The Hummingbird Value Fund, LP

Value Investing in the Graham and Dodd Tradition

The Tarsier Nanocap Value Fund, LP

We Fish Deeper and We Fish Alone

Investment Strategy

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A FRAMEWORK FOR ADDING VALUE

We operate within a framework constructed from six principles, each of them chosen to add value to the investment process:

- **Traditional Graham and Dodd Value Investing**
- **Microcap and Nanocap Value Sector**
- **Portfolio Construction**
- **Security Selection Criteria**
- **Search, Research and Catalysts**
- **Portfolio Management**

1 COMMITMENT TO TRADITIONAL GRAHAM AND DODD VALUE INVESTING

Our strategy is built on the foundation of value investing in the Graham and Dodd tradition. Though value investing may not be exciting, glamorous or sexy, it has been consistently profitable. This discipline was pioneered by Benjamin Graham and advanced by his students Walter Schloss, Irving Kahn, Warren Buffett, and by other alumni of Columbia Business School such as Chuck Royce and Mario Gabelli.

Value investing rests on two intellectual commitments:

- It is possible for the diligent and intelligent investor to establish the real, fundamental, or intrinsic value of some investment securities. A company's intrinsic value may be based on its assets or its earnings power.

- There are times when the market offers to sell these securities for substantially less than their intrinsic value. The difference between market price and intrinsic value is what Benjamin Graham, in *The Intelligent Investor*, defined as the margin of safety. The true value investor buys securities only when there is a sufficient margin of safety both to protect the capital that has been invested and to provide a substantial return once the market realizes that the securities have been mispriced.

Over the long run – as long as records have been kept – value investing has outperformed all other styles, although there have been periods during which growth or momentum investing has excelled. Studies by academics and the track records of value managers support this claim. We feel we are in an extraordinary time for value investors – opportunities abound in the current market.

Our basic aim is to buy securities – a fractional ownership in a company - at a discount to their intrinsic value. The questions we are seeking to answer are: (1) Why should I buy the stock? (2) What is going to make the stock go up? (3) How long will it take?

Five factors are crucial in deciding whether a security is a legitimate candidate:

1. Potential upside – the discount to our estimate of intrinsic value

2. Valuation -- whether we have the ability to estimate the intrinsic value of this security

3. Certainty – how sure we are of the outcome

4. Time – how long will it take to close the gap between the current price and the intrinsic value

5. The margin of safety – to protect us in case we make a mistake or if something goes wrong

Like most value investors, we do not try to forecast the future course of the securities market. In evaluating the prospects of individual companies, we do not let rosy conjectures of future developments enter into our calculations. Our preference for tangible assets and current earnings implies that we may trail the market during periods of speculative euphoria, when people are willing to pay exorbitant multiples for companies on the basis of little more than hopes and dreams. During periods when we see few opportunities and we may remain in cash. Additionally, in periods of severe market dislocation, the absence of liquidity can cause our performance to lag as people make a flight to quality and abandon those securities they deem risky. As one of our main underlying tenets is the concept of mean reversion, we believe that these market imbalances will be self-correcting. Therein lies the **current** opportunity, the major indices will correct but our opportunity set will remain robust until our sector corrects.

2 Significant Opportunities in the Small, Micro and Nanocap Sector

Mistakes in pricing are not spread uniformly across all areas of the capital markets. The market is more prone to error in areas where fewer security analysts are scrutinizing corporate financial statements. Analysts cannot afford to spend time on smaller companies in which their clients cannot invest significant sums of money. This institutional constraint means that large cap stocks tend to be priced more efficiently—

closer to intrinsic value—and that most bargains or mispricings are found in the small, micro and nano capitalization sectors of the market. To take advantage of this disparity, we concentrate our investments in companies with market capitalizations well below $1 billion. Our preference is for truly small companies, those well under $100 million. In the case of our Nanocap Fund, we focus on companies below $15 million.

There is significant evidence that investors (and speculators) have abandoned the area where we operate, sub $50 million. Trading volume has dried up and bid-ask spreads are huge – in many cases the offer can be 100% above the bid. We are in the market every day, sitting on the bid (and in some cases offering stock as well) to take advantage of these situations.

Our experience is that a portfolio of small companies will provide us with a greater return than the market as a whole, with lower risk and volatility. Because these firms usually operate in a single niche, they are easier to analyze than companies in ten or twenty separate lines of business. Their financial statements are clearer, and the management of the company is more accessible to those few investors who bother to get in touch with them. Their small size does make them vulnerable if things go wrong . But we protect ourselves by owning shares in many companies, and also by looking for firms with little or no debt.

By owning large stakes in small companies, we are better able to influence management both directly and indirectly. We make our thoughts and ideas known, especially what we expect in terms of capital allocation regarding share repurchases, dividends, and acquisitions. We rarely make suggestions concerning a company's operating business. We are generally not activists, but we do defend our rights as shareholders.

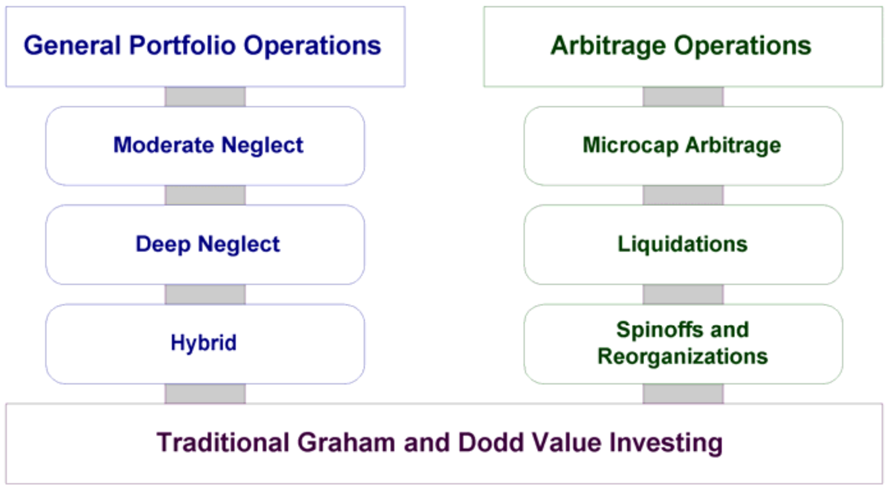
The crux of our value add, of our "edge", is that we invest in the most inefficient sector of the US capital markets and in many cases, work closely with management to unlock value. We are unaware of any other fund that allows investors access to these extremely tiny companies.

3 PORTFOLIO CONSTRUCTION

Both funds follow the same small, micro, and nanocap value philosophy. They differ only in how their portfolios are constructed:

The Hummingbird Value Fund

We divide our investments in this fund into two basic types -- General Portfolio Operations and Arbitrage Operations -- each with several sub-categories. We look to maintain a rough 50/50 mix between the General Portfolio and Arbitrage sections. If we are unable to find enough securities in either category, we hold the remainder of its allocation in cash. That is, even if there are additional opportunities on the General Portfolio side, we will try not to let it expand beyond 75% of the entire portfolio. Maintaining this balance is one of our mechanisms for reducing risk.



General Portfolio Operations involves purchasing securities at prices below their intrinsic value as determined by careful analysis. Given our value commitment, we try to buy securities when the sentiment for a company's outlook is bleak and the price of the stock is low, and to sell them in periods of optimism and high prices. There are three sub-categories within this portion of the portfolio:

- *Moderately neglected companies* are firms that maintain some level of institutional sponsorship and analyst coverage. In many cases, a black cloud hovers over the company. This pessimism can have several causes: industry overcapacity; product transitions; production problems; botched acquisitions.

  These are companies that still care about Wall Street and maintain friendly relations with buy and sell side analysts. Wall Street, however, doesn't care much about them. This asymmetry creates opportunities when shares are priced to incorporate nothing but doom and gloom.

- *Deeply neglected companies* have lost sponsorship and analyst coverage. Disparities between intrinsic value and price can be extreme because few investors are watching. It is not uncommon to find a company trading at the value of the cash on its balance sheet, net of all debt. When buying the stock, we pay for the cash and get the business for free.

  These companies have given up on Wall Street. They might choose not to be public, but somehow they are stuck. A frequent catalyst in realizing the value of this kind of investment is that someone, (often the management), pays a premium to take them private.

- *Hybrid Securities* consist of convertible and non-convertible bonds and preferred stock. The company features are similar to those in the neglect categories mentioned above, but the securities are in a different area of the company's capital structure.

Arbitrage Operations seeks opportunities created by the announcement of some kind of deal. As with the General Portfolio side, we are trying to buy securities for less than their intrinsic value. In these deal-driven situations, that value can be estimated with greater certainty, and there is a clear catalyst to realize it. Arbitrage also breaks down into three sub-categories:

- *Microcap Arbitrage* involves purchasing securities of companies that are merging or being acquired. Because of their small size, these deals do not turn up on the radar screens of the established arbitrage community. A nimble investor can profit handsomely from deals too small to attract the big players.

- *Liquidations* refer to the purchase of securities of a company in the legal process of liquidation. In these situations, the intrinsic value can be estimated with some precision; the timetable is relatively short and predictable.

- *Spin-offs and Reorganizations* consists of purchasing securities of companies that are in the midst of a major change in their corporate organization or their capital structure. Reorganizations focus on companies making a major divestiture, shutting down a division, or changing their capital structure. This section also includes companies emerging from bankruptcy.

The following table summarizes the divergent characteristics of the portfolio segments. It illustrates how much they differ from one another on important dimensions like time horizon, liquidity, and market capitalization. This structure provides a level of diversification not generally found in portfolios in which all the investments are correlated with movements of the market as a whole.

	GENERAL PORTFOLIO OPERATIONS			ARBITRAGE OPERATIONS		
	Moderate Neglect	**Deep Neglect**	**Hybrid**	**Microcap Arbitrage**	**Liquidations**	**Spin-offs and Reorgs**
Time horizon	1 to 3 years	3 years +	3 years +	1 to 3 months	1 to 36 months	1 to 18 months
Intrinsic value	growing	growing	set to growing	set	set to growing	set to growing
Discount to IV	large	extreme	large	small	varies	varies
Time table	unpredictable	unpredictable	unpredictable	predictable	predictable	predictable
Market cap	micro to small	micro to small	micro to small	micro to small	micro to small	micro to large
Market Correlation	moderate to high	low	low	low	low	low to high
Liquidity	low to excellent	poor to low	poor to low	poor to good	poor to good	low to excellent

Benjamin Graham in the Graham-Newman Partnership and Warren Buffett in the Buffett Partnerships split their investments between arbitrage situations and cheap stocks (Buffett had an additional portion for controlling positions.) We have added another level of differentiation to create a structure that is unique among current investment managers.

Portfolio Characteristics: Liquidity, Market Correlation, and Risk

When all of these strategies are combined in Hummingbird, the portfolio has these favorable characteristics:

- *Generates cash* The arbitrage component returns cash to the portfolio each time a deal is completed. This cash can be reinvested either in other Arbitrage opportunities or in the General Portfolio.

- *Has lower market correlation* Since many of the investments in the Arbitrage category operate on their own time schedules, swings in the general market have less impact on this portion of the portfolio. Because stocks in the General Portfolio Operations area have been beaten down, shareholders with high expectations about future prospects have already sold out. The remaining shareholders, often referred to as "strong hands," are less prone to panic and sell into a declining market.

- *Seeks to limit risk* Risk has a number of meanings in the investment world, most of them bad. We define it as the chance of a permanent loss of capital, and it is something we try to keep to a minimum.

  We employ two powerful tools to reduce risk. The first is stock selection, where we look for a substantial margin of safety between the intrinsic value of the shares and the price at which we are able to buy them.

  Our second tool for limiting risk is diversification. Though some value investors prefer to focus their investments on a select number of companies they follow with great intensity and expert knowledge, we remain committed to diversification. Diversification in the small, micro, and nano cap sector is different from diversification in the large cap sector. In the small, micro and nano cap universe, each company is likely to be in one or two lines of business. We could own shares in twenty separate companies and still have a portfolio more concentrated, as measured by lines of business, than if we invested only in General Electric or Hewlett Packard. A large capitalization mutual fund may be diversified with twenty names, provided they represent 100 separate businesses. We need 100 names to do that job.

  In our case, diversification comes from two sources. First, as previously noted, we diversify the portfolio into two sections with three sub-sections within each. Second, we spread the investments within each segment among enough companies to ensure that each represents only a small fraction of the whole portfolio. For example, in the microcap arbitrage sub-section, we may have 30 positions, of varying size. If one deal breaks, it will hurt, but damage to the entire portfolio will be limited.

The Tarsier Nanocap Value Fund

The Tarsier Nanocap Value Fund does *not* have the mandate to invest approximately half of its portfolio in Arbitrage Operations. Though it is not prohibited from making these investments, the majority of its holding will be in the General Portfolio. These investments will resemble those in The Hummingbird Value Fund: companies that pass all the value tests we apply in The Hummingbird Value Fund although the companies will be much smaller – all below $15 million market value at the time of purchase. We expect there to be some but not considerable overlap between the two funds.

Tarsier will generally invest in the most neglected companies -- our tagline is *"We fish deeper and we fish alone"*. Often the upside is substantial but there is no catalyst – valuations are extreme. Many of the companies are traded in the Pink Sheets and not on major exchanges. In many cases, they do not file periodic reports with the US Securities and Exchange Commission. Therein lies the opportunity. We are diligent in identifying these companies, getting financials, performing research, and accumulating a position. For example, we were recently purchasing a company with a $2.7 million market value with over $4.5 million of cash and a burn rate of $50,000 per quarter. We sit on the bid at 5 cents, the offer is 10 cents.

We expect The Tarsier Nanocap Value Fund to differ from The Hummingbird Value Fund in these respects:

- *More volatile* Arbitrage Operations act like super cash, dampening the volatility of the portfolio. Without that anchor, Tarsier will probably go up and down more than Hummingbird. We also expect significantly more volatility due to the lower liquidity of many of the companies.

- *Lower turnover* Most of the arbitrage situations have a short investment cycle. They turn over rapidly, which is one of their benefits. But they also generate short-term taxable income. Without arbitrage, Tarsier should find more of its returns coming from long-term capital gains than does The Hummingbird Value Fund.

4 Security Investment Criteria

Why does anyone buy a stock? They expect it will go up. Why does a stock go up? A change in expectations about future cash flows. Why cash flow? Because the value of any asset is the cash flows produced by that asset discounted for risk. If an asset can't produce cash flow it is worthless or may have negative value. If you can get increased cash flow from an asset, it becomes more valuable. A security's cash flow equals dividends plus capital appreciation which in turn is a function of cash flow times some multiple.

A value investor either is buying assets which are not producing cash flow or buying assets which are producing cash flow but where the expectation is that cash flow won't continue. The three main cases:

1. Cash flows down = depressed earnings → low price to book.

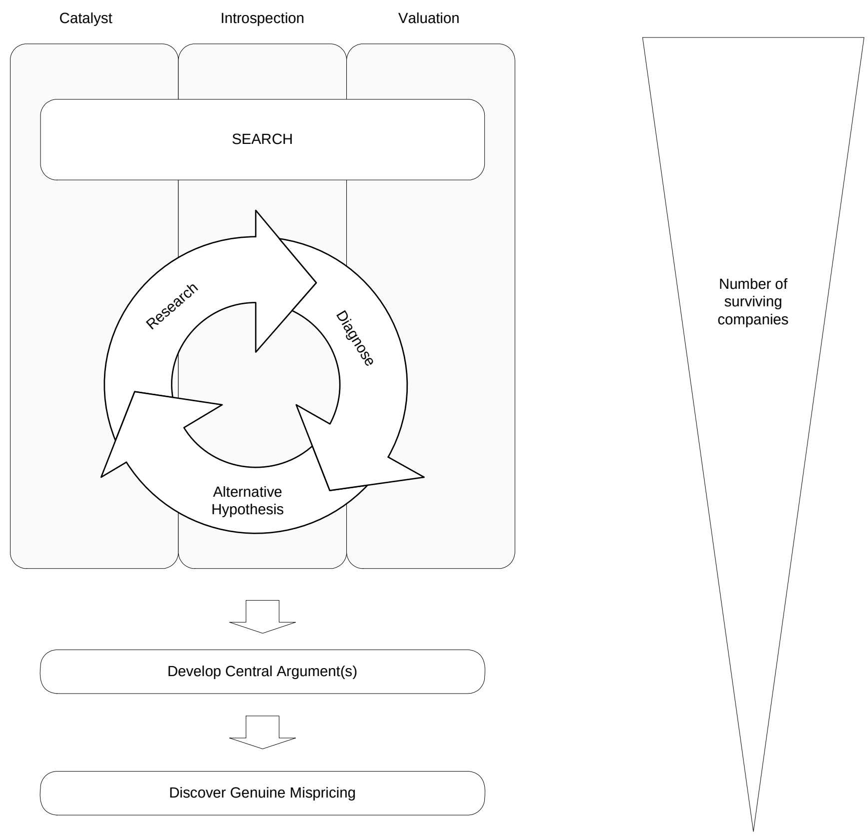
2. Perceived cash flow decline = depressed earnings expected → low price to earnings.

3. Some new development is or will be occurring that will increase cash flows which has gone unnoticed by Wall Street → growth within the franchise.

We will predominantly buy either low price to book or low price to earnings stocks. We want to buy assets or earnings power at a significant discount to intrinsic value. We look to get any growth within the franchise for free.

5 SEARCH, RESEARCH, AND CATALYSTS

We have designed a search and research process to locate and evaluate those investments that fit our specifications without too much wasted effort. The diagram below lays out this process:

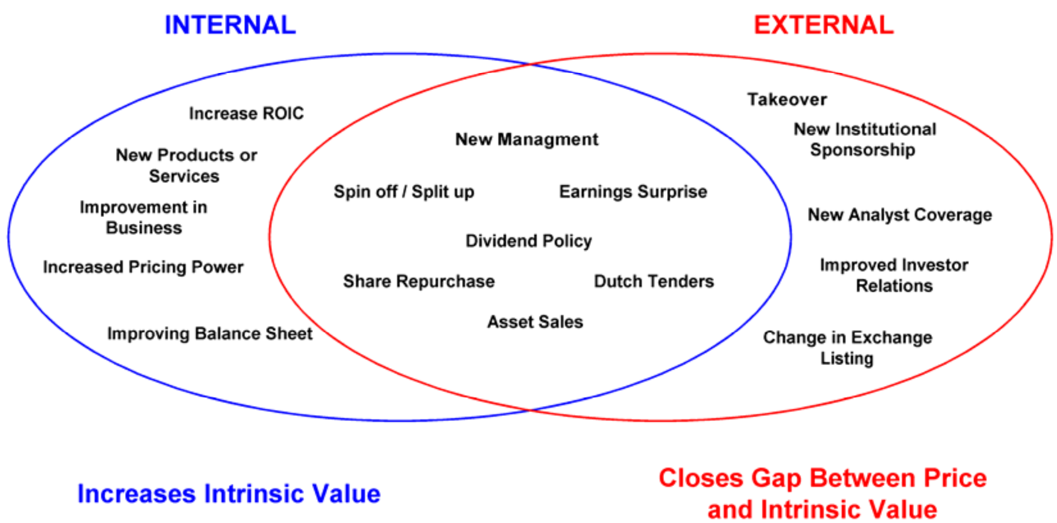


Three main themes permeate our investment process. We think about these things throughout the entire process. They drive our search strategy and help us to develop our central argument or thesis.

Catalyst: The central question is how we are going to make money. The catalyst is an event, person, or other source of change that causes the gap between the price and the intrinsic value to shrink. If we can identify a catalyst, we have an answer to the question of how we are going to make money, and also a sense of when that will happen.
We earn money only when the gap between the discounted market price and the intrinsic value closes. We want this closing to be upwards; it does no good if the intrinsic value falls to the price of the security. And the closing should be timely -- a security trading at a significant discount may not be a good investment if the spread closes only over an extended period. In most cases, we try to identify a specific catalyst that will close the gap.

There are two main types of catalysts—internal or external. An internal catalyst may simply be that the business improves, thereby increasing the intrinsic value. In this case, the gap remains but the stock price increases in conjunction with the rise in intrinsic value. For example, a stock trading at five times earnings of $1, or at $5 per share, should go to $10 if earnings double, even though the price/earnings ratio doesn't change.

An example of an external catalyst could be that the company gains increased recognition on Wall Street. In this case the company continues to earn $1 per share but is rewarded with a higher P/E multiple. We locate internal and external catalysts in the following picture:



Introspection: Throughout the process, we continually ask where we could have made a mistake. Introspection starts with the search process and stays with us like a guilty conscience always asking, "Have we made this mistake before?" What might happen that will cause us to sustain a permanent loss of capital?" We challenge each of our assumptions. After all, we have picked a security that the market has rejected. What makes us confident that the market is wrong and we are correct? This is something we must think about constantly.

Valuation: Valuation answers the "how much" question. Through research we attempt to determine the intrinsic value of the company. If a situation proves to be impervious to analysis, we discard it and move on to the next. Sometimes a competitor turns out to be much more interesting and becomes the new target of our analysis. The best case is where we can arrive at a reliable estimate of intrinsic value. We are looking for securities selling at a discount to their intrinsic value; this discount is both the margin of safety and the gauge of potential gains. How large the discount should be 10 percent, 50 percent, 90 percent -- depends on the circumstances. A 5 percent discount may be rewarding for an arbitrage deal that is closing in two weeks with a high level of certainty. A 50 percent discount maybe illusory if the discount has persisted for ten years and no catalyst is visible.

Keeping these three points in mind we begin to seek out candidates for investment.

Search Strategies

Companies generally sell below their intrinsic value because they have disappointed the investment community. The price of their shares has plummeted, and expectations for them are low. The margin of safety lies on a bed of broken dreams. Fortunately for us, lists of broken dreams are published daily. They include the greatest percent decliners and stocks hitting new lows for the last twelve months. These are rich hunting grounds in which to identify candidates. Screens, keyword searches of databases and reading the news carefully are all techniques we use to identify potential ideas. Thanks to the availability of SEC filings on the internet, we can quickly determine whether a company is truly compelling and warrants further scrutiny. To cull the list we examine valuation and financial leverage.

In Tarsier, our search strategy has a bit of a twist. We diligently look through the new lows list each day but we also take note of interesting companies trading on the Pink Sheets or companies filing a Form 15 and delisting their stock. We often track these and monitor their financial results and trading patterns over time. We get emails containing results of keyword searches and monitor changes to a company's website announcing new information. In that sector of the market, you are at an advantage just by *getting* the financial statements!

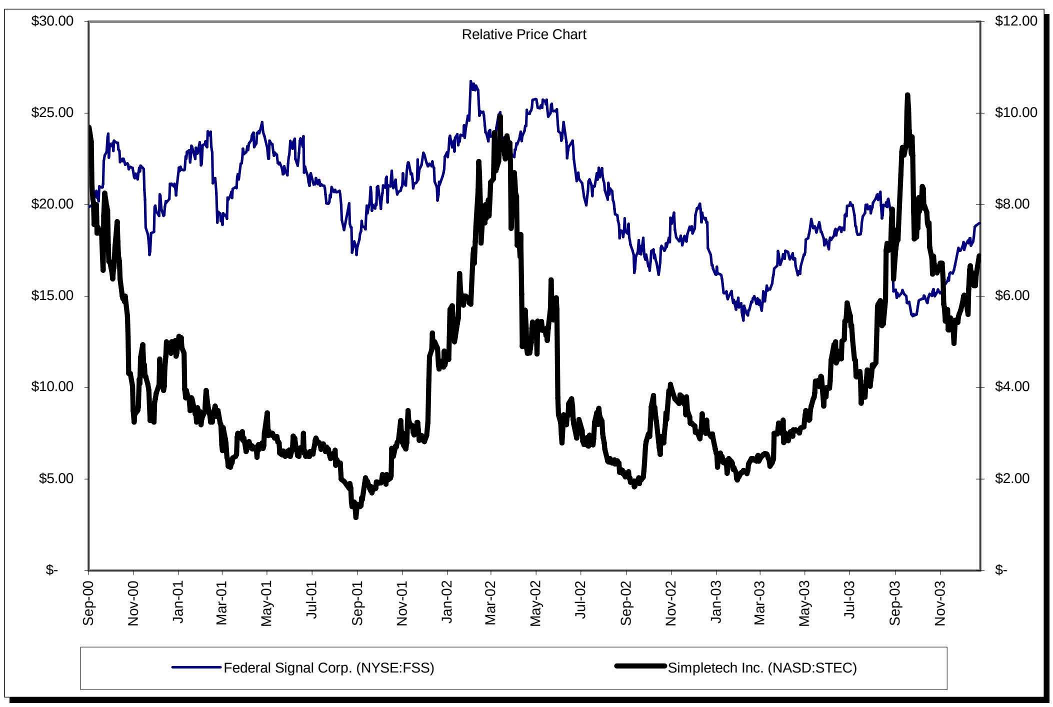
What do we look for? Ideally, we want to purchase securities in a company engaged in a business with great economics as evidenced by high returns on invested capital. The perfect business is one that has a large spread between its return on capital and its cost of capital, has boundless opportunities for growth, and requires little investment to generate this growth. These companies are extremely rare in the business world and are hardly ever available at a reasonable multiple of earnings, much less a low one.

We adhere closely to our strict valuation parameters when evaluating companies for purchase. Ideally, we buy established small and microcap companies with customers, revenues, and earnings. We look for companies with pristine balance sheets including large cash balances, good growth prospects, seasoned management, large product and customer bases, defendable competitive positions, share repurchase programs, insider buying, and high returns on capital which generates free cash flow. We seek to purchase these businesses at low multiples to normalized cash flow. Most of the time we have to compromise on some of these features. Premium companies usually command premium multiples, for which we refuse to pay. Alternatively, we also find opportunities buying break-even businesses at a discount to their tangible assets. For example, we might buy a broken dot com trading at the value of the cash on its balance sheet, which is currently breakeven but with a potential to grow.

We prefer to invest in a situation where the stock price can become detached from the fundamentals or the economics of the business. We look for a story or a dream. Will people buy the stock because they believe? In these situations, each incremental penny of earnings may be worth 25 to 50 times in a dot-com; if the company made some mundane product, such as drill bits, the same penny might be worth only 10 times.

We also seek out volatility. Volatility is the friend of the value investor. It gives us opportunities to buy at low prices and sell at high prices. One area, which offers a lot of volatility, is the technology sector..

Below is a chart of our proverbial "drill bit" company, Federal Signal (which just has a small subsidiary that makes drill bits) and a technology company, Simpletech. In the time period from September 2000 to January of 2004, Simpletech has gone from $10 to $1 to $10 to $2 to $10. This volatility has given us opportunities to enter and exist the stock. By contrast, Federal Signal has oscillated between $15 and $25.



Research / Diagnose / Alternative Hypothesis

Once we have a list of candidates, we proceed into our grinding process of research → diagnosis → alternative hypothesis. As we begin to read filings, talk to management and gather other information, we are continually trying to diagnose why the security is cheap, to feel secure that there a genuine mispricing. We develop an alternative hypothesis, try to figure out what is the market missing. As we perform more research and gather more information, our diagnosis and hypothesis may change.

Research

There is an art to identifying what needs to be analyzed in each situation and how to go about analyzing it. An arbitrage deal can entail reading reams of documents and speaking with the company. A moderate neglect situation may require a complete competitive analysis, talking with customers, competitors and industry consultants as well as the company. We always begin by reading. This includes public filings and screening online databases for articles about the company and its principals. We also do enough industry analysis to put the company into some type of context. For example, if a company makes parts that go into forklifts, we need to know the outlook for the forklift industry. We also analyze competitors and customers. We array as many years of financial data as possible to see how the company has performed in good and bad times. With a long list of questions, we then either talk or meet with management.

We are always looking for either confirmation or red flags. We seek information that confirms our hypothesis but are very careful not to ignore information that disproves it. In that case, we throw out the hypothesis and develop another or dispose of the name entirely and move on to the next.

Diagnosis: Is the market really making a mistake?

Once we have weeded out the obviously undesirable, we scrutinize the remaining to understand why the price has declined. We ask ourselves whether the market is really making a mistake. Prices in the stock market are set by the collective judgment of many intelligent and energetic investors. While we believe that prices do not always reflect intrinsic value, we start with the assumption that most prices are reasonable. We want to know whether the security is in fact a bargain. Why are we getting such a gift? Once we have uncovered what looks like a mispricing, we seek to understand why it should exist.

Alternative Hypothesis: What is the market missing?

Some apparent bargains are tainted goods. For example, a company with a large liability –for example, a lawsuit -- that doesn't appear on the balance sheet may look cheap but isn't. The market has already incorporated this information into the price of the security.

Fortunately, some apparent bargains are legitimate opportunities. The share prices have declined for reasons that we regard as trivial or irrelevant. For example, a company may cut a dividend or omit it entirely. Sometimes this is a distress signal, but an alternative hypothesis is that the company sees profitable reinvestment opportunities within its business or prefers to use the cash to repurchase stock. Whatever the real cause, the stock is likely to decline because investments funds and individuals own it for the income. When the dividend is cut, they sell (in the case of some funds, they may be obliged by their charter to sell, driving down the price and creating an opportunity.

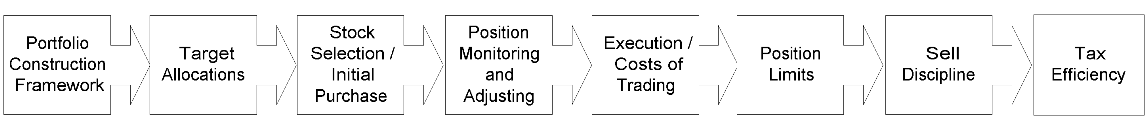
A mispricing may have nothing to do with the company. An analyst may switch firms and drop coverage of the stock. Brokers in the old firm can no longer give guidance to their clients, so the stock is sold. This creates another genuine opportunity.

Classic arbitrage occurs when an identical good can be simultaneously bought and sold in different markets at different prices. In the securities markets, there are close variants, such as a takeover in the form of a stock for stock transaction. Once arbitrageurs move in to take advantage of the spread in prices, the spread shrinks. Lucrative arbitrage opportunities do not last very long. We try to exploit opportunities in the micro-cap area that are too small for the established arbitrage community. The spreads on these deals may not close instantaneously, affording us our opening.

Finally, genuine mispricing can exist because prevailing opinion often goes to extremes, from too pessimistic to too optimistic and sometimes back again. For example, in the fall of 2002, many Internet companies, some of the verge of profitability, were trading below the cash on their balance sheets. The whole sector was tainted by the collapse of the euphoric bubble that had pushed some share prices beyond any reasonable valuation, and investors were still shying away. Our alternative hypothesis recognized that some of these companies had restructured, focused on cash flow and profitability, and were ready to put up financial results that would surprise the few analysts or investors that still cared. We bought one stock for around $.50 a share and were able to sell out the position at prices ranging from $1 to $5.

6 PORTFOLIO MANAGEMENT PROCESS

Portfolio management refers to all of the decisions an investor makes after the desired securities have been identified. For us, it is an element crucial to the success of the strategy.



Portfolio Construction Framework

The portfolio management process refers to the steps we take to implement the strategy within our two funds.

Stock Selection and Initial Purchase

We buy and sell on a security-by-security basis. We are not market timers. We are not sector rotators, although finding one opportunity in an industry will often make us attentive to other possibilities among competitor or complementary firms.

The search process is never-ending; we look for new candidates every day. After a stock comes to our attention and we do a preliminary analysis, we put it into one of three baskets: discard, put on the watch list, take an initial position. The stocks on the watch list generally have the business characteristics we want but are, at the moment, selling in the market for more than we are willing to pay. We continue to follow them in case the price declines to the point where we can justify making a purchase.

When we first buy a security, we tend to take a small position. Only in the most exceptional situation do we commit to a full position all at once. A security can look like a great bargain and then fall an additional 50 percent. Having conviction in our estimate of its intrinsic value allows us to move with confidence and buy more after the price drops. Even if the price does not decline, we gradually scale into a security as we become more comfortable with management, the company's business, and the way it trades. Accumulating a full position can take months, and if the price rises, we may never get a full position.

Position Monitoring and Adjusting

Once we have established a tracking position, we learn more about the company and the industry. We watch how events unfold over time. Companies in the portfolio constant attention. As our level of understanding grows, we may be willing to increase our position, provided the price is still reasonable.

Our decision to increase a position depends on three variables:

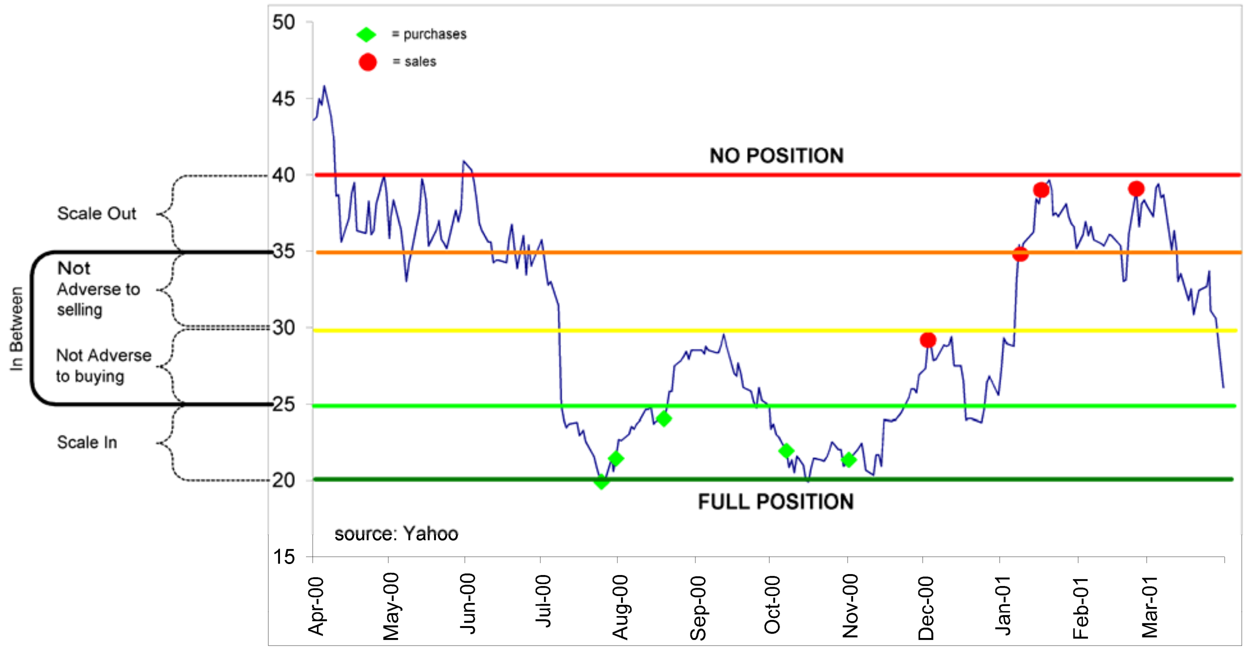
- The intrinsic value of the company, which changes slowly.
- The market price of the security, which can change rapidly.
- The size of the position as a percentage of the portfolio, which can also change quickly, since it depends largely on market price.

As always, we concentrate on the margin of safety -- the spread between intrinsic value and market price. If the margin increases, we will buy more of the security. There are many scenarios through which this may occur. The simplest is a decline in price with no change in intrinsic value. But there are other possibilities. For instance, a company may announce some bad news, causing us to lower our estimate of intrinsic value from $12 to $8. If the stock falls from $9 to $4, we will probably purchase additional shares. Alternatively, if good news comes out and our estimate of intrinsic value goes from $12 to $15, we will buy if the stock stays below $11.

The decision to sell is the converse of the decision to buy. We rarely sell the whole position in a single trade. And the same relationship between intrinsic value and market price governs our actions. If the price rises without a corresponding increase in our estimate of intrinsic value, we sell into this strength. If the intrinsic value declines more than the price, we also sell. This process holds for the securities in the General Portfolio section and also for those in the Arbitrage section. A company in liquidation, even with the amount and timing of the liquidating distributions already established, may see its share price rise and fall by 20 or 30 percent. We try to take advantage of this fluctuation.

Position limits are an additional constraint we impose on ourselves to ensure that we stay disciplined. If the price of a security drops after we have established a full position, it may become a smaller portion of the portfolio. This decline allows us to buy more shares and restore the position to the level we want. If the price rises, we trim back our holdings to regain that level. Though there is some flexibility here, we use the position limit rule to reinforce our goal of buying low and selling high. Combined with the margin of safety requirement, position limits work to make us move against the market trends, selling when prices rise and buying when they fall.

Here is an example of how we make an initial purchase and then scale into and out of a position: We bought shares in a company after an analyst downgraded it because adoption of its new products was progressing more slowly than anticipated. We continued to scale in over the next three months, as further details about its business were made public. In late fall, the stock moved up sharply after a positive earnings announcement and an upbeat presentation at a Wall Street conference. We sold some shares into this strength. We were entirely out when the shares fell back to earth, at which point we began to consider it as a candidate for purchase again.



We sold into the price rise for three reasons. First, the move happened very quickly; the stock went from $20 to $30, a 50 percent increase, in just one month. We thought this rise was unsustainable, so we reduced our position. Second, as the stock approached our estimate of intrinsic value, the margin of safety shrank. Though we were willing to hold on to some of our shares because it was still a decent value, it was no longer the undisputed bargain it had been at $20 per share. Third, as it increased in price, it came to represent a larger portion of the portfolio, and our diversification guidelines mandated that we trim it back.

Execution / Cost of trading

Some of the stocks we want to buy have limited liquidity. The spread between the bid and the asked price is likely to be large. It requires a lot of patience to purchase them without having to absorb the full spread. Good execution is essential if our performance is not to be penalized by high transaction costs. This is especially critical in the Tarsier Fund. Spreads are often extreme and what might be dirt cheap on the bid, might be expensive on the offer. In many cases we are on both sides of the market, the bid and the offer. We use several market makers who we know and trust to help us with trading these illiquid names.

Position Limits

Position limits serve two related purposes. First, they are simply another way to think about diversification. As such, they serve as a powerful tool for containing risk. In The

Hummingbird Value Fund, we try to keep our largest positions at no more than 7 percent of the portfolio although depending on circumstances positions might be higher. We expect most will be in the 1 percent to 5 percent range. Second, position limits allow us to buy more shares when prices drop and compel us to sell when prices appreciate. In the illustration above, our position limit rule forced us to dispose of shares when they rose above $30, although in this case the position was never above 1.5 percent of the portfolio. In concert with our valuation analysis, position limits are another discipline encouraging us to buy low and sell high.

Sell Discipline

Selling is generally the most difficult decision we have to make. No one, ourselves included, can consistently buy at the bottom or sell at the top; realizing this limitation reduces frustration. As with buying, we try to sell in stages and scale out of a position. We can lock in a sure gain, leaving the rest to sell later.

The decision to sell or prune back a position is driven by two factors -- the margin of safety and our position limits. If the margin of safety shrinks due to a rise in the stock price or a decrease in our estimate of the intrinsic value we will usually sell. We also sell when we realize we have simply made a mistake and overestimated the intrinsic value from the start. Alternatively, if a security rises in price, especially within a short period of time, we may be moved to sell if the position becomes too large.

Tax efficiency

Although we do concentrate on the real returns investors will earn after taxes are paid, we do not manage the portfolio to maximize tax efficiency. The arbitrage portion of the portfolio will be especially tax *in*efficient because of its short-term nature. Some of the moderately neglected and deeply neglected stocks may stay in the portfolio for a number of years and thus reduce our tax liabilities. In today's volatile and hyperactive market, however, they may be repriced by a quick change in sentiment and have their share prices double or triple in a month. We make our decisions to sell based on the relationship between price and intrinsic value. If we have to take a short-term gain because we think the stock is fully valued, we do it and reinvest the cash somewhere else. Tax considerations are generally secondary. We may sell losing positions while they are still short-term losses to offset short-term gains and make other moves to reduce the tax bill, but tax consequences are not our primary concern.

Biography

Paul D. Sonkin is the portfolio manager of The Hummingbird Value Fund and the Tarsier Nanocap Value Fund. Paul is currently an adjunct professor at Columbia University Graduate School of Business, where he teaches courses on security analysis and value investing. His is a member of the board of Meade Instruments Corp and Conihasset Capital Partners, Inc. He was previously a senior analyst at First Manhattan & Co., a firm that specializes in mid and large cap value investing. Before that he was an analyst and portfolio manger at Royce & Associates, the investment advisor to the Royce Funds. Royce & Associates practice small and micro cap value investing. Prior to receiving an MBA from Columbia University, he worked at Goldman Sachs & Co. and at the U.S. Securities and Exchange Commission. He is a co-author of *Value Investing: From Graham to Buffett and Beyond.*, (John Wiley & Sons, Inc, 2001.)