land.....it's worth **$10 million**. - Is that fair?
- Yeah.

Let's lay the $10 under the $30. That makes ***$40* million**. You bought some other companies, didn't you, Bill? You have a plumbing, an electrical and some kind of adhesive company. Boring, but all making a decent profit. Carmen says they're worth another **$60 mil**. Let's put the *$60* under the *$40*.

And you have working capital of $25 million, $10 of it in cash. Let's put down $25 million, add them up and see what you got. ***$125* million**. The only bad news is.....that this wire and cable division isn't making a profit.....and all the other divisions have to support you. Now, as a stockholder, that doesn't make me very happy.

For example, one division losing $1 per share, while other divisions are making $2 per share so the net earnings are $1. But if losing division is shut down, then $2 per share in earnings. A huge difference

Are you finished, Mr. Garfield?

No, I'm not, Bill.

Let's say Carmen was suffering from premenstrual syndrome. No offense. A little nuts. Let's say she was too optimistic. Let's knock off $25 million. Here we go. Let's make it...

***$100* million**. A nice round number. **I like nice round numbers**. Any debt? No. Any lawsuits? Any environmental bullshit? You throwing your garbage in the water? Of course not. Not you. What about pension liabilities? Carmen says you're fully funded. You people are dreams.

"I think this meeting is over." (Jorgy)

No, no, wait a minute. Here comes the fun part. How many shares outstanding you got? Four million.

Divide 4 million shares of stock into $100 million, what do you get?
$25.00, Twenty-five.

- Good.

That means each share is worth *$25.* But that was all foreplay. Let's go for the real thing. The stock was *$10* when I woke up three weeks ago. **That's a *$10* for a $25 item.** What a sale! Something worth *$25 I* can buy it for $10.

The company's not for sale, Mr. Garfield.

I don't want your company, Jorgy. I just want what every other stockholder wants:

- I wanna make money.
- You are making money, Mr. Garfield.

You bought the stock at $10. It's now $14.

The stock is *$14 because* I'm buying it.

I'm doing my part. Now you do yours. **Get rid of this wire and cable division.** It's a financial cancer.

Liquidation Valuation in $ mils.	*Low*	*High Estimate*
Equipment at salvage	*$30*	*$35*
Land as grazing land lowest use value	*$10*	*$20*
Sub-total	*$40*	*$55*
Other Profitable Businesses	*$60*	*$60*
Sub-total	*$100*	*$115*
Working Capital	*$25*	*$25*
Sub-total	*$125*	*$140*
Round Down conservatively	*$100*	*$140*
Number of Shares	*4 mil.*	*4 mil.*
Price per share	*$25*	*$35*
Purchase Price	*$10*	*$10*
Discount from Intrinsic/liquidating Value	*60%*	*71%*

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Summary:

There are lessons everywhere in that clip for the budding investor.

Search: How did *Larry the Liquidator* find *NE Wire & Cable*? A broker didn't call him; he didn't hear about it on CNBC. No, he searched through a database to uncover a hidden gem. As Buffett says, start with the Moody's Manual or Value-Line and go A-Z through the company tear sheets.

Valuation: Larry knew *Wire & Cable* wasn't a franchise but he could value the assets using *very* conservative assumptions (…even as **grazing land**, it is worth….). Larry asks what every CNBC commentator does *not* ask, **"So what is IT worth?** Make sure your checklist has that on the first page.

Risk: Larry understood why Mr. Market was pricing the stock at $10 versus his intrinsic value estimate of $25-- because the market feared continued losses from a losing division.

Plan: Larry asked the Founder and fellow shareholder, Jorgy, to better allocate the resources and capital of the company by shuttering the losing division (the "financial cancer").

In that three-minute clip you have all the ingredients of classic value investment: a valuation on hard numbers, conservative assumptions, and a discount from intrinsic value large enough to allow for considerable error.

How does the story end? **A prayer for the dead:** http://youtu.be/62kxPyNZF3Q. This five minute clip is a classic for an activist investor using corporate finance to reallocate capital to better uses.

Your Ultimate Purpose

As a value investor you are helping the market become more efficient by closing the gap between price and value which ultimately lowers the cost of capital in the secondary market--and ultimately the IPO market--for entrepreneurs who start new businesses. I disagree with one famous investor who believes value investing doesn't contribute much to society. Social contribution can divert us to philosophical discussions, but let's stay on our path.

--
Now that we know what an activist value investor does, **what causes prices to deviate from intrinsic value?**

Let's spend three minutes in a **Boiler Room**: **http://youtu.be/4zakyg3thfY** Then let's analyze what we just saw courtesy of http://**fundooprofessor.**wordpress.com/2005/11/01/the-boiler-room-lollapalooza/…….

How can a prosperous man take *one* phone call from someone he *never* met or even talked to before, and over the course of the next few minutes agree with the request of the caller to make a foolish "investment" in a company he *never* heard of before?

Obviously *greed* is a reason. Greed is associated with reward super response tendency which is a mental model from psychology. In this case, it's the greed of the broker, induced by huge commissions, which drives his behaviour, and it's the greed of the customer, whose desire to get rich quick, contributes to his mental malfunction.

But is greed the *only* reason which produced this outcome, or is there something else?

There *has* to be something else, isn't it? **Lollapalooza outcomes are *never* due to only *one* reason.** It's a combination of many mental models, all working in the same direction, which produce lollapalooza outcomes.

So which models combined to produce this lollapalooza outcome?

The above story was taken from the film Boiler Room, an awesome movie which I screened in my class recently to students who had earlier read Mr. Munger's talks on psychology. Members of the audience enjoyed the film, I think, because they could easily relate the Munger mental models from the talks to the scenes in the film.

My favorite scene is a lollapalooza. In this scene, Seth (played by Giovanni Ribisi) is a broker dealer working for a boiler room operation under the name of J.T Marlin Associates. Seth and his mentor, Chris (played by Vin Diesel) talk to Dr. Jacobs (played by Peter Maloney) on the phone, and by the end of the conversation, which lasts just a few memorable minutes, they basically get him to foolishly hand over his hard-earned money to them.

How did Seth and Chris do it? I think it's *very* interesting to see how the pair used several mental models from psychology in combination to achieve the desired outcome – for them, not for Dr. Jacobs (boiler room operations are *zero-sum games*, which, incidentally, is also a mental model with enormous applicability – more about that one in a future blog post.)

An excellent way to identify the mental models embedded in the scene is to read its script, which I am reproducing below, while having the Munger Mental Model Checklist from psychology in front of you[3].

This is the procedure I followed, and was amused, though not surprised, to find the presence of multiple models in Munger's checklist in that memorable scene.

Read the script of the scene below along with my comments[IN CAPITALISED **BOLD** LETTERS IN BRACKETS] and I think you'll arrive at the same conclusion as mine.

INT. BOILER ROOM – DAY
SETH (O.S.)
I'm sorry, sir, I didn't realize…

DR. JACOBS
I'm really busy, Seth.

[3] Links to Munger Articles on Mental Models

Seth looks over towards Michael's office and sees Greg and three other team leaders coming out.

SETH
I understand. I'm real busy here myself, Doctor. Look, we're going to come back to you in a month with one idea and one idea only. If you like what we have to say, great, we'll do business. Worst case scenario you'll hear yourself a new business idea. Chat about it with your golfing buddies and we'll part as friends. That's fair, right? **[ONE IDEA AND ONE IDEA ONLY - SETH INVOKES THE SCARCITY MODEL HERE]**

A nurse is asking the Doctor a question and he loses focus.
DR. JACOBS
Ummm what?

SETH
Great. So tell me, Doc, are you working with a million dollars in the market right now?

DR. JACOBS
Who is this again?

SETH
Tell me something, you're a doctor. Have you ever heard of a drug called Fenamul? It's being manufactured by MSC pharmaceuticals. **[INFLUENCE FROM MERE-ASSOCIATION TENDENCY I.E. ASSOCIATION OF DRUG WITH DOCTOR]**

DR. JACOBS
No.
SETH
Well it's in the third stage of FDA approval right now. Word is, it's going to get approved in the next three months. Could be tomorrow for all I know. Anyway, I'm getting ahead of
myself. And you're real busy over there. Why don't I send you out the info you requested about the firm and a senior broker will call you next month with that one
idea. **[AUTHORITY MISINFLUENCE TENDENCY - FDA AS AUTHORITY HERE. ALSO SCARCITY - SCARCE, VALUABLE INSIDE INFORMATION PRESENTED EXCLUSIVELY]**

DR. JACOBS
Wait, wait, wait, hold on a second, forget the info, let's talk about this now. What was the name of the drug again? **[DEPRIVAL SUPERREACTION TENDENCY - DR JACOBS REACTS TO THE POTENTIAL LOSS OF AN OPPORTUNITY BY DISPENSING WITH THE NEED TO BE DILIGENT]**

Seth begins to smile.

SETH
You know what, sir, let me pass you on to a senior broker who's more involved with this particular stock. Hold on a second. **[AUTHORITY MISINFLUENCE TENDENCY - SENIOR BROKER AS AN AUTHORITY FIGURE WHO IS SUPPOSED TO KNOW MORE, HE WILL NOT SAY ANYTHING INCONSISTENT WITH WHAT THE JUNIOR BROKER SAID - THE WHOLE THING IS PART OF THE ELABORATE GAME DESIGNED TO GAIN THE CUSTOMER'S CONFIDENCE]**

Seth pushes the hold button. He pauses and then YELLS:
Reco!!

Everything and everyone in the room stops. There is a slight pause and then CHAOS. About 20 brokers BOLT toward Seth.

Chris is closest. Another broker JUMPS onto the table separating him from Seth and clambers over it. Chris puts on the steam and gets there first. The other broker runs straight into Seth, unable to stop.

Chris regains his composure wiping the smile off his face.

CHRIS
Card.

SETH
Okay, his name's Dr. Jacobs and from the sound of it, I'd say he's definitely…

CHRIS
Whoa, whoa, I don't wanna hear it, kid.

Chris grabs the card from his hand and looks at it briefly.

CHRIS (CONT'D)
Hi, Dr. Jacobs, this is Chris Marlin over at JT Marlin.

DR. JACOBS
Marlin?

CHRIS
Right. He's my father.

Another broker connects a wire to a jack on the back of the phone and the conversation is now heard on the PA system.

CHRIS (CONT'D)
So my associate tells me you're interested in one of our stocks.

DR. JACOBS
Yes, MSC sounds like it might be interesting.

CHRIS
Might be? Might be doesn't sell stock at the rate MSC is going, Dr. Jacobs. We're talking about very high volume here. **[SOCIAL PROOF TENDENCY - VERY HIGH VOLUME IMPLIES THAT THERE ARE MANY OTHERS WHO APPROVE OF THE IDEA WHICH AUTOMATICALLY MUST MEAN THAT IT'S A GOOD IDEA]**

DR. JACOBS
Well, I still have to run it by my people.
CHRIS
That's great, Doc. If you want to miss yet another opportunity here and go watch your colleagues get rich doing clinical trials, then don't buy a share and hang up the phone. **[DEPRIVAL SUPERREACTION TENDENCY, AND ENVY/JEALOUSY TENDENCY INVOKED TOGETHER IN JUST TWO SENTENCES RESULT IN TOTAL SUPRESSSION OF THE DESIRE TO QUESTION ANYTHING]**

DR. JACOBS
Well hold on a second. I didn't say that. I just wanted to talk more about it.
CHRIS
Honestly Doc, I don't have the time. This stock is blowing up right now. The whole firm is going nuts. Let me open the door to my office.

Chris holds the phone up to the 100 brokers standing there silently. They begin talking loudly and screaming "Buy, Sell". Chris makes a hand motion and they stop.

You hear that? That's my trading floor, Doc. Now I have a million calls to make to other doctors who are already in the know. I can't walk you through this right now. I'm sorry.

Huge pause. Everyone looks on waiting to hear what he'll do. Chris doesn't even look mildly concerned. Then… **[DEPRIVAL SUPERREACTION TENDENCY I.E. TIME IS RUNNING OUT DR JACOBS + SOCIAL PROOF TENDENCY I.E. JUST HEAR HOW PEOPLE ARE NUTS OVER THIS STOCK + ENVY I.E. OTHER DOCTORS ARE GOING TO GET RICHER = BUY NOW! IT HAS TO WORK NOW ISN'T IT?]**

DR. JACOBS
Okay, okay. Let's do this. **[MISSION ACCOMPLISHED! - THEY GOT HIM - HOOK, LINE, AND SINKER]**

CHRIS
Now, since you're a new account I cannot go any higher than two thousand shares. I'd love to but I just can't do it. **[AVAILABILITY MISINFLUENCE TENDENCY - CHRIS VERY CLEVERLY NOW MENTIONS A FIGURE OF 2,000 SHARES**

WHICH IS PROBABLY MORE THAN WHAT DR. JACOBS WOULD HAVE BOUGHT - HE CREATES AN AVAILABLE ANCHOR IN THE MIND OF DR. JACOBS - ANCHORING BIAS AS A SPECIAL CASE OF AVAILABILITY BIAS COMBINES WITH DEPRIVAL SUPERREACATION TENDENCY]

DR. JACOBS
Two thousand?! Whoa! That's way more than I was thinking about. Two thousand, Jesus. (pause)
I'm just curious, why can't you sell me more than that? **[THE STRATEGY IS WORKING! DEPRIVAL SUPER-REACTION TENDENCY COMBINES WITH REWARD SUPERRESPONSE TENDENCY TO MAKE DR. JACOBS TO WANT MORE SHARES!]**
The brokers hold in their laughter.
CHRIS
Well, we like to establish a relationship with our clients on something small before we get to the more serious trades. Let me show you several percentage points on this small trade and then we'll talk about doing future business.

DR. JACOBS
That sounds good. Give me two thousand shares.

CHRIS
Done.

DR. JACOBS
You sure you can't do any better on this one?

CHRIS
No, I'm sorry, Dr. Jacobs.

DR. JACOBS
Alright, let's start with this trade then.

CHRIS
Great. I promise we'll go big on the next one.

Now do you want the confirmation sent to your office or your mansion?

DR. JACOBS
(laughs)
Very funny, Mr. Marlin.

CHRIS
Alright, let me put my secretary on. She'll take your info.

Chris hits the hold button and then…

CHRIS (CONT'D)
Done and done.

The entire firm applauds when he gets off the phone. The crowd disperses. Chris sits down on Seth's desk.

CHRIS (CONT'D)
I love doctors, man. All that money and not a clue what to do with it. Fucking rollovers. Hold onto your ankles, Doc, here comes the love.

SETH
Why'd you put a max on his buy?

CHRIS
Didn't you tell him how it works?

GREG
He's still a trainee. He doesn't need to know about initial sell limits.

CHRIS
Right, right. Make sure he shows you the ropes. He's too busy calling his bookie. You fucking Hebrews, man. Always looking out for yourselves, never the trainees.

GREG
That's great. Why don't you go back to little Italy now?

Greg points across the room.

CHRIS
Why don't you go make a latke dreidel boy.
(back to Seth)
The reason I capped him is in case he's a piker. See, we're going to go ahead and front the money for this sale. If he doesn't send the check, I'm the one holding the bag.
(whispers)
Last commission month a kid on Jim's team wrote a million dollar ticket.
Stock was down three and a half points by settlement. Fucking kid took a one quarter million dollar hit. Besides, first sale just whets the appetite. If he's a whale, which it looks like he
is, then I'll get him on a day when there's a real rip.

SETH
Rip?

CHRIS
(surprised)
Rip. Commission. That's why we work here. We get huge rips. **[REWARD SUPERRESPONSE TENDENCY- INCENTIVES AS SUPERPOWERS - GIVEN SUFFICIENT INCENTIVES AND YOU CAN BE VIRTUALLY SURE THAT THE PRODUCT/SERVICE WILL GET PUSHED TO THE CUSTOMER, NO MATTER HOW TOXIC IT MAY BE]**

SETH
(quietly)
I actually still don't know how it works.
CHRIS
A two dollar rip, which is unheard of anywhere on Wall Street, means you're walking away with two dollars for every share you sell. Real money. Jesus Greg, you tell him where the bathroom is yet?

GREG
Seth, I showed you where Chris' desk is.

SETH
How does Michael afford that?

CHRIS
I don't know, but if he's doing it, he's making money on it. Point is, don't worry about selling small on the first trade. You service the client right and he'll be back for more. Bide your time. Show him a three percent return and he'll trust you to watch his kids for the weekend. If he's serviced correctly it's not a matter of whether he's making a second trade with you, it's a matter of how much.

Chris' secretary calls out from across the room.

CHRIS
Gotta bounce.

Seth stands there in awe. He sees the potential here.

Go see the clip again. Now you have an inkling that not all activity in the market is linked to determining intrinsic value. Even smart people invest with their emotions not with cool calculation.

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If you want to further your understanding of how an auction market works then view:

http://wp.me/p2OaYY-1ej

--

Later, we will go into much more depth about how prices are actually formed through reservation demand and supply, marginal utility and more…

But let's test your **aptitude for investing and thinking about business operations** with this **Munsingwear Case Study**

Munsingwear, Inc. Case Study Instructions

This case tests your ability to think strategically.

Prize:

Pretend you have traded in your hush puppy shoes or sandals in for a pair of wing-tips. You are now an investment banker who is being asked to help Munsingwear, Inc. **"enhance shareholder value."** How would you advise the CEO in improving their operations and profitability? Your fee, if your advice salvages value for shareholders and/or turns this company around, would be $500,000. If you solve this case with an analysis of how this company could be profitable and your idea of its probable valuation with an explanation backing your valuation, tell me where to send your fee.

Instructions:

Use only what is in this case study for your analysis. If you feel critical information is lacking, then state what is missing and how it prevents you from advising your client. You will have a chance to speak to the CEO, Mr. Lowell Fisher, in class.

After reading the 10-K what would you advise? Why? Please give no more than a written paragraph answer. Provide a brief pro-forma of your analysis if necessary.

Please provide a short analysis (no more than one or two paragraphs of how you would restructure the company to make it profitable on a normalized basis. Then provide a back of the envelop valuation based on conservative assumptions.

Good luck in your new wing tips! Do not take more than 30-40 minutes! If you win, do you want the funds wired to your off-shore account?

Munsingwear, Inc. Case Study

FORM 10-K

For the fiscal year ended January 6, 1996

Munsingwear, Inc.

IRS # 41-0429620

8000 W. 78th Street, Suite-400, Minneapolis, Minnesota 55439
Telephone number: 612-943-5000

Delaware: State of Incorporation

The aggregate market value of the voting stock held by nonaffiliates of the Registrant at April 1, 1996 was $9,384,000 based on the closing price of $7.25 per share at that date.

The number of shares of common stock outstanding at April 1, 1996 was 2,037,078

A. GENERAL DEVELOPMENT OF BUSINESS

The Company was incorporated under the laws of Delaware in 1923 as the successor to a business founded in 1886. The Company's principal executive offices are located at 8000 W. 78th Street, Suite-400, Minneapolis, Minnesota 55439, and its telephone number: 612-943-5000. As used in this document, the term "Company" refers to Munsingwear, Inc. and its subsidiaries unless otherwise noted or indicated by the context. At Jan. 6, 1996, the Company had one subsidiary, Munsingwear UK Limited, which was idled in 1994.

After suffering a severely weakened financial condition, primarily due to losses of $89, 243,000 during the years 1989 through 1990, the Company, on July 3, 1991, filed a voluntary petition for bankruptcy under Chapter 11 of the US Bankruptcy Code, together with a proposed Plan of Reorganization. The Company emerged from bankruptcy on Oct. 29, 1991.

Prior to the reductions in operation implemented during 1989 through 1991, the Company designed, manufactured and distributed a broad range of men's and children's apparel through several operating divisions and subsidiaries. Today the Company's operations consist of what was formerly the Men's Apparel Division and sell primarily men's knit sport shirts under the following major brands or labels:

Munsingwear ®, Grand Slam ®, Grand Slam Tour ™, Penguin Sport ™ and Slammer ®. In addition, the Company licenses its trade names and trademarks for use in a variety of products.

In the recent two fiscal years, the Company's sales by channel of distribution have undergone significant change. In 1995, sales to premium/special markets and golf Pro shop customers rose 52% collectively over 1994. This is the result of management's attempt to reduce the Company's reliance on sales to traditional retail apparel channels of distribution where heavy promotional pricing, discounting and advertising activities are required.

In late 1995, the Company retained the services of an investment banking firm to explore a range of opportunities to maximize shareholder value.

B. FINANCIAL INFORMATION ABOUT INDUSTRY SEGMENTS

The Company operates in one industry segment, apparel manufacturing. As of Jan. 6, 1996, the Company's foreign operations were not material.

C. NARRATIVE DESCRIPTION OF BUSINESS

Principal Products:

The Company sells primarily men's knit sport shirts under four major brands or labels: Munsingwear ®, Grand Slam ®, Grand Slam Tour ™, and Penguin Sport ™. Grand Slam ® and Penguin Sport ™ products are sold primarily to department stores, specialty stores and Sears. Munsingwear ® products are sold primarily to premium/special markets customers and to national chain stores, such as Montgomery Ward. Grand Slam Tour ™ is sold primarily through golf pro shops.

Sources and Availability of Raw Materials and Products:

Approximately 60% of the Company's products are manufactured domestically. The other 40% is sourced primarily from manufacturers in the Far East through a relationship with Associated Merchandising Corporation (AMC). The Company also sources some product through the 807 program in the Caribbean Basin. The principal raw materials used in the domestic production process are cotton, synthetic and cotton/synthetic blended goods obtained principally from United States sources. The Company purchases most of its piece goods from approximately ten sources. There are currently no major problems in availability of raw materials and alternative sources are available. The Company's Fairmount, NC manufacturing facility includes a material warehouse, cutting, sewing and embroidery operations, and finished goods distribution center. The company also utilizes contract swing manufacturers in close proximity to its North Carolina facility to meet demand during peak production periods. All products, both domestically and offshore produced, are distributed to customers from the North Carolina facility.

Trademarks and Trade Names:

In 1991, management initiated the strategy to actively pursue licensing as a vital part of the Company's growth plan. During the period 1991 through 1993, the Company entered into eleven license agreements, and in 1994, renegotiated its licenses with Fruit of the Loom which, among other things, extended the original agreement for twenty-five years. In 1995, the Company entered into four additional license agreements. Management intends to continue development of its licensing programs and believes that its advertising, styling and brand name identification established over many years are important to the competitive position of the company. The Company has the following license agreements:

- A license with Fruit of the Loom, Inc. to market underwear and active wear.
- A license with a New York entity to market sleepwear.

- Five licenses with Montgomery Ward to market men's pants, outerwear, accessories, dress wear and shirts.
- A license with a Canadian corporation to market knit shirts.
- A license with a North Carolina entity to market men's and boys' hosiery.
- A license with a Peoples Republic of China entity to market a variety of clothing and accessories.
- A license with a South Carolina entity to market sweaters.
- A license with a Missouri entity to market outerwear.
- A license with a New York entity to market woven shirts.
- A license with a South African entity for apparel.

Management's emphasis on licensing activities in recent years has led to a dramatic increase in the Company's royalty income, from $1,162,000 in 1991 to $4,609,000 in 1995.

Seasonal Aspects of the Business:

Sales of the Company's products can vary significantly by season, with peak shipments normally occurring in the first and second quarters of the fiscal year.

Working Capital Practices:

The Company maintains a secured bank line of credit to meet its working capital needs. Peak borrowings under this agreement normally occur in the first six months of the year during the heavier shipping period and during the fourth quarter when inventories are increased to meet the additional first and second quarter sales volume. Seasonal increases in inventory are normal for the apparel manufacturing industry. The bank line of credit is also used for letters of credit that are required for generally all of the Company's purchases from offshore sources. The Company allows returns of merchandise as a result of shipping errors, damaged merchandise and for other reasons. Returns have been less than 4% of sales in each of the past two years.

Customers:

The Company sells to approximately 4,500 customers. Sales to Sam's Club (a division of Wal-Mart Stores, Inc.) in 1994 and 1993 were 16% and 21%, respectively, of net sales. In 1995, no single customers represented more than 10% of total Company sales.

Backlog of Orders:

The Company's backlog of unfilled orders at January 6, 1996 was approximately $15,600,000 as compared to $18,800,000 a year ago. The decrease was due primarily to management's emphasis on reducing reliance on traditional retail apparel customers. The unfilled order backlog does not necessarily relate directly to future sales.

Competition:

The apparel industry in the United States is highly competitive and characterized by a relatively small number of broad line companies and a large number of specialty manufacturers. In addition, there are unbranded and private label competitors as well as numerous, small specialty manufacturers competing with the Company. The principal methods of competition in the apparel industry are pricing, styling, quality (both in material and production), inventory replenishment programs and customer service. The

Company seeks to maintain its competitive position in the markets in which it operates through the use of all these methods.

Research and Development:

The Company is involved in limited experimental research activities related to the development of new fabrics and production methods. Research and development expenses, other than for product design, are not significant.
Environmental Considerations:

The Company's manufacturing operations are subject to various federal, state and local laws restricting the discharge of materials into the environment. The Company is not involved in any pending or threatened proceedings which would require curtailment of its operations because of such regulations. In 1995, the company's capital expenditures for environmental control facilities were not significant, and no significant capital expenditures related to environmental issues are projected in 1996.

Item 1: Employees:

As of January 6, 1996, there were 343 employees, none of whom were represented by a union.

D. FINANCIAL INFORMATION ABOUT FOREIGN AND DOMESTIC OPERATIONS AND EXPORT SALES

Sales to unaffiliated foreign customers located outside the United States and its territories for the past three years were not significant.

Item 2. Properties

At January 6, 1996, the Company occupied the following properties:
Management considers facilities adequate for current operations. At Jan. 6, 1996, no facilities were occupied
Under capitalized leases.

Property	Sq/ Footage	Approx. Percentage Utilized	Lease Expires
Minn., MN HQ	29,200	50	1996
Fairmont, NC – Cutting and sewing plant, warehouse and distribution center	139,100	100	Owned
New York, NY – Sales office/showroom	1,000	100	1997
Dallas, TX – Sales office/showroom	500	100	1996

Item 3. Legal Proceedings

None of a significant nature.

Item 4. Submission of Matters to a Vote of Security Holders

None.

Executive Officers of the Registrant

The following information is furnished with respect to the Company's executive officers as of the date hereof, pursuant to Item 401 (b) of Regulation S-K. Each of the officers has been appointed to serve in his respective office until his successor has been elected.

Name and Age	Position	Officer Since
Lowell M. Fisher (63)	Director of the Company; President and CEO, October 1993 to	1993

ABOUT THE COMPANY

The Company was founded in 1886 as a manufacturer of men's underwear. Throughout the early 1900's, the Company was an innovator of new textile and apparel manufacturing processes and, during the 1940's and 1950's, expanded its product lines, acquired a women's intimate apparel company and, in 1955, introduced the Gran Slam (R) collection of golf apparel bearing the well-known Penguin ® emblem. During the 1960's and 1970's, manufacturing facilities were added, textile research and development departments were established and the Company entered into numerous licensing agreements for the use of its trade names and trademarks.

Today the Company derives its revenues primarily from the sale of men's sportswear apparel and the licensing of men's underwear, active wear and other related apparel. The Company's products are sold primarily through premium/special markets, department stores, golf pro shops, national chain stores, specialty stores, sporting goods stores and wholesale clubs. The Company designs, manufactures, imports, markets and licenses branded men's lifestyle apparel under the Grand Slam ®, Grand Slam Tour®, Munsingwear ®, and Penguin Sport ™ labels. The Company is headquartered in Minneapolis, MN and has 343 employees in company-wide operations.

LETTER TO STOCKHOLDERS

Revenues for 1995 were $56.1 million, a 34% increase over last year. Dramatic sales growth in our premium/special markets and golf pro shop businesses more than offset a small decline in business with our traditional customers, such as department and specialty stores, national chain stores and wholesale clubs. Premium/special markets volume increased seven-fold while golf Pro shop volume increased 52%. In 1995 these two businesses represented 40% of our total sales volume and are expected to exceed 50% of total Company sales in 1996. As recent transition the Company has undergone over the past two years, significantly reducing our exposure to the difficult retail apparel marketplace.

Royalty income was up slightly to $4.6 million. As a reminder, 1994 royalty income had increased 25% as a result of additional license agreements and a twenty-five year extension to the Fruit of the Loom license, which will also lead to lower cash receipts from existing licensing agreements starting in 1996. The Munsingwear trade names and trademarks have always signified quality to the licensing market and we will continue to actively pursue additional license agreements.

While we achieved significant revenue growth in 1995, we were not successful in becoming profitable. The loss of $2.3 million, $1.13 per share, was primarily the result of deep markdowns on excess end-of-season merchandise related to the retail department store channel of distribution, losses related to an unsuccessful entry into "Friday-wear", increased advertising expenses in support of the retail department store business and restructuring costs related to completed staff reductions and reduced office space requirements. In addition, costs associated with our PGA Tour endorsement program increased, yet we feel this program is necessary to give Munsingwear brands consumer exposure. We were successful in reducing selling, general and administrative expenses as a percent of sales – from 32% in 1994 to 27% in 1995. Interest expense was up significantly due to inventory build-up required to service the explosive sales growth in the premium/special markets business. Throughout the year we also experienced higher

than planned levels of inventory for the retail department store business, which did not meet sales forecasts. Ultimately, we sold this inventory at deep discounts.

Looking ahead to 1996, we plan to continue to grow the premium/special markets business which has achieved exceptional results the past two years. Munsingwear's strong consumer brand recognition, the Penguin logo, quality product and the agility to merchandise across a broad product line give us a competitive advantage. We are confident that increased revenues and a return to profitability will be achieved due to the following:

- Continued strong sales growth in premium/special markets and golf pro shop businesses.
- Cost reduction programs.
- Continued focus on core capability – men's, short sleeve, knit, and moderately priced golf shirts.

(Picture of LOWELL M. FISHER)

- Innovative designs and fabrics throughout all product lines.
- Continued upgrading of management information systems.
- Strengthening of our Board of Directors by the addition of three new members, Thomas D. Gleason, who was named non-executive Chairman of the Board in January of this year, and Kevin S. Moore and William J. Morgan, who represent the Company's two largest single stockholders.

In late 1995 we retained the services of an investment banking firm to help us explore a range of opportunities to maximize shareholder value, and we expect this activity to accelerate in 1996. Please refer to the Management's discussion and analysis section in this annual report for additional financial analysis and a statement regarding forward-looking information.

Although 1995 was a difficult year for retailing, the Company achieved extremely promising revenue growth in our two most profitable businesses—premium/special markets and golf pro shops. These results reaffirmed our decision to continue the Company's transition – expanding markets, enhancing product quality, increasing consumer value and investing in infrastructure. As a result, we are now in a much stronger strategic position and I look forward to working with Tom Gleason and the Board in continuing our efforts to ensure the long-term success and profitability of the Company.

In closing, I would like to thank our customers, suppliers and lender, who have continued to support us throughout the Company's transition. Finally, I would like to take this opportunity to thank all Munsingwear employees for their hard work and effort which led to spectacular 1995 sales growth and reinforces our optimism for 1996.

Sincerely,
/s/ Lowell M. Fisher
Lowell M. Fisher, President and CEO.

CONSOLIDATED STATEMENTS OF OPERATIONS
(AMOUNTS IN THOUSANDS, EXCEPT PERSHARE DATA)

MUNSINGWEAR, INC.	**Year Ended January 6, 1996**	**Year Ended January 7, 1995**	**Year Ended January 1, 1994**
REVENUES			
Net Sales	$ 51,512	$ 37,407	$ 37 635
Royalties	4,609	4,528	3,624
	56,121	**41,935**	**41,259**
EXPENSES:			
Cost of goods sold	42,714	30,029	28,783
SG&A	13,961	12,134	11,869
Restructuring costs (Note 9)	520	---	---

(Gain) loss on closing of facilities (Note 9)	---	(100)	450
	57,195	42,063	41,102
OPER. INCOME (LOSS)	**(1,074)**	**(128)**	**157**
Interest expense	(1,158)	(353)	(286)
Other	2	177	(74)
Loss before inc. taxes and extraordinary item	**(2,230)**	**(304)**	**(203)**
Provision for inc. taxes	105	108	139
Loss before extraordinary item	(2,230)	(304)	(203)
Extraordinary loss from early debt extinguishment	---	161	---
NET LOSS	**$ (2,335)**	**$ (573)**	**$ (342)**
Net Loss per common share:			
Loss before extraordinary item	$ (1.13)	$ (.20)	$ (.16)
Extraordinary item	---	(.08)	---
NET LOSS PER CS	$ (1.13)	$ (.28)	$ (.16)
Weighted avg. OS	2,066	2,066	2,093

The accompanying notes are an integral part of these financial statements

CONSOLIDATED BALANCE SHEETS (AMOUNTS IN THOUSANDS, EXCEPT SHARE DATA)

	January 6, 1996	**January 7, 1995**
ASSETS		
Current Assets:		
Cash and CE	$62	$ 73
Receivables:		
Trade, net of allowance of $511 and $442	8,260	4,852
Other	277	286
Inventories	14,641	14,219
Prepaid expenses	1,004	1,286
TOTAL CURRENT ASSETS	**24,244**	**20,716**
PP&E		
Land	15	15
Buildings and leasehold improvements	568	550
Machinery and equipment	3,928	3,041
	4,511	3,606
Less accumulated D&A	1,584	1,330
	2,927	2,276
TRADEMARKS net of accumulated Amortization of $1,274 and $1,010	4,173	4,437
Deferred taxes, NET OF VALUATION ALLOWANCE OF $11,796 AND $11,151	2,309	2,309
	$ 33,653	$ 29,738
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Line of credit borrowings	$ 10,890	$ 5,592

Current maturities of long-term debt	21	19
Accounts payable	5,008	3,760
Accrued payroll and employee benefits	1,009	1,028
Unearned royalty income	2,993	3,159
Other accruals	397	311
TOTAL CURRENT LIABILITIES:	**20,318**	**13,869**
LONG-TERM LIABILITIES:		
Long-term debt, less current liabilities	22	38
Postretirement benefits	319	312
Unearned royalty income	10	200
	351	550
TOTAL LONG-TERM LIABILITIES	351	550
STOCKHOLDERS' EQUITY		
Common Stock, $0.01 par value 2,065,594 shares issued and issuable	21	21
Additional paid-in capital	15,112	15,112
	(2,149)	185
TOTAL STOCKHOLDERS' EQUITY	12,984	15,319
	$ 33,653	$ 29,738

CASH FLOWS	**Year Ended January 6, 1996**	**Year Ended January 7, 1995**	**Year Ended January 1, 1994**
OPERATING ACTIVITIES			
Net loss from continuing operations	$ (2,335)	$ (573)	$ (342)
Reconciling items:			
Deprec. & Amort.	782	712	873
Deferred Taxes	--	(69)	--
Provision for losses on accounts receivable	69	142	204
Loss on restructuring	193	---	--
(gain) loss on closing of facilities	--	(100)	450
Change in unearned royalty income	(356)	2,729	(690)
Changes in operating assets and liabilities:			
Receivables	(3,468)	(380)	(716)
Inventories	(422)	(5,986)	(425)
Prepaid expenses	282	(254)	(192)
Accounts Payable	1,248	944	(164)
Other accrued liabilities	(87)	(292)	(305)
NET CASH USED IN OPERATING ACTIVITIES	**(4,094)**	**(3,127)**	**(1,307)**
INVESTING ACTIVITIES	(1,201)	(865)	(490)
Purchases of PP&E			
NET CASH USED IN INVESTING ACTIVITIES	(1,201)	(865)	(490)
FINANCING ACTIVITIES			
Net Change in previous line of credit borrowings	---	($1,698)	$1,698
Net Change in new line of credit borrowings	5,298	5,592	--

Principal payments on long-term debt and capital lease obligations	(14)	(270)	(303)
Proceeds from exercise of stock options	--	--	133
NET CASH PROVIDED BY FINANCING ACTIVITIES	5,284	3,624	1,528
DECREASES IN CASH AND CASH EQUIVALENTS	(11)	(368)	(269)
Cash and Cash Equivalents at beginning of period	73	441	710
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$ 62	$ 73	$ 441
Supplemental disclosures of cash flow information:			
Cash paid for taxes	$ 178	$ 122	$ 153
Cash paid for interest	$ 1,078	$ 370	$ 273

The **Solution** will be provided later in this introduction.

The Secret to Investing

Is there a secret to successful investing? Can a guru or method provide the golden key? Well, if there was a secret then here is an example of the pig farmer:

The Eternal Secret of Successful Investing

A Little Wonderful Advice from Where Are The Customer's Yachts? by Fred Schwed, Jr., 1940 (pages 180-182)

For no fee at all I am prepared to offer to any wealthy person an investment program which will last a lifetime and will not only preserve the estate but greatly increase it. Like other great ideas, this one is simple:

When there is a stock-market boom, and everyone is scrambling for common stocks, take all your common stocks and sell them. Take the proceeds and buy conservative bonds. No doubt the stocks you sold will go higher. Pay no attention to this—just wait for the depression which will come sooner or later. When this depression—or panic—becomes a national catastrophe, sell out the bonds (perhaps at a loss) and buy back the stocks. No doubt the stocks will go still lower. Again pay no attention. Wait for the next boom. Continue to repeat this operation as long as you live, and you will have the pleasure of dying rich.

A glance at financial history will show that there never was a generation for whom this advice would not have worked splendidly. But it distresses me to report that I have never enjoyed the social acquaintance of anyone who managed to do it. **It looks as easy as rolling off a log, but it isn't.** The chief difficulties, of course, are **psychological**. It requires buying bonds when bonds are generally unpopular and buying stocks when stocks are universally detested.

I suspect that there are actually a few people who do something like this, even though I have never had the pleasure of meeting them. I suspect it because someone must buy the stock that the suckers sell at those awful prices—a fact usually outside the consciousness of the public and of

financial reporters. An experienced reporter's poetic account in the paper following a day of terrible panic reads this way:

Large selling was in evidence at the opening bell and gained steadily in volume and violence throughout the morning session. At noon a rally, dishearteningly brief, took place as a result of short covering. But a new selling wave soon threw the market into utter chaos, and during the final hour equities were thrown overboard in huge lots, without regard for price or value.

The public reads the papers, and reading the foregoing, it gets the impression that on that catastrophic day everyone sold and nobody bought, except that little band of shorts (who most likely didn't exist). Of course, there is just no truth in that at all. If on that day the terrific "selling" amounted to seven million, three hundred and sixty-five thousand shares, the volume of the buying can also be calculated. In this case it was 7,365,000 shares.

CASE STUDY

How Mr. Womack Made a Killing by John Train (1978)

The man never had a loss on balance in 60 years.

His technique was the ultimate in simplicity. When during a bear market he would read in the papers that the market was down to new lows and the experts were predicting that it was sure to drop another 200 points in the Dow, the farmer would look through a S&P Stock Guide and select around 30 stocks that had fallen in price below $10—solid, profit making, unheard of companies (pecan growers, home furnishings, etc.) and paid dividends. He would come to Houston and buy a $25,000 "package" of them.

And then, one, two, three or four years later, when the stock market was bubbling and the prophets were talking about the Dow hitting 1500, he would come to town and sell his whole package. It was as simple as that.

He equated buying stocks with buying a truckload of pigs. The lower he could buy the pigs, when the pork market was depressed, the more profit he would make when the next seller's market would come along. He claimed that he would rather buy stocks under such conditions than pigs because pigs did not pay a dividend. You must feed pigs.

He took "a farming" approach to the stock market in general. In rice farming, there is a planting season and a harvesting season, in his stock purchases and sales he strictly observed the seasons.

Mr. Womack never seemed to buy stock at its bottom or sell it at its top. He seemed happy to buy or sell in the bottom or top range of its fluctuations. He had no regard whatsoever for the cliché'—Never send Good Money After Bad—when he was buying. For example, when the bottom fell out of the market of 1970, he added another $25,000 to his previous bargain price positions and made a virtual killing on the whole package.

I suppose that a modern stock market technician could have found a lot of alphas, betas, contrary opinions and other theories in Mr. Womack's simple approach to buying and selling stocks. But none I know put the emphasis on "buy price" that he did.

I realize that many things determine if a stock is a wise buy. But I have learned that during a depressed stock market, if you can get a cost position in a stock's bottom price range it will forgive a multitude of misjudgments later.

During a market rise, you can sell too soon and make a profit, sell at the top and make a very good profit. So, with so many profit probabilities in your favor, the best cost price possible is worth waiting for.

Knowing this is always comforting during a depressed market, when a "chartist" looks at you with alarm after you buy on his latest "sell signal."

In sum, Mr. Womack didn't make anything complicated out of the stock market. He taught me that you can't be buying stocks every day, week or month of the year and make a profit, any more than you could plant rice every day, week or month and make a crop. He changed my investing lifestyle and I have made a profit ever since.

Keep this a secret!

--

Although Mr. Womack had a feeling for the rhythm of the markets, perhaps if he found great companies that compounded their capital at high rates (like Wal-Mart from 1970 to 1995) and just held on, he would have fared even better.

Of course after reading those pieces, you realize there is no secret to investing. All the principles are laid out in *Security Analysis* **(Link:)** and *The Intelligent Investor* by Benjamin Graham **(Link).** The application and evolution of value investing principles are laid out each year in Mr. Buffett's shareholder letters (www.berkshirehathaway.com. The study, application and discipline are up to you, but then who would want it any other way?

You will learn about developing an investment philosophy, valuation, search, portfolio and risk management and monitoring yourself from investment greats like Phil Fisher, Ben Graham, Warren Buffett, Walter Schloss, Robert Bruce and many more. Case studies will be the main way we will practice.
--

I hope you are excited to learn, but remember the reality is that when values become available, usually in a bear market, investing can FEEL like this:
http://www.youtube.com/watch?feature=player_detailpage&v=bwBkQy9CpS0. Simple but not easy.

Let's return to our Munsingwear case study. Did you earn your wingtips and the $500,000 fee?

Munsingwear, Inc. Case Study Analysis (Answer)

First jump to the financial statements to get an overview of the company. Quickly glance at the numbers to note anything unusual then you can go to the narrative and notes to the financial statements. What jumps out at you?

This should take no more than 10 to 15 minutes—jot down your thoughts for reference if you wish.

MUNSINGWEAR, INC.	**Yr. Ended Jan. 6,1996**	**Year Ended Jan. 7, 1995**	**Year Ended January 1, 1994**
REVENUES	*Increasing sales*		
Net Sales *NOTE: 2 separate items!*	$ 51,512	$ 37,407	$ 37 635
Royalties	4,609	4,528	3,624
	56,121	**41,935**	**41,259**
EXPENSES:			
Cost of goods sold (*bigger jump in CGC relative to sales)*	42,714	30,029	28,783
SG&A *Increase as well*	13,961	12,134	11,869
Restructuring costs (Note 9)	520	---	---
(Gain) loss on closing of facilities (Note 9)	---	(100)	450
	57,195	42,063	41,102
OPER. INCOME (LOSS)	**(1,074)**	**(128)**	**157**
Int. expense *large increase in borrowing*	(1,158)	(353)	(286)
Other	2	177	(74)
Loss before inc. taxes and extraordinary item *Increasing losses!*	**(2,230)**	**(304)**	**(203)**
Provision for inc. taxes	105	108	139
Loss before extraordinary item	(2,230)	(304)	(203)
Extraordinary loss from early debt extinguishment	---	161	---
NET LOSS	**$ (2,335)**	**$ (573)**	**$ (342)**
Net Loss per common share:	*Increasing losses*		
Loss before extraordinary item	$ (1.13)	$ (.20)	$ (.16)
Extraordinary item	---	(.08)	---
NET LOSS PER CS	$ (1.13)	$ (.28)	$ (.16)
Weighted avg. OS *NO CHANGE*	2,066	2,066	2,093

CONSOLIDATED BALANCE SHEETS (AMOUNTS IN THOUSANDS, EXCEPT SHARE DATA)

	January 6, 1996	**January 7, 1995**
ASSETS		
Current Assets:		
Cash and CE *0.10% cash balance as pct of sales*	$62	$ 73
Receivables:		
Trade, net of allowance of $511 and $442 *Note a potential collectible problem? Jump in credit sales*	**8,260**	4,852
Other	277	286
Inventories	14,641	14,219
Prepaid expenses	1,004	1,286
TOTAL CURRENT ASSETS	**24,244**	**20,716**
PP&E		
Land *How long have they owned this land? Higher value in the market?*	15	15
Buildings and leasehold improvements	568	550
Machinery and equipment	3,928	3,041
	4,511	3,606

Less accumulated D&A	1,584	1,330
	2,927	2,276
TRADEMARKS net of accumulated Amortization of $1,274 and $1,010	4,173	4,437
Deferred taxes, NET OF VALUATION ALLOWANCE OF $11,796 AND $11,151	2,309	2,309
	$ 33,653	$ 29,738
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Line of credit borrowings *Company increasing debt to fund increase in sales*	$ 10,890	$ 5,592
Current maturities of long-term debt	21	19
Accounts payable	5,008	3,760
Accrued payroll and employee benefits	1,009	1,028
Unearned royalty income	2,993	3,159
Other accruals	397	311
TOTAL CURRENT LIABILITIES:	**20,318**	**13,869**
LONG-TERM LIABILITIES:		
Long-term debt, less current liabilities	22	38
Postretirement benefits	319	312
Unearned royalty income	10	200
	351	550
TOTAL LONG-TERM LIABILITIES	351	550
STOCKHOLDERS' EQUITY		
Common Stock, $0.01 par value **2,065,594** shares issued and issuable	21	21
Additional paid-in capital	15,112	15,112
Losing Money	(2,149)	185
TOTAL STOCKHOLDERS' EQUITY	12,984	15,319
	$ 33,653	$ 29,738

CASH FLOWS	**Year Ended January 6, 1996**	**Year Ended January 7, 1995**	**Year Ended January 1, 1994**
OPERATING ACTIVITIES	*Increasing losses as sales rise! Ouch! By losing on each sale, we'll make it up on volume!*		
Net loss from continuing operations	$ (2,335)	$ (573)	$ (342)
Reconciling items:			
Deprec. & Amort.	782	712	873
Deferred Taxes	--	(69)	--
Provision for losses on accounts receivable	69	142	204
Loss on restructuring	193	---	--
(gain) loss on closing of facilities	--	(100)	450
Change in unearned royalty income	(356)	2,729	(690)
Changes in operating assets and liabilities:			
Receivables *Note large change*	(3,468)	(380)	(716)
Inventories	(422)	(5,986)	(425)
Prepaid expenses	282	(254)	(192)
Accounts Payable	1,248	944	(164)
Other accrued liabilities	(87)	(292)	(305)

NET CASH USED IN OPERATING ACTIVITIES	**(4,094)**	**(3,127)**	**(1,307)**
Operating cash flows are WORSE than operating income so quality of earnings is worse than shown on income statement.	*DANGER! CF decline accelerating.*		
INVESTING ACTIVITIES	(1,201)	(865)	(490)
Purchases of PP&E			
NET CASH USED IN INVESTING ACTIVITIES	(1,201)	(865)	(490)
FINANCING ACTIVITIES			
Net Change in previous line of credit borrowings	---	($1,698)	$1,698
Net Change in new line of credit borrowings	5,298	5,592	--
Principal payments on long-term debt and capital lease obligations	(14)	(270)	(303)
Proceeds from exercise of stock options	--	--	133
NET CASH PROVIDED BY FINANCING ACTIVITIES	5,284	3,624	1,528
DECREASES IN CASH AND CASH EQUIVALENTS	(11)	(368)	(269)
Cash and Cash Equivalents at beginning of period	73	441	710
Note decline in cash balances-not a sign of strength			
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$ 62	$ 73	$ 441
Supplemental disclosures of cash flow information:			
Cash paid for taxes	$ 178	$ 122	$ 153
Cash paid for interest - *rising borrowing and costs*	$ 1,078	$ 370	$ 273

Ok, so now we see the company has two sources of sales: manufactured clothing sales and licensing revenues. Always break apart business lines or separate businesses from the consolidated statements. Increasing sales are generating increasing losses! Costs are too high and/or prices are too low—obviously—but we need to find out which is which from the narrative or notes to the financials.

The company is borrowing more to fund growth, which increases risk.

Inventories have risen—not a good sign unless the company is planning for a large increase in sales.

The company is losing money the more it sells! Operating Cash flows are increasingly negative and worse than net income so the cash flow deterioration is a danger to the company's survival considering the low cash balances and increasing use of short term borrowings.

That is what we know from glancing at the financials.

We will quickly note what is of interest in the case study.

And we always ask if this company's business or businesses has a competitive advantage? Are there barriers to entry in this industry?

Munsingwear, Inc. Case Study

FORM 10-K

For the fiscal year ended January 6, 1996

The aggregate market value of the voting stock held by nonaffiliates of the Registrant at April 1, 1996 was $9,384,000 based on the closing price of $7.25 per share at that date.

The number of shares of common stock outstanding at April 1, 1996 was **2,037,078**

E. GENERAL DEVELOPMENT OF BUSINESS

The Company was incorporated under the laws of Delaware in 1923 as the successor to a business founded in **1886.** *A Long Time in Business.* The Company's principal executive offices are located at 8000 W. 78th Street, Suite-400, Minneapolis, Minnesota 55439, and its telephone number: 612-943-5000. As used in this document, the term "Company" refers to Munsingwear, Inc. and its subsidiaries unless otherwise noted or indicated by the context. At Jan. 6, 1996, the Company had one subsidiary, Munsingwear UK Limited, which was idled in 1994.

After suffering a severely weakened financial condition, primarily due to losses of $89, 243,000 during the years 1989 through 1990, the Company, on July 3, 1991, filed a voluntary petition for bankruptcy under Chapter 11 of the US Bankruptcy Code, together with a proposed Plan of Reorganization. The Company emerged from bankruptcy on Oct. 29, 1991. *Bankruptcy and losses!*

Prior to the reductions in operation implemented during 1989 through 1991, the Company designed, manufactured and distributed a broad range of men's and children's apparel through several operating divisions and subsidiaries. Today the Company's operations consist of what was formerly the Men's Apparel Division and sell primarily men's knit sport shirts under the following major brands or labels: Munsingwear ®, Grand Slam ®, Grand Slam Tour ™, Penguin Sport ™ and Slammer ®. In addition, the Company licenses its trade names and trademarks for use in a variety of products.

This is IMPORTANT information combined with the financial statement breakout of two types of sales. The company manufacturers clothing brands—the majority of its revenues and almost all of its costs—and licenses it brands to others.

In the recent two fiscal years, the Company's sales by channel of distribution have undergone significant change. In 1995, sales to premium/special markets and golf Pro shop customers rose 52% collectively over 1994. This is the result of management's attempt to reduce the Company's reliance on sales to traditional retail apparel channels of distribution where heavy promotional pricing, discounting and advertising activities are required.

Management wants to move away from the heavy price discounting of its products. Good but can they be successful? What signs to we have of less price discounting through new sales channels.

In late 1995, the Company retained the services of an investment banking firm to explore a range of opportunities to maximize shareholder value.

F. FINANCIAL INFORMATION ABOUT INDUSTRY SEGMENTS

The Company operates in one industry segment, apparel manufacturing. As of Jan. 6, 1996, the Company's foreign operations were not material.

But we know the company manufacturers and licenses—two distinct activities.

G. NARRATIVE DESCRIPTION OF BUSINESS

Principal Products:

The Company sells primarily men's knit sport shirts under four major brands or labels:

1. Munsingwear ®,
2. Grand Slam ®,
3. Grand Slam Tour ™, and
4. Penguin Sport ™.

Grand Slam ® and Penguin Sport ™ products are sold primarily to department stores, specialty stores and Sears. Munsingwear ® products are sold primarily to premium/special markets customers and to national chain stores, such as Montgomery Ward. Grand Slam Tour ™ is sold primarily through golf pro shops.

Sources and Availability of Raw Materials and Products:

Approximately 60% of the Company's products are manufactured domestically. The other 40% is sourced primarily from manufacturers in the Far East through a relationship with Associated Merchandising Corporation (AMC). *Perhaps the company can outsource more to lower their costs but nothing in the case tells us that this would improve margins. Even if the company could lower its manufacturing costs it does not mean profits would rise. Competitors could do the same thing and the price discounting could continue or worsen—we don't know based on this case.*

The Company also sources some product through the 807 program in the Caribbean Basin. The principal raw materials used in the domestic production process are cotton, synthetic and cotton/synthetic blended goods obtained principally from United States sources. The Company purchases most of its piece goods from approximately ten sources. There are currently no major problems in availability of raw materials and alternative sources are available. The Company's Fairmount, NC manufacturing facility includes a material warehouse, cutting, sewing and embroidery operations, and finished goods distribution center. The company also utilizes contract swing manufacturers in close proximity to its North Carolina facility to meet demand during peak production periods. All products, both domestically and offshore produced, are distributed to customers from the North Carolina facility.

Trademarks and Trade Names:

In 1991, management initiated the strategy to actively pursue licensing as a vital part of the Company's growth plan. During the period 1991 through 1993, the Company entered into eleven license agreements, and in 1994, renegotiated its licenses with Fruit of the Loom which, among other things, extended the original agreement for twenty-five years. In 1995, the Company entered into four additional license agreements. Management intends to continue development of its licensing programs and believes that its advertising, styling and brand name identification established over many years are important to the competitive position of the company. The Company has the following license agreements:

- A license with Fruit of the Loom, Inc. to market underwear and active wear.
- A license with a New York entity to market sleepwear.
- Five licenses with Montgomery Ward to market men's pants, outerwear, accessories, dress wear and shirts.
- A license with a Canadian corporation to market knit shirts.
- A license with a North Carolina entity to market men's and boys' hosiery.
- A license with a Peoples Republic of China entity to market a variety of clothing and accessories.

- A license with a South Carolina entity to market sweaters.
- A license with a Missouri entity to market outerwear.
- A license with a New York entity to market woven shirts.
- A license with a South African entity for apparel.

Management's emphasis on licensing activities in recent years has led to a dramatic increase in the Company's royalty income, from $1,162,000 in 1991 to $4,609,000 in 1995.

This is a bright spot for the company. Licensing revenue is rising and a 25 year contract was signed which guarantees some recurring revenues. Good news! Also, we know by the nature of licensing that there is no CGS associated with the business.

Working Capital Practices:

The Company maintains a secured bank line of credit to meet its working capital needs. Peak borrowings under this agreement normally occur in the first six months of the year during the heavier shipping period and during the fourth quarter when inventories are increased to meet the additional first and second quarter sales volume. Seasonal increases in inventory are normal for the apparel manufacturing industry. The bank line of credit is also used for letters of credit that are required for generally all of the Company's purchases from offshore sources. The Company allows returns of merchandise as a result of shipping errors, damaged merchandise and for other reasons. Returns have been less than 4% of sales in each of the past two years. *No problem here.*

Customers:

The Company sells to approximately 4,500 customers. Sales to Sam's Club (a division of Wal-Mart Stores, Inc.) in 1994 and 1993 were 16% and 21%, respectively, of net sales. In 1995, no single customers represented more than 10% of total Company sales.

The company is selling to a big discounter so there could be pressure on pricing and margins. The company has no pricing power.

Backlog of Orders:

The Company's backlog of unfilled orders at January 6, 1996 was approximately $15,600,000 as compared to $18,800,000 a year ago. The decrease was due primarily to management's emphasis on reducing reliance on traditional retail apparel customers. The unfilled order backlog does not necessarily relate directly to future sales.

Competition:

The apparel industry in the United States is **highly competitive and characterized by a relatively small number of broad line companies and a large number of specialty manufacturers. In addition, there are unbranded and private label competitors as well as numerous, small specialty manufacturers competing with the Company.** The principal methods of competition in the apparel industry are pricing, styling, quality (both in material and production), inventory replenishment programs and customer service. The Company seeks to maintain its competitive position in the markets in which it operates through the use of all these methods.

The above tells us that the industry is competitive with numerous competitors and easy entry. No barriers to entry. The company can only become efficient to compete effectively. But how will the company become the most cost efficient in this industry?

Research and Development:

The Company is involved in limited experimental research activities related to the development of new fabrics and production methods. Research and development expenses, other than for product design, are not significant.

Environmental Considerations:

The Company's manufacturing operations are subject to various federal, state and local laws restricting the discharge of materials into the environment. The Company is not involved in any pending or threatened proceedings which would require curtailment of its operations because of such regulations. In 1995, the company's capital expenditures for environmental control facilities were not significant, and no significant capital expenditures related to environmental issues are projected in 1996.

Item 1: Employees:

As of January 6, 1996, there were 343 employees, none of whom were represented by a union.

H. FINANCIAL INFORMATION ABOUT FOREIGN AND DOMESTIC OPERATIONS AND EXPORT SALES

Sales to unaffiliated foreign customers located outside the United States and its territories for the past three years were not significant.

Item 2. Properties

At January 6, 1996, the Company occupied the following properties:
Management considers facilities adequate for current operations. At Jan. 6, 1996, no facilities were occupied
Under capitalized leases.

Property	Sq/ Footage	Approx. Percentage Utilized	Lease Expires
Minn., MN HQ	29,200	50	1996
Fairmont, NC – Cutting and sewing plant, warehouse and distribution center	139,100	100	Owned
New York, NY – Sales office/showroom	1,000	100	1997
Dallas, TX – Sales office/showroom	500	100	1996

Item 3. Legal Proceedings

None of a significant nature.

Item 4. Submission of Matters to a Vote of Security Holders

None.

Executive Officers of the Registrant

The following information is furnished with respect to the Company's executive officers as of the date hereof, pursuant to Item 401 (b) of Regulation S-K. Each of the officers has been appointed to serve in his respective office until his successor has been elected.

Name and Age	Position	Officer Since
Lowell M. Fisher (63)	Director of the Company; President and CEO, October 1993 to 1996	1993

ABOUT THE COMPANY

The Company was founded in 1886 as a manufacturer of men's underwear. Throughout the early 1900's, the Company was an innovator of new textile and apparel manufacturing processes and, during the 1940's and 1950's, expanded its product lines, acquired a women's intimate apparel company and, in 1955, introduced the Gran Slam (R) collection of golf apparel bearing the well-known Penguin ® emblem. **During the 1960's and 1970's, manufacturing facilities were added, textile research and development departments were established and the Company entered into numerous licensing agreements for the use of its trade names and trademarks.**

The company manufactures and licenses branded apparel since the 1960's.
Today the Company derives its revenues primarily from the sale of men's sportswear apparel ***and*** the licensing of men's underwear, active wear and other related apparel. The Company's products are sold primarily through premium/special markets, department stores, golf pro shops, national chain stores, specialty stores, sporting goods stores and wholesale clubs. The Company designs, manufactures, imports, markets and licenses branded men's lifestyle apparel under the **Grand Slam ®, Grand Slam Tour®, Munsingwear ®, and Penguin Sport ™ labels.** The Company is headquartered in Minneapolis, MN and has 343 employees in company-wide operations.

LETTER TO STOCKHOLDERS

Revenues for 1995 were $56.1 million, a 34% increase over last year. Dramatic sales growth in our premium/special markets and golf pro shop businesses more than offset a small decline in business with our traditional customers, such as department and specialty stores, national chain stores and wholesale clubs. **Premium/special markets volume increased seven-fold while golf Pro shop volume increased 52%.** In 1995 these two businesses represented 40% of our total sales volume and are expected to exceed 50% of total Company sales in 1996. As recent transition the Company has undergone over the past two years, significantly reducing our exposure to the difficult retail apparel marketplace.

But losses have increased. There is no indication that this is helping the company move away from price discounting.

Royalty income was up slightly to $4.6 million. As a reminder, 1994 royalty income had increased 25% as a result of additional license agreements and a twenty-five year extension to the Fruit of the Loom license, which will also lead to lower cash receipts from existing licensing agreements starting in 1996. The Munsingwear trade names and trademarks have always signified quality to the licensing market and we will continue to actively pursue additional license agreements. *25% increase in licensing sales is a good sign for this business segment.*

While we achieved significant revenue growth in 1995, **we were not successful in becoming profitable.** The loss of $2.3 million, $1.13 per share, was primarily the result of:

deep markdowns on excess end-of-season merchandise related to the retail department store channel of distribution,

losses related to an unsuccessful entry into "Friday-wear", increased advertising expenses in support of the retail department store business

and restructuring costs related to completed staff reductions and reduced office space requirements.

In addition, costs associated with our PGA Tour endorsement program increased, yet we feel this program is necessary to give Munsingwear brands consumer exposure.

We were successful in reducing selling, general and administrative expenses as a percent of sales – from 32% in 1994 to 27% in 1995. Interest expense was up significantly due to inventory build-up required to service the explosive sales growth in the premium/special markets business. Throughout the year we also experienced higher than planned levels of inventory for the retail department store business, which did not meet sales forecasts. Ultimately, we sold this inventory at deep discounts.

Sales of manufactured clothing was a disaster—rising inventory of unsold goods, price discounting, increasing advertising costs to maintain consumer exposure.

Looking ahead to 1996, we plan to continue to grow the premium/special markets business which has achieved exceptional results the past two years. Munsingwear's strong consumer brand recognition, the Penguin logo, quality product and the agility to merchandise across a broad product line give us a competitive advantage. We are confident that increased revenues and a return to profitability will be achieved due to the following:

- Continued strong sales growth in premium/special markets and golf pro shop businesses.
- Cost reduction programs.
- Continued focus on core capability – men's, short sleeve, knit, and moderately priced golf shirts.

None of the above is backed up by facts. Where in the financials or the case study does it show that sales to the golf shops and premium/special markets leads to improved gross margins or operating profits! Where, what and how much will the cost reduction programs accomplish—no mention by management. Continuing to grow by manufacturing is a negative for the sustainability of the business. One is reminded of the joke, "I lose a dollar on each unit, but I will make it up on volume."

(Picture of LOWELL M. FISHER, the President)

- Innovative designs and fabrics throughout all product lines.
- Continued upgrading of management information systems.
- Strengthening of our Board of Directors by the addition of three new members, Thomas D. Gleason, who was named non-executive Chairman of the Board in January of this year, and Kevin S. Moore and William J. Morgan, who represent the Company's two largest single stockholders.

Nothing specific to solve a growing negative cash flow problem—fluff.

In late 1995 we retained the services of an investment banking firm to help us explore a range of opportunities to maximize shareholder value, and we expect this activity to accelerate in 1996. Please refer to the Management's discussion and analysis section in this annual report for additional financial analysis and a statement regarding forward-looking information.

Although 1995 was a difficult year for retailing, the Company achieved extremely promising revenue growth in our two most profitable businesses—**premium/special markets and golf pro shops.** These results reaffirmed our decision to continue the Company's transition – expanding markets, enhancing product quality, increasing consumer value and investing in infrastructure. As a result, we are now in a much stronger strategic position and I look forward to working with Tom Gleason and the Board in continuing our efforts to ensure the long-term success and profitability of the Company.

No evidence that sales through p ***premium/special markets and golf pro shops will benefit the company!*** *Will pricing be better and/or margins improve? No facts given.*

In closing, I would like to thank our customers, suppliers and lender, who have continued to support us throughout the Company's transition. Finally, I would like to take this opportunity to thank all

Munsingwear employees for their hard work and effort which led to spectacular 1995 sales growth and reinforces our optimism for 1996.

The "spectacular" sales growth led to increasing losses with increasing use of debt. How would that lead to optimism? Management sanity is a concern here—a joke, but an issue, nevertheless.

Sincerely,
/s/ Lowell M. Fisher
Lowell M. Fisher, President and CEO.

The solution should become apparent. If you are hitting yourself in the head with a hammer and your head hurts, how do you stop the pain? STOP HITTING YOURSELF WITH A HAMMER! Getting a new hammer won't help.

Do not neglect the obvious. Keep it simple! If your head hurts because you are smashing it against the wall, one solution would be to stop.

Munsingwear should stop manufacturing clothes, shut down and sell its manufacturing facilities because it has no competitive advantages in this business. More sales bring more losses due to price discounting and high advertising costs. Without a competitive advantage then all cost savings will be pushed through to the consumer or discounter in the form of price discounting. All of its competitors can outsource as well as the company can so it has or will not have cost advantages.

The only bright spot is its **licensing business** which it should retain and try to increase.

So pro-forma after shutting down the manufacturing apparel business we have:

	1996	
Sales: Royalties	$4,609	*SG&A Expenses:*
CGS	$0.00	
Gross Profit	$4,609	*There are over 300 employees and SG&A expenses of $13.96 mil. Now, to run a royalty business- Advertising, secretary, president and sales person--$1.5 to $2 mil.?*
SG&A	$2,000	
Operating Profit	$2,609	
Taxes	40%	
Net Income	$1,565	
EPS on **2,037,078 Outstanding shares**	$0.77	*Probably $500,000 to $1 mil. But be conservative.*
A turn from losses to profitability.	Collect FEE	

Once Munsingwear shuts down its money losing apparel business, it can focus on the profitable licensing business. The company has a valuable asset(s): its brands. The company is better off licensing its brands to others rather than losing money manufacturing its own brands. The history of bankruptcy and increasing losses on increasing sales indicates that shutting down its manufacturing operations makes sense. The brands that Munsingwear has developed have value as indicated by its increasing (25%) sales in royalty revenues. The company should just focus on leveraging its valuable brands (assets) as efficiently as possible.

END

Don't worry if you struggled with this case study (though the Danny Devito video should have been a clue—"This division that's losing money is a financial cancer!") You will be an expert business analyst by the time you complete your CS analyst handbook. You'll be better than Buffett! No, let's shoot for being the best you can be as an investor.

Let's hear what the great **Seth Klarman of Baupost and Editor of the *Sixth Edition of Security Analysis*** (2009) has to tell us about investing through his preface: *The Timeless Wisdom of Graham and Dodd*

Seventy-five years after Benjamin Graham and David Dodd wrote Security Analysis **(LINK:),** a growing coterie of modern-day value investors remain deeply in indebted to them. Graham and Dodd were two assiduous and unusually insightful thinkers seeking to give order to the mostly uncharted financial wilderness of their era. They kindled a flame that has illuminated the way for value investors ever since. Today, *Security Analysis* remains an invaluable roadmap for investors as they navigate through unpredictable, often volatile, and sometimes treacherous financial market. Frequently referred to as the "bible of value investing," *Security Analysis* is extremely thorough and detailed, teeming with wisdom for the ages. **Although many of the examples are obviously dated, their lessons are timeless.** And while the prose may sometimes seem dry readers can yet discover valuable ideas on nearly every page. The financial market have morphed since 1934 in almost unimaginable ways, but Graham and Dodd's approach to investing remains remarkably applicable today.

Value investing, today as in the era of Graham and Dodd, is the practice of **purchasing securities or assets for less than they are worth—the proverbial dollar for 50 cents.** Investing in bargain priced securities provides a "margin of safety"—room for error, imprecision, bad luck, or the vicissitudes of the economy and stock market. While some might mistakenly consider value investing a mechanical tool for identifying bargains, **it is actually a comprehensive investment philosophy that emphasizes the need to perform in-depth fundamental analysis, pursue long-term investment results, limit risk, and resist crowd psychology.**

Far too many people approach the stock market with a focus on making money quickly. Such an orientation involves speculation rather than investment and is based on the hope that share prices will rise irrespective of valuation. Speculators generally regard stocks as pieces of paper to be quickly traded back and forth, foolishly decoupling them from business reality and valuation criteria. Speculative approaches—which pay little or no attention to downside risk--are especially popular in rising market. In heady times, few are sufficiently disciplined to maintain strict standards of valuation and risk aversion, especially when most of those abandoning such standards are quickly getting rich. After all, it is easy to confuse genius with a bull market.

In recent years, some people have attempted to expand the definition of an investment to include any asset that has recently—or might soon—appreciate in price: art, rare stamps, or a wine collection. Because these items have no ascertainable fundamental value generate no present or future cash flow, and depend for their value entirely on buyer whim, they clearly constitute speculations rather than investments.

In contrast to the speculators' preoccupation with rapid gain, value investors demonstrate their risk aversion by striving to avoid loss. A risk-averse investor is one for whom the perceived benefit of any gain is outweighed by the perceived cost of an equivalent loss. Once any of us has accumulated a modicum of capital, the incremental benefit of gaining more is typically eclipsed by the paid of having less.[4] Imagine how you would respond to the proposition of a coin flip that would either double your net worth or extinguish it. Being risk averse, nearly all people would respectfully decline such a gamble. Such risk aversion is deeply ingrained in human nature. Yet many unwittingly set aside their risk aversion when the sirens of market speculation call.
Value investors regard securities not as speculative instruments but as **fractional ownership** in, or debt claims on, the **underlying businesses**. This orientation is key to value investing. When a small slice of a business is offered at a bargain price, it is helpful to evaluate it as if the whole business were offered for sale there. This analytical anchor helps value investors remain focused on the pursuit of long term results rather than the profitability of their daily trading ledger.

[4] Losing money, as Graham noted, can also be psychologically unsettling. Anxiety from the financial damage cause by recently experienced loss or the fear of further loss can significantly impede out ability to take advantage of the next opportunity that comes along. If an undervalued stock falls by half while the fundamentals—after checking and rechecking—are confirmed to be unchanged, we should relish the opportunity to buy significantly more "on sale." But if our net worth has tumbled along with the share price, it may be psychologically difficult to add to the position.

At the root of Graham and Dodd's philosophy is the principle that the **financial markets are the ultimate creators of opportunity.** Sometimes the markets price securities correctly, other times not. Indeed, in the short run, the market can be quite inefficient, with great deviations between price and underlying value. Unexpected developments, increased uncertainty and capital flows can boost short-term market volatility, with prices overshooting in either direction.[5] In the words of Graham and Dodd, "The price of a security is frequently an essential element, so that a stock….may have investment merit at one price level but not at another." (p.106) As Graham has instructed, those who view the market as a weighing machine--a precise and efficient assessor of value—are part of the emotionally driven herd. Those who regard the market as a voting machine—a sentiment-driven popularity contest--will be well positioned to take proper advantage of the extremes of market sentiment.

While it might seem that anyone can be a value investor, the essential characteristics of this type of investor—patience, discipline, and risk aversion--may be well be **genetically determined**. When you first learn of the value approach, it either resonates with you or it doesn't. Either you are able to remain disciplined and patient, or you aren't. As Warren Buffett said in his famous article, "The Superinvestors of Graham and Doddsville, " **Link here _____:**

"It is extraordinary to me that the idea of buying dollar bills for 40 cents takes immediately with people or it doesn't take at all. It is like an inoculation. If it doesn't grab you right away, I find you can talk to him for years and show him records, and it doesn't make any difference."[6]

If ***Security Analysis*** resonates with you—if you can resist speculating and sometimes sit on your hands--perhaps you have a predisposition toward value investing. If not, at least the book will help you understand where you fit into the investing landscape and give you an appreciation for what the value-investing community may be thinking.

JUST AS RELEVANT NOW

Perhaps the most exceptional achievement of Security Analysis, first published in 1934 and revised in the acclaimed 1940 edition, is that its lessons are timeless. Generations of value investors have adopted the teachings of Graham and Dodd and successfully implemented them across highly varied market environments, countries, and asset classes. This would delight the authors, who hoped to set forth principles that would "stand the test of the ever enigmatic future."

In 1992, Tweedy, Browne Company LLC **(Link)** published a compilation of 44 research studies entitled ***"What has Worked in Investing."*** **(LINK:)** The study found that what has worked is fairly simple: cheap stocks (measured by price-to-book values, price-to-earnings ratios, or dividend yields) reliably outperform expensive ones, and stocks that have underperformed (over three-and five year periods) subsequently beat those that have lately performed well. In other words, value investing works! I know of no long time practitioner who regrets adhering to a value philosophy; few investors who embrace the fundamental principles ever abandon this investment approach for another.

Today, when you read Graham and Dodd's description of how they navigated through the financial markets of the 1930s, it seems as if they were detailing a strange, foreign, and antiquated era of economic depression, extreme risk aversion, and obscure and obsolete businesses. But such an exploration is considerably more valuable than it superficially appears. After all, each new day has the potential to bring

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[5] Over the long run, however, as investors perform fundamental analysis and corporate managements explain their strategies and manage their capital structures, share prices often migrate toward underlying business value. In particular, shares priced significantly below underlying value will attract bargain hunters and ultimately corporate acquirers, reinforcing the tendency toward longer-term share price efficiency. This tendency, however, is always subject to interruption by the short-term forces of greed and fear.

[6] *The Superinvestors of Graham-and –Doddesville,"* Hermes, 1984

My (Seth Klarman) own experience has been exactly the same as Buffett describes. My 1978 summer job at Mutual shares, a no-load value-based fund set the course for my professional career. The planned liquidation of Telecor and spin-off of its Electra Rent Subsidiary in 1980 forever imprinted in my mind the merit of fundamental investment analysis. A buyer of Telecor stock was effectively creating an investment in the shares of Electro Rent, a fast-growing equipment rental company at the giveaway valuation of approximately 1 times the cash flow. **You always remember your first value investment.**

with it a strange and foreign environment. Investors tend to assume that tomorrow's markets will look very much like today's , and, most of the time, they will. But every once in a while,[7] conventional wisdom is turned on its head, circular reasoning is unraveled, prices revert to the mean, and speculative behavior is exposed as such. At those times, when today fails to resemble yesterday, most investors will be paralyzed. In the words of Graham and Dodd, "We have striven throughout to guard the student against overemphasis upon the superficial and the temporary," which is "at once the delusion and the nemesis of the world of finance**." It is during periods of tumult that a value-investing philosophy is particularly beneficial.**

In 1934, G&D had witnessed over a five-year span the best and the worst of times in the markets—the run-up to the 1929 peak, the October 1929 crash, and the relentless grind of the Great Depression (See chart on page _). They laid out a plan for how investors in any environment might sort through hundreds or even thousands of common stocks, preferred shares, and bonds to identify those worthy of investment. Remarkably, their approach is essential the same one that value investors employ today. The same principles they applied to the U.S. stock and bond markets of the 1920s and 1930s apply to the global capital markets of the early twenty first century, to less liquid asset classes like real estate and private equity and even to derivative instruments that hardly existed when *Security Analysis* was written.

While formulas such as the classic "net working capital" test are necessary to support an investment analysis, value investing is not a paint-by numbers exercise.[8] **Skepticism and judgment are always required.** For one thing, **not all elements affecting value are captured in a company's financial statements**—inventories can grow obsolete and receivables uncollectible; liabilities are sometimes unrecorded and property values over-or understated. Second, valuation is an art, not a science. Because the value of a business depends on numerous variables, it can typically be assessed only within a range. Third, the outcomes of all investments depend to some extent on the future, which cannot be predicted with certainty; for this reason, even some carefully analyzed investment fail to achieve profitable outcomes. Sometimes a stock becomes cheap for good reason: a broken business model, hidden liabilities, protracted litigation, or incompetent or corrupt management. Investors must always act with caution and humility, relentlessly searching for additional information while realizing that they will never know everything about a company. In the end, the most successful value investors combine detailed business research and valuation work with endless disciple and patience, a well-considered sensitivity analysis, intellectual honesty, and years of analytical and investment experience.

Interestingly, **Graham and Dodd's value-investing principles apply beyond the financial markets—** including, for example, to the market for baseball talent, as eloquently captured in ***Moneyball,*** Michael Lewis's 2003 bestseller (LINK:). The market for baseball players, like the market for stocks and bonds, is inefficient—and for many of the same reasons. In both investing and baseball, there is no single way to ascertain value, no one metric that tells the whole story. In both, there are mountains of inflation and no broad consensus on how to assess it. Decision makers in both arenas misinterpret available data, misdirect their analysis, and reach inadequate conclusions. In baseball, as in securities, many overpay because they fear standing apart from the crowd and being criticized. They often make decisions for emotional, not rational, reasons. They become exuberant; they panic. Their orientation sometimes becomes overly short term. They fail to understand what is mean reverting and what isn't. Baseball's value investors, like financial market value investors, have achieved significant outperformance over time. While Graham and Dodd didn't apply value principle to baseball, the applicability of their insights to the market for athletic talent attest to the universality and timelessness of this approach.

Value Investing Today

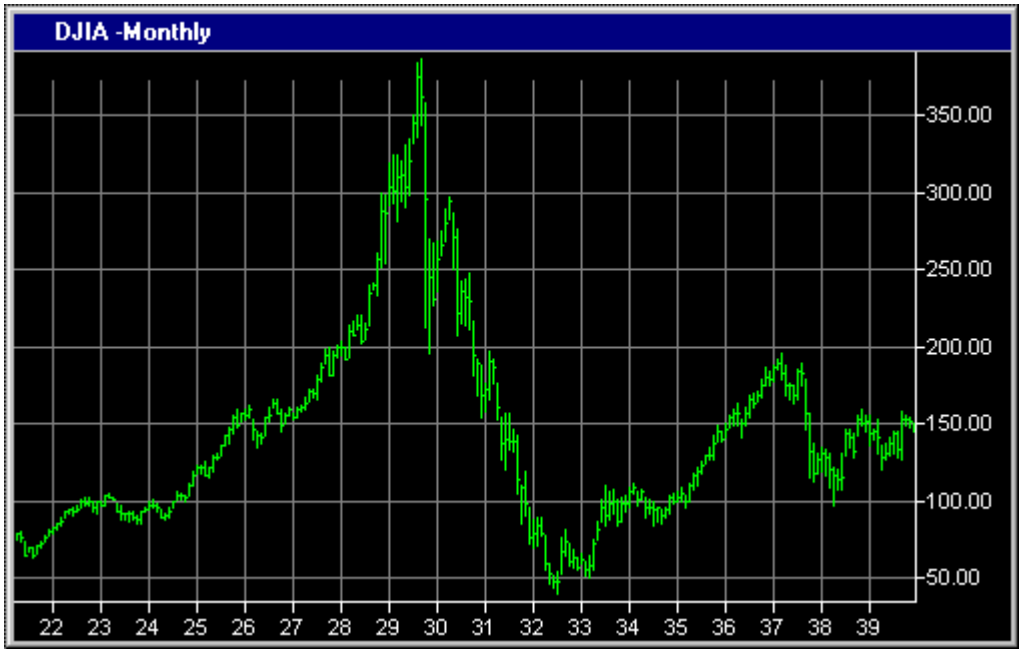
Amidst the Great Depression (**Link: AGD, Rothbard**), the stock market and the national economy were exceedingly risky. Downward movements in share prices and business activity came suddenly and could be severe and protracted. Optimists were regularly rebuffed by circumstances. Winning, in a sense, was accomplished by not losing. Investors could achieve a margin of safety by buying shares in businesses at a

[7] The credit crunch triggered by subprime mortgage losses that began in the July 2007 is a recent an dramatic example.

[8] Graham and Dodd recommended that investors purchase stocks trading for less than two thirds net working capital," defined as working capital less all other liabilities. Many stocks fit this criterion during the Depression years, far fewer today **LINK:).**

large discount to their underlying value, and they needed a margin of safety because of all the things that could—and often did—go wrong.

Even in the worst of markets, Graham and Dodd remained faithful to their principles, including their view that the economy and markets sometimes go through painful cycles, which must simply be endured.



They expressed confidence, in those dark days, that the economy and stock market would eventually rebound: "While we were writing, we had to combat a wide a widespread conviction that financial debacle was to be the permanent order."

Of course, **just as investors must deal with down cycles when business results deteriorate and cheap stocks become cheaper, they must also endure up cycles when bargains are scarce and investment capital is plentiful.** In recent years, the financial markets have performed exceedingly well by historic standards, attracting substantial fresh capital in need of managers. Today, a meaningful portion of that capital—likely totaling in the trillions of dollars globally--invests with a value approach. This includes numerous value-based asset management firms and mutual funds, a number of today's roughly 9,000 hedge funds, and some of the largest and most successful university endowments and family investment offices.

It is important to note that not all value investors are alike. In the aforementioned ***"Superinvestors of Graham-and-Doddesville,"*** (LINK:) Buffett describes numerous successful value investors who have little portfolio overlap. Some value investors hold obscure, "pink-sheet shares" while others focus on the large-cap universe. Some have gone global, while others focus on a single market sector such as real estate or energy. Some run computer screens to identify statistically inexpensive companies, while others assess "private market value" –the value an industry buyer would pay for the entire company. Some are activists who aggressively fight for corporate change, while others seek out undervalued securities with a catalyst already in place—such as a spin-off, asset sale, major share repurchase plan, or new management team—for the partial or full realization of the underlying value. And, of course, as in any profession, some value investors are simply more talented than others.

In the aggregate, the value investing community is no longer the very small group of adherents that it was several decades ago. Competition can have powerful corrective effect on market inefficiencies and mispricing. With today's many amply capitalized and skilled investors, **what are the prospects for a value practitioner?** Better than you might expect, for several reasons. First, even with a growing value

community, **there are far more market participants with little or no value orientation.** Most managers, including growth and momentum investors and market indexers, pay little or no attention to value criteria. Instead, they concentrate almost single-mindedly on the growth rate of a company's earnings, the momentum of its share price, or simply its inclusion in a market index.

Second, nearly all money managers today, including some hapless value managers, are forced by the (real or imagined) performance pressures of the investment business to have an absurdly short-term investment horizon, sometimes as brief as a calendar quarter, month, or less. A value strategy is of little use to the impatient investor since it usually takes time to pay off.

Finally, human nature never changes. **Capital market manias regularly occur on a grand scale:** Japanese stocks in the late 1980's, Internet and technology stocks in 1999 and 2000, sub-prime mortgage lending in 2006 and 2007, and alternative investments currently (2009). It is always difficult to take a contrarian approach. Even highly capable investors can wither under the relentless message from the market that they are wrong. The pressures to succumb are enormous; many investment managers fear they will lose business if they stand too far apart from the crowd. Some also fail to pursue value because they have handcuffed themselves (or been saddled by clients) with constraints preventing them from buying stocks selling at low dollar prices, small-cap stocks, stocks of companies that don't pay dividends or are losing money, or debt instruments with below investment grade ratings.[9] Many also engage in career management techniques like "window dressing" their portfolios at the end of the calendar quarters or selling off losers even if they are undervalued) while buying more of the winners (even if overvalued). Of course, for those value investors who are truly long-term oriented, it is a wonderful thing that many potential competitors are thrown off course by constraints that render them unable or unwilling to effectively compete.

Another reason that greater competition may not hinder today's value investors is the broader and more divers investment landscape in which they operate. Graham faced a limited lineup of publicly traded U.S. equity and debt securities. Today, there are many thousands of publicly traded stocks in the United States alone and many tens of thousands worldwide, plus thousands of corporate bonds and asset-backed debt securities. Previously illiquid assets, such as bank loans, now trade regularly. Investors may also choose from an almost limitless number of derivative instruments, including customized contracts designed to meet any need or hunch.

Nevertheless, 25 years of historically strong stock market performance e have left the market far from bargain-priced. High valuations and intensified competition raise the specter of lower returns for value investors generally. **Also, some value investment firms have become extremely large, and size can be the enemy of investment performance because decision making is slowed by bureaucracy and smaller opportunities cease to move the needle.**

In addition, because growing numbers of competent buy-side and sell0-side analysts are plying their trade with the assistance of sophisticated information technology, far fewer securities seem likely to fall through the cracks to become extremely undervalued.[10] Today's value investors are unlikely to find opportunity armed only with a **Value Line Guide (LINK:)** or by thumbing through stock tables. While bargains still occasionally hide in plain sight, securities today are most likely to become mispriced when they are either accidently overlooked or deliberately avoided. Consequently, value investors have had to become thoughtful about where to focus their analysis. In the early 2000s, for example, investors became so disillusioned with the capital allocation procedures of many South Korean companies that few considered them candidates for worthwhile investment. As a result, the shares of numerous South Korean companies

[9] Another sort of constraint involves the "prudent man rules," which is a legal concept that divides permissible from impermissible investments, in the mid-to-late 1970s, manly interpreted this rule to preclude meaningful exposure to equities. Since then, prudence had become a moving target as investors, gaining comfort over time from the actions of their peers, have come to invest in more exotic and increasingly illiquid asset classes.

[10] Great innovations in technology have made vastly more information an analytical capability available to all investors. This democratization has not, however, made value investors any better off. With information more widely and inexpensively available, some of the greatest market inefficiencies have been corrected. Developing innovative sources of ideas and information such as those available from business consultants and industry experts, has become increasingly important.

traded at great discounts from prevailing international valuations: at two or three times the cash flow, less than half the underlying business value, and, in several cases, less than the cash (net of debt) held on their balance sheets. Bargain issues, such as Posco and SK Telecom, ultimately attracted many value seekers; Warren Buffett reportedly profited handsomely from a number of South Korean holdings.

Today's value investors also find opportunity in the stocks and bonds of companies stigmatized on Wall Street because of involvement in protracted litigation, scandal, accounting fraud, or financial distress. The securities of such companies sometimes trade down to bargain levels, where they became good investments for those who are able to remain stalwart in the face of bad news. For example, the debt of Enron, perhaps the world's most stigmatized company after an accounting scandal forced it into bankruptcy in 2001, traded as low as 10 cents on the dollar of claims; ultimate recoveries are expected to be six times that amount. Similarly, companies with tobacco or asbestos exposure have in recent years periodically come under severe selling pressure due to the uncertainties surrounding litigation and the resultant risk of corporate financial distress. More generally, companies that disappoint or surprise investors with lower –than-expected returns, sudden management changes, accounting problems, or ratings downgrades are more likely than consistently strong performs to be sources of opportunity.

When bargains are scarce, (Insert S&P 500 like today, Insert www.hussmanfunds.com) value investors must be patient, compromising standards is a slippery slope to disaster. New opportunities will emerge. Even if we don't know when or where. In the absence of compelling opportunity holding at least a portion of one's portfolio in cash equivalents (for example U.S. Treasury bills) awaiting future deployment will sometimes be the most sensible option. Recently, Warren Buffett stated that he has more cash to invest than he has good investments. As all value investors must do from time to time, Buffett is waiting patiently.

Still, value investors are bottom-up analysts, good at assessing securities one at a time based on the fundamentals. They don't need the entire market to be bargain priced, just 20 or 25 unrelated securities—a number sufficient for diversification of risk. Even in an expensive market, value investors must keep analyzing securities and assessing busine3sses, gaining knowledge and experience that will be useful in the future. Value investors, therefore, should not try to time the market or guess whether it will rise of fall in the near-term. Rather, they should rely on a bottom-up approach, sifting the financial markets for bargains and then buying them, regardless of the level or recent direction of the market or economy. Only when they cannot find bargains should they default to holding cash.

A FLEXIBLE APPROACH

Because our nation's founders could not foresee—and knew they could not foresee—technological, social, cultural, and economic changes that the future would bring, they wrote a flexible constitution that still guides us over two centuries later. Similarly, Ben Graham and David Dodd acknowledged that they could not anticipate the business, economic, technological, and competitive changes that would sweep through the investment world over the ensuing years. But they, too, wrote a flexible treatise that provides us with the tools to function in an investment landscape that was destined—and remains destined—to undergo profound and unpredictable change.

For example, companies today sell products that Graham and Dodd could not have imagined. Indeed, there are companies and entire industries that they could not have envisioned. Security Analysis offers no examples of how to value cellular phone carriers, software companies, satellite television providers, or Internet search engines. But the book provides the analytical tools to evaluate almost any company, to assess the value of its marketable securities, and to determine the existence of a margin of safety. (Where you will need to go further is in understanding barriers to entry, competitive advantages and the sources of advantage). Questions of solvency, liquidity, predictability, business strategy, and risk occur across businesses, nations, and time.

Graham and Dodd did not specifically address how to value private businesses or how to determine the value of an entire company rather than the value of a fractional interest through ownership of its shares.[11] But their analytical principle apply equally well to these different issues. Investor still need to ask, how stable is the enterprise, and what are its future prospects? What are its earnings and cash flow? What is the downside risk of owning it? What is its liquidation value? How capable and honest is its management? What would you pay for the stock of this company if it were public? What factors might cause the owner of this business to sell control at a bargain price?

Similarly, the pair never addressed how to analyze the purchase of an office building or apartment complex. Real estate bargains come about for the same reasons. As securities bargains—an urgent need for cash, inability to perform proper analysis, a bearish macro view, or investor disfavor or neglect, In a bad real estate climate, tighter lending standards can cause even healthy properties to sell at distressed prices. Graham and Dodd's principles—such as the stability of cash flow, sufficiency of return, and analysis of downside risk—allow us to identify real estate investments with a margin of safety in any market environment.

Even complex derivatives not margined in an earlier era can be scrutinized with the value investor's savvy. While traders today typically price put and call options via the black-Scholes model, one can instead use value investing precepts—upside potential, downside risk, and the likelihood that each of various possible scenarios will occur—to analyze these instruments. An inexpensive option may, in effect, have the favorable risk return characteristics of a value investment—regardless of what the Black Scholes model dictates.

INSTITUTIONAL INVESTING

Perhaps the most important change in the investment landscape over the past seventy-five years is the ascendancy of institutional investing. In the 1930s, individual investors dominated the stock market. Today, by contrast, most market activity is driven by institutional investors—large pools of pension, endowment, and aggregated individual capital. While the advent of these large, quasi-permanent capital pools might have resulted in the wide-scale adoption of a long term value-oriented approach, in fact this has not occurred. Instead, institutional investing has evolved into a short term performance derby, which makes it difficult for institutional managers to take contrarian or long term positions. Indeed, rather than standing apart from the crowd and possibly suffering disappointing short term results that could cause clients to withdraw capital, institutional investors often prefer the safe haven of assured mediocre performance that can be achieved only by closely following the herd.

Alternative investments—a catch- all category that includes venture capital, leveraged buyouts, private equity, and hedge funds—are the current institutional rage. No investment treatise written today could fail to comment on this development.

Fueled by performance pressures and a growing expectation of low (and adequate) returns from traditional equity and debt investments, institutional investors have sought high returns and diversification by allocating a growing portion of their endowments and pension funds to alternative, Pioneering Portfolio Management, written in 2000 by David Swensen, the groundbreaking head of Yale's Investment Office, makes a strong case for alternative investments. In it, Swensen points to the historically inefficient pricing of many asset classes,[12] the historically high risk-adjusted returns of many alternative managers, and the limited performance correlation between alternatives and other asset classes. He highlights the importance of alternative manager selection by noting the large dispersion of returns achieved between top-quartile and

[11] They did not consider the relative merits of corporate control enjoyed by a private business owner versus the value of marketability for a listed stock (p. 372)

[12] Many investors make the mistake of thinking about returns to asset classes as if they were permanent. Returns are not inherent to an asset class, they result from the fundamentals of the underlying businesses and the price paid by investors for the related securities. Capital flowing into an asset class can, reflectively impair the ability of those investing in that asset class to continue to generate the anticipated, historically attractive returns.

third-quartile performers. A great many endowment managers have emulated Swensen, following him into large commitment to alternative investments, almost certainly on worse terms and amidst a more competitive environment than when he entered the area.

Graham and Dodd would be greatly concerned by the commitment of virtual all major university endowments to one type of alternative investment: venture capital. The authors of the margin of safety approach to investing would not find one in the entire venture capital universe[13] While there is often the prospect of substantial upside in venture capital, there is also very high risk of failure. Even with the diversification provided by a venture fund, it is not clear how to analyze the underlying investments to determine whether the potential return justifies the risk. Venture capital investment would, therefore, have to be characterized as pure speculation, with no margin of safety whatsoever.

Hedge funds—a burgeoning area of institutional interest with nearly $2 trillion of assets under management—are pools of capital that vary widely in their tactics but have a common fee structure that typically pays the manager 1% to 2% annually of assets under management and 20% (and sometimes more) of any profits generated. They had their start in the 1920s, when Ben Graham himself ran one of the first hedge funds.

What would Graham and Dodd say about the hedge funds operating in today's markets they would likely disapprove of hedge funds that make investments based on macroeconomic assessments or that pursue speculative, short-term strategies. Such funds, by avoiding or even selling undervalue securities to participate in one or another folly, inadvertently create opportunities for value investors. The illiquidity, lack of transparency, gargantuan size, embedded leverage, and hefty fees of some hedge funds would no doubt raise red flags. But Graham and Dodd would probably approve of hedge funds that practice value-oriented investment selection.

Importantly, while Graham and Dodd emphasized limiting risk on an investment by investment basis, they also believed that diversification and hedging could protect the downside for an entire portfolio. P 106 This is what most hedge funds attempt to do. While they hold individual securities that, considered alone, may involve an unfathomable degree of risk, they attempt to offset the risks for the entire portfolio through the short sale of similar but more highly valued securities, through the purchase of put options on individual securities or market indexes, and through adequate diversification (Although many are guilty of over diversification, holding too little of their truly good ideas and too much of their mediocre ones), In this way, a hedge fund portfolio could (in theory, anyway) have characteristics of good potential return with limited risk that its individual components may not have.

Modern-day Developments

As mentioned, the analysis of businesses and securities has become increasingly sophisticated over the years. Spreadsheet technology for example, allows for vastly more sophisticated modeling than was possible even one generation ago, Ben Graham's pencil, clearly one of the sharpest of his era, might not be sharp enough today. On the other hand, technology can easily be misused; computer modeling requires making a series of assumptions about the future that can lead to a **spurious precision** of which Graham would have been quite dubious. While Graham was interested in companies that produced consistent earnings, analysis in his day was less sophisticated regarding why some company's earning might be more consistent than others. Analysts today examine businesses but also business models; the bottom-line impact of changes in revenues, profit margins, product mix, and other variables is carefully studied by managements and financial analyst alike. Investors know that businesses do not exist in a vacuum; the actions of competitors, suppliers, ad customers can greatly impact corporate profitability and must be considered. [14]

[13] No would they find one in leveraged buyout, through which businesses are purchased at lofty prices using mostly debt financing and a thin layer of equity capital. The only value investing rationale for venture capital or leverage buyouts might be if they were regarded as mispriced call options. Even so, it is not clear that these areas constitute good value.

[14] Professor Michael Porter of the Harvard Business School in his seminal book ***Competitive Strategy*** (Free Press, 1980) lays out the groundwork for a more intensive, thorough, and dynamic analysis of businesses and industries in the modern economy. A broad industry analysis has become particularly necessary as a result of the passage of 2000 of Reg. D (Fair Disclosure), which regulates and

Another important change in focus over time is that while Graham looked at corporate earnings and dividend payments as barometers of a company's health, most value investors today analyze free cash flow. This is the cash generated annually from the operations of a business after all capital expenditures are made and changes in working capital are considered. Investors have increasingly turned to this metric because reported earnings can be an accounting fiction, masking the cash generated by a business or implying positive cash generation when there is none. Today's investors have rightly concluded that following the cash as the manager of a business must do—is the most reliable and revealing means of assessing a company.

In addition, many value investors today consider balance sheet analysis less important than was generally thought a few generations ago. With returns on capital much higher at present than in the past, most stocks trade far above book value; balance sheet analysis is less helpful in understanding upside potential of downside risk of stocks priced at such levels. The effects of sustained inflation over time have also wreaked havoc with the accuracy of assets accounted for using historic cost; this means that two companies owning identical assets could report very different book values. Of course, balance sheets must still be carefully scrutinized. Astute observers of corporate balance sheets are often the first to see business deterioration or vulnerability as inventories and receivables build, debt grows, and cash evaporates. And for investors in the equity and debt of underperforming companies, balance sheet analysis remains one generally reliable way of assessing downside protection.

Globalization has increasingly affected the investment landscape, with most investors looking beyond their home countries for opportunity and diversification. Graham and Dodd's principles fully apply to international markets, which are, if anything, even more subject to the vicissitudes of investor sentiment—and thus more inefficiently prices—than the U.S. market is today. Investors must be cognizant of the risks of international investing, including exposure to foreign currencies and the need to consider hedging them, Among the other risks are political instability, different (or absent) securities laws and investor protections, varying accounting standards, and limited availability of information.

Oddly enough, **despite 75 years of success achieved by value investors**, one group of observers largely ignores of dismisses this discipline: academics. Academics tend to create elegant theories that purport to explain the real world but in fact oversimplify it. One such theory, the Efficient Market Hypothesis (EMH), holds that security prices always and immediately reflect all available information, and idea deeply at odds with Graham and Dodd's notion that there is great value to fundamental security analysis. The Capital asset Pricing Model (CAPM) relates risk to return but always mistakes volatility, or beta, for risk. MPT applauds the benefits of diversification in constructing an optimal portfolio. But insisting that higher expected return comes only with greater risk, MPT effectively repudiates the entire value-investing philosophy and its long-term record of risk-adjusted investment outperformance. Value investors have no time for these theories and generally ignore them.

The assumptions made by these theories—including continuous markets. Perfect information, and low or no transaction costs—are unrealistic. Academics, broadly speaking, are so entrenched in their theories that they cannot accept that value investing works. Instead of launching a series of studies to understand the remarkable 50 year investment record of Warren Buffett, academics instead explain him away as an aberration, Greater attention has been paid recently to behavioral economics, a field recognizing that individuals do not always act rationally and have systematic cognitive biases that contribute to market inefficiencies and security mispricing. These teaching—which would not seem salient to Graham—have not yet entered the academic mainstream, but they are building some momentum.

Academic have espoused nuanced permutations of their flawed theories for several decades. Countless thousands of their students have been taught that security analysis is worthless, that risk is the same as volatility, and that investors must avoid overconcentration in good ideas (because in efficient markets there can be no good ideas) and thus diversify into mediocre or bad ones. Of course, for value investors, the

restricts the communications between a company and its actual or potential shareholders. Wall Street analysts, facing a dearth of information from the companies they cover, have been forced to expand their areas of inquiry.

propagation of these academic theories has been deeply gratifying: the brainwashing of generations of young investors produces the very inefficiencies that savvy stock pickers can exploit.

Another important factor for value investors to take into account is the growing propensity of the Federal Reserve to intervene in financial markets at the first sign of trouble. Amidst severe turbulence, the Fed frequently lowers interest rates to prop up securities prices and restore investor confidence. While the intention of Fed officials is to maintain orderly capital markets, some money managers view Fed intervention as a virtual license to speculate. Aggressive Fed tactics, sometimes referred to as the "Greenspan put" (now the "Bernanke put"), create a moral hazard that encourages speculation while prolonging overvaluation. So long as value investors aren't lured into a false sense of security, so long as the can maintain a long-term horizon and ensure their staying power, market dislocation caused by Fed action (or investor anticipation of it) may ultimately be a source of opportunity.

Another modern development of relevance is the ubiquitous cable television coverage of the stock market. This frenetic lunacy exacerbates the already short-term orientation of most investors. It foments the view that it is possible—or even necessary--to have an opinion on everything pertinent to the financial markets, as opposed to the patient and highly selective approach endorsed by Graham and Dodd. This sound-bite culture reinforces the popular impression that investing is easy, not rigorous and painstaking. The daily cheerleading pundits exult at rallies and record highs and commiserate over market reversals; viewers get the impression that up is the only rational market direction and that selling or sitting on the sidelines is almost unpatriotic. The hysterical tenor is exacerbated at every turn. For example, CNBC frequently uses a formatted screen that constantly updates the level of the major market indexes against the digital clock (INSERT YOUTUBE VIDEO link) . Not only is the time displayed in hours, minutes and seconds but in completely useless hundreds of a second, the numbers flashing by so rapidly (like tenths of a cent on the gas pump) as to be completely unreadable. The only conceivable purpose is to grab the viewers' attention and ratchet their adrenaline to full throttle.

Cable business channels bring the herd-like mentality of the crowd into everyone's living room, thus making it much harder for viewers to stand apart from the masses. Inly on financial cable TV would a commentator with a crazed persona become a celebrity shoes pronouncement regularly move markets. In a world in which the differences between investing and speculating are frequently blurred, the nonsense on financial cable channels only compounds the problem. Graham would have been appalled. The only saving grace is that value investors proper at the expense of those who fall under the spell of the cable pundits. Meanwhile, human nature virtually ensures that there will never be a Graham and Dodd channel.

UNANSWERED QUESTIONS

Today's investors still wrestle, as Graham and Dodd did in their day, with a number of important investment questions. One is whether to focus on relative or absolute value. Relative value involves the assessment that one security is cheaper than another, that Microsoft is a better bargain than IBM. **Relative value is easier to determine than absolute value**, the two-dimensional assessment of whether a security is cheaper than other securities and cheap enough to the worth purchasing. The most intrepid investors in relative value manage hedge funds where they purchase the relatively less expensive securities and sell short the relatively more expensive ones. This enables them potentially to profit on both sides of the ledger, long and short. Of course, it also exposes them to double barreled losses if they are wrong.[15]

It is harder to think about absolute value than relative value. When is a stock cheap enough to buy and hold without a short sales as a hedge? One standard is to buy when a security trades At an appreciable—say, 40%, 40%, or greater—discount from to underlying value, calculated either as its liquidation value, going-concern value, or private-market value (the value a knowledgeable third party would reasonably pay for the business). Another standards is to invest when a security offers and acceptably attractive return to a long-term holder, such as a low-risk bond priced to yield 10% or more, or a stock with an 8% to 10% or higher

[15] Many hedge funds also use significant leverage to goose their returns further, which backfires when analysis is faulty or judgment is flawed.

free cash flow yield at a time when "risk-free" U.S. government bonds deliver 4% to 5% nominal and 2% to 3% real returns. Such demanding standards virtually ensure that absolute value will be quite scarce.

Another area where investors struggle is trying to define what constitutes a good business. Someone once defined the best possible business as a post office box to which people send money. That idea has certainly been eclipsed by the creation of subscription Web sites that accept credit cards. Today's most profitable businesses are those in which you sell a fixed amount of work product—say, a piece of software or a hit recording—million and millions of times at very low marginal cost. Good businesses are generally considered those with strong barriers to entry, limited capital requirements, reliable customers, low-risk of technological obsolescence. Abundant growth possibilities, and thus significant and growing free cash flow.

Businesses are also subject to changes in the in the technological and competitive landscape. Because of the Internet, the competitive moat surrounding the newspaper business-which was considered a very good business only a decade ago—has eroded faster than almost anyone anticipate, In an era of rapid technological change, investors must be ever vigilant, even with regard to companies that are not involved in technology but are simply affected by it. In short, today's good businesses may not be tomorrow's (**Reader's Digest** INSERT LINK)

Investors also expend considerable effort attempting to assess the quality of a company management. Some managers are more capable or scrupulous than others, and some may be able to manage certain businesses and environments better than others. Yet, as Graham and Dodd noted, "Objectives tests of managerial ability are few and far from scientific." (p .84) Make no mistake about it: a management's acumen, foresight, integrity, and motivation all make a huge difference in shareholder returns. In the present era of aggressive corporate financial engineering, managers have many levers at their disposal to positively impact returns, including share repurchase. Prudent use of leverage, and a valuation-based approach to acquisitions. Managers who are unwilling to make shareholder-friendly decisions risk their companies becoming perceives as "value traps": inexpensively values, but ultimately poor investments, because the assets are underutilized. Such companies often attract activist investors seeking to unlock this trapped value. Even more difficult, investors must decide whether to take the risk of investing—at any price—with management teams that have not always done right by shareholders. Shares of such companies may sell at steeply discounted levels, but perhaps the discount is warranted; value that today belongs to the equity holders may tomorrow have been spirited away or squandered.

An age-old difficulty for investors is ascertaining the value of future growth. In the preface to the first edition of Security Analysis, the authors said as much: Some matter of vital significance, e.g., the determination of the future prospects of an enterprise, have received little space, because little of definite value can be said on the subject."

Clearly , a company that will earn (or have the cash flow of) $1 per share today and $2 per share in five years is worth considerably more than a company with identical current per share earnings and no growth. This is especially true if the growth of the first company is likely to continue and is not subject to great variability. Another compilation is that companies can grow in many different ways.—for example, selling the same number of units at higher prices, selling more units at the same (or even lower) prices; changing the product mix (selling proportionately more of the high-profit-margin products); or developing an entirely new product line. Obviously, some forms of growth are worth more than others.

There is a significant downside to paying up for growth or, worse, to obsessing over it. Graham and Dodd astutely observed that "analysis is concerned primarily with value which are supported by facts and not with those which depend largely upon expectations." (p.86) Strongly preferring the actual to the possible, they regarded the "future as a hazard which his (the analyst's) conclusions must encounter rather than as the source of his vindication." P. 86 Investors should be especially vigilant against focusing on growth to the exclusion of all else, including the risk of overpaying. Again, Graham and Dodd were spot on, warning that "carried to its logical extreme…(there is no price) too high for a good stock, and that such an issue was equally 'safe After it had advanced to 200 as it had been at 25." (p.105). Precisely this mistake was made when stock prices surged skyward during the Nifty-Fifty era of the early 1970s and the dot-com bubble of 1999 to 2000.

The flaw in such a **growth-at-any-price** approach becomes obvious when the anticipate growth fails to materialize. When the future disappoints, what should investors do? Hope growth resumes? Or give up and sell? Indeed, failed growth stocks are often so aggressively dumped by disappointed holders that their price falls to levels at which value investors, who stubbornly pay little or nothing for growth characteristics, become major holders. This was the case with many technology stocks that suffered huge declines after the dot-com bubble burst in the spring of 2000. By 2002, hundreds of fallen technology stocks traded for less than the cash on their balance sheets, a value investor's dream. One such company was Radvision, an Israeli provider of voice, video, and data products whose stock subsequently rose from under $5 to the mid-$20s after the urgent selling abated and investors refocused on fundaments

Another conundrum for value investors is **knowing when to sell**. Buying bargains is the sweet spot of value investors, although how small a discount one might accept can be subject to debate. Selling is more difficult because it involves securities that are closer to fully priced. As with buying, investors need a discipline for selling. First, sell targets, once set, should be regularly adjusted to reflect all currently available information. Second, individual investors must consider tax consequences. Third, whether or not an investor is fully invested may influence the urgency of raising cash from a stockholding as it approaches full valuation. The availability of better bargains might also make one a more eager seller. Finally, value investors should completely exit a security by the time it reaches full value; owning overvalued securities is the realm of speculators. Value investors typically begin selling at a 10% to 20% discount to their assessment of underlying value—based on the liquidity of the security, the possible presence of a catalyst for value realization, the quality of management, the riskiness and leverage of the underlying business, and the investors' confidence level regarding the assumptions underlying the investment.

Finally, investors need to deal with the complex subject of risk. As mentioned earlier, academics and many professional investors have come to define risk in terms of the Greek letter beta, which they use as a measure of past share price volatility: a historically more volatile stock is seen as riskier. But value investors, who are inclined to think about risk as the probability and amount of potential loss, find such reasoning absurd. In fact, a volatile stock may become deeply undervalue, rendering it a very low risk investment.

One of the most difficult questions for value investors is how much risk to incur. One facet of this question involves position size and its impact on portfolio diversification. How much can you comfortably own of even the most attractive opportunities? Naturally, investors desire to profit fully from their good ideas. Yet this tendency is tempered by the fear of being unlucky or wrong. Nonetheless, value investors should concentrate their holdings in their best ideas; if you can tell a good investment from a bad one, you can also distinguish a great one from a good one.

Investors must also ponder the risks of investing in politically unstable countries, as well as the uncertainties involving currency, interest rate, and economic fluctuations. How much of your capital do you want tied up in Argentina or Thailand, or even France or Australia, no matter how undervalued the stocks may be in those markets?

Another risk consideration for value investors, as with all investors, is whether or not to use leverage. While some value-oriented hedge funds and even endowments use leverage to enhance their returns, I side the those who are unwilling to incur the added risks that come with margin debt. Just as leverage enhances the return of successful investments, it magnifies the losses from unsuccessful ones. More importantly, nonrecourse (margin) debt raises risk to unacceptable levels because it places one's staying power in jeopardy. One risk-related consideration should be paramount above all others: the ability to sleep well at night, confident that your financial position is secured whatever the future may bring.

FINAL THOUGHTS

In a rising market, everyone makes money and a value philosophy is unnecessary. But because e there is no certain way to predict what the market will do, one must follow a value philosophy at all times. By controlling risk and limiting loss through extensive fundamental analysis, strict discipline, and endless

patience, value investors can expect good results with limited downside. You may not get rich quick, but you will keep what you have, and if the future of value investing resembles its past, you are likely to get rich slowly. As investment strategies go, this is the most that any reasonable investor can hope for.

The real secret to investing is that there is no secret to investing. Every important aspect of value investing has been made available to the public many times over, beginning in 1934 with the first edition of Security Analysis. That so many people fail to follow this timeless and almost foolproof approach enables those who adopt it to remain successful. The foibles of human nature that result in the mass pursuit of instant wealth and effortless gain seem certain to be with us forever. So long as people succumb to this aspect of their natures, value investing will remain, as it has been for 75 years, a sound and low-risk approach to successful long-term investing.

May 2008.

We just heard from Seth Klarman, a value investing legend, give us his overview of value investing. Now let's test our creative thinking skills. Or if you don't know who the sucker is then……?

Thinking out of the box

You bet a group of hustlers/bettors that if there is enough prize money--$500,000 or more, you will play the winner of this match http://youtu.be/Ne9LVpnYeFQ in a two-out-of-three match in games to twenty-one. You have only played twice before against your little sister and lost. You win $500,000 or you lose $500,000. However, **you get to choose** how you will play the game of table tennis (ping pong). Both of you are under the same rules/equipment and you must abide by the rules of table tennis—hit the ball over the net, one bounce, no touching the net, etc.

You have 15 days to prepare and you have only played ping-pong once. What are you gonna do?

If you lose, then these guys will help you pay: http://youtu.be/aPLvu-Zg-mE. Your career is over.

Having trouble solving the above puzzle then: "The most power mind is the quiet mind. It is the mind that is present, reflective, mindful of its thoughts and its state. It doesn't often multitask, and when it does, it does so with a purpose."

Shut out noise (auditory as well as visual) and focus.

The solution is on the next page, but first try your best.

AMARILLO SLIM HUSTLES THE HUSTLERS.

Excerpts from *Amarillo Slim in a World Full of Fat People* by Amarillo Slim Preston

Bobby Riggs, the 1939 Wimbledon

Excerpts from *Amarillo Slim in a World Full of Fat People* by Amarillo Slim Preston

Bobby Riggs, the 1939 Wimbledon Tennis Champion tried to hustle Amarillo Slim in Ping Pong. Riggs was looking to bust Slim's skinny ass.

Slim tells the story, **"I told Riggs I would play him in Ping Pong straight up with *one* stipulation: that I got to choose the paddles.**

"We both use the same paddle?" Bobby asked.

"Yessir."

"So when you show up with two of the *same* paddles,
can I get my choice of which one of them?"

"Yessir, so long as I can bring the paddles."

Bobby thought I was pulling a schoolboy's scam—that it was a weight thing or that one of the paddles was hollow or something. But once **I told him that he could choose** whichever of the two paddles he wanted to use, he couldn't post his money fast enough.

We bet $10,000 and agreed to play at two o'clock the next day. Before I left, just to avoid any misunderstanding, I confirmed the bet: We were to play a game of Ping Pong to twenty-one, each using the paddles of *my* choosing.

I showed up the next day at the Bel Air Country Club ready to wage battle. When Bobby asked to see the paddles, I reached into my satchel and handed him two skillets, the exact same weight and size, and told him he could use either one. Now, Bobby was about as coordinated an athlete that ever lived, but he was swinging that skillet like a fry cook on speed. It wasn't until I had him buried that he started to get the hand of that skillet, but it wasn't soon enough. I won the game 21-8, and it could have been much worse.

Once again I proved that you can make a living beating a champion just by using your head instead of your ass. **The easiest person in the world to hustle is a hustler**, and Bobby had taken the bait like a country hog after town slop. You see, I had been practicing with that skillet since I saw him in Houston, and after I collected the money, I shook Bobby's hand and we both had a good laugh.

Naturally, word spread like wildfire about old Slim fleecing Bobby Riggs, and seven or eight months after it happened, I was in Knoxville, Tennessee, at an American Legion club, to play some poker. There were quite a few wise guys there, including a man named Lefty, who said to me, "Slim that was a pretty good thing you did, playing Ping-Pong with Riggs." Then Lefty said to me, "I've got a buddy that can beat you at Ping-Pong."

"You haven't got a buddy who can beat me if I choose the paddles," I said.

Now, this guy knew how I beat Bobby. The whole world knew how I beat Bobby. **And I knew he knew it**, so I couldn't just set up a match to play with skillets, now, could I?

I knew I had to find a way to relieve old Lefty of his money.
I left for Amarillo the next day, wondering how in the hell I was going to find a way to beat Lefty's pal at Ping-Pong. A few days later, I was drinking Coke from a glass bottle in between games of a friendly pick-up game of Ping-Pong. For fun, I reached down with the bottle and hit the Ping-Pong ball and it went plumb over the net.

I tried to do that again but I couldn't. You see, there is an area of only about a sixteenth of an inch on a bottle that will make the ball go over the net. **So I practiced and practiced until I could hit the ball over the net every time, and right then I knew that Coke bottle was going to make me a boatload of money.**

My only problem was that I couldn't just show up in Tennessee looking for Lefty—that would have awoken the dead—so I had to find me a reason to go back to Tennessee. I waited a few months for the next big poker game up there, and when I showed up, Lefty didn't waste any time approaching me. "I guess you've been practicing your Ping-Pong back in Amarillo," he said.

You said it, Lefty. I've been playing Ping-Pong *all* day, every day, for thirty hours a day."

"That right? My friend will be here in two days."'

Well, I'm gonna do a little bit of fishing as soon as I bust these poker players. If he wants to play me some, let me choose the paddles and he is got him a game."

"What if he is a good player?"

"I don't give a damn if he is a good player or an aviator. If I get to choose the paddles, we will play."

"Oh, I'll *guarantee* you he'll play."

So I went fishing for a couple of days, and when I came back, boy, they didn't disappoint me with their ringer. Wouldn't you know it, but they had gotten themselves the world-champion table-tennis player from Taiwan, and he was there waiting for me, licking his chops like a dog at a luau.

Let's get it on!" Lefty said.

"No," I said, savoring the moment. "Let's post our money and play thirty days from now. I need to practice a little, now that I see you got yourself a real-life Ping-Pong champion."

While I can play a fair game of Ping-Pong with a skillet, **I am not interested in speculating, nor am I interested in making a small score. You see, friend, when I make a wager, the bet has *already* been won. And if I'm gonna win, I sure as hell want to break somebody doing it.**

Even though Lefty and the rest of them wise guys had suitcases full of money, I knew that if I stalled, word would spread that old Slim was going to receive his comeuppance—and Lefty would have the rest of his rich buddies there to get a piece of me, too. So we agreed to hold the match in thirty days—and then we'd play for *real* money. Not only did I want to give Lefty an opportunity to tell all his associates, but **I also wanted to give that champion even more time to practice with his skillet.**

I made sure we agreed that we were to play a game of Ping-Pong to twenty-one, each using the paddles of *my* choosing.

About a month later, just a day before the match, I got a call from one of my associates saying that the champ was practicing with the biggest frying pan this side of Texas. That wasn't news to me—I knew that was their intention all along-but I suppose they **underestimated this here country cowboy.**

The next day I arrived in Tennessee I bet with everybody who wanted to bet against me at even money, and when I couldn't get any more action, I bet everything else I had laying 6 to 5, which meant that if I lost, I'd pay them suckers $6 for every $5 they bet me. Now it was time to play, and everyone was standing around waiting for me to pull out those skillets. They figured I was just stalling when I went over to a vending machine, put in a dime, and bought a bottle of Coca-Cola. Then I put in another dime and bought another one. I opened both bottles and walked over to a wastebasket and dumped the Coke right out.

Lefty and the rest of the crowd were getting impatient, but I didn't say a word. I simply walked over to the Ping-Pong table with the Coke bottle and I said to that champion, "It's your choice of paddle, son. Which one will it be?"

"Paddles?" he asked.

"Yeah, these here Coke bottle are our paddles. Have your pick." Well, that boy looked like he couldn't swallow boiled okra!

Once he grabbed one of the bottle, I said, "I'll even give you the choice—do you want to serve or return serve first?"

This champion glanced over at Lefty, who didn't look so good himself. "Well, goddamn, "Lefty said, "take the serve."

"Okay," I said, "Let's go."

On his first round of serves, he never even hit the ball over the net. Not one shot. So it was love-5 when he threw me the ball. When I served it over—I'll give that boy credit, he did hit it every time, but it would go either straight up in the air
or right into the net. He never did return one of my serves.

I'd rather not say how much I had on the match, because it caused a severe audit when word got around. But suffice it to say that no one—not even a world champion—ever challenged me to a game of Ping-Pong again.

I like to bet on anything—as long as the odds are in my favor.
....I also learned that there are people who love action and others who love money. The first group is called suckers, and the second is called professional
gamblers, and it was a cinch which one I wanted to be.

Rather than try to take advantage of the ignorance of a sucker for a few dollars, I take aim at the ego of a millionaire and try to win me a few thousand. If there is one fatal flaw, the **Achilles' heel of every gambler, it is hubris**. No gambler ever wants to lose face, and I have used that **psychological edge** to my advantage. All I have to do is play to a wealthy man's ego, and not only can I get him to gamble, but I can get him to gamble with me *for life*.

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You learn something every day. Think through all the lessons the next time you make an investment. Next we need to look into whether value investing works before we move onto building an investment process, prices, valuation, search, risk management and monitoring ourselves.

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