THE MANUAL OF IDEAS ™

Value-oriented Equity Investment Ideas for Sophisticated Investors

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

Investing In The Tradition of Graham, Buffett, Klarman

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

Top Ideas In This Report

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About The Manual of Ideas

Our goal is to bring you investment ideas that are compelling on the basis of value versus price. In our quest for value, we analyze the top holdings of top fund managers. We also use a proprietary methodology to identify stocks that are not widely followed by institutional investors.

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

BEST IDEAS 2014

- ► 100 Biggest Losers of 2013
- ► 20 Companies Profiled by The Manual of Ideas Research Team
- ► Proprietary Selection of Top Three Candidates for Investment
- ► Exclusive Interview with Mariko Gordon
- ► 10 Essential Screens for Value Investors

Companies analyzed in this issue include Activision Blizzard (ATVI), Apollo Group (APOL), C.H. Robinson (CHRW), Compuware (CPWR), Corinthian Colleges (COCO), Dice Holdings (DHX), EXCO Resources (XCO), GenCorp (GY), GigaMedia (GIGM), Gold Fields (GFI), Gravity (GRVY), Harvest Natural (HNR), MFC Industrial (MIL), New Gold (NGD), Pioneer Natural (PXD), Redwood Trust ... (SHOS), Strayer Education (STRA), Weight ...).

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Jerry Getsos,
Director of Research and
Senior Vice President,
Klingenstein, Fields & Co.

With compliments of
The Manual of Ideas

Exclusive Interview with Jerry Getsos

Jerry Getsos

We recently had the pleasure of interviewing Jerry Getsos, Director of Research and Senior Vice President at Klingenstein, Fields & Co., a New York City-based investment firm with $4 billion in assets under management. Jerry began his career in 1987 as an Analyst for Lexington Global Asset Management. In 1995, he joined Lepercq de Neuflize & Co. as Chief Investment Officer and Portfolio Manager of International Equities. There, he managed the Ontario International Fund and high net worth individual accounts. In 2002, he joined Tocqueville Asset Management as Deputy Director of Research and Senior Equity Analyst responsible for all European Equity investments. He joined Klingenstein, Fields as Director of Research in 2006. Jerry graduated from Fordham University with a B.S. in Finance and Economics and an M.B.A. in Portfolio Management.

The Manual of Ideas: Please tell us about your background and how you became interested in value investing. What events or people shaped your investment philosophy the most?

Jerry Getsos: In 1987 I began my career in the fund accounting group of Lexington Global Asset Management. I led a team of accountants and began to work closely with Caesar Bryan, who managed the Lexington Global Fund and Lexington Gold Fund. Caesar was a value investor and developed winning track records for Lexington. Over time, he asked me if I would like to work more on investing than fund accounting. I jumped at the chance and began to run screens and models for him, eventually studying individual companies. So I learned fundamental security research from Caesar, and his team of analysts, as well as the essential ingredients of how to value a business.

After Lexington went public, I joined Lepercq de Neuflize & Co. where I had the chance to work with Paul Lepercq, a legendary deep value investor who handled the assets of some of the wealthiest families in the world. Paul was a big believer in owning the shares of a small number of thoroughly researched "transforming" companies where there was a clear disconnect between the companies long-term earnings power and current stock price. In short, he reinforced the importance of conducting independent research on companies, trying to purchase a dollars worth of assets at 40-50 cents and managing concentrated portfolios of ~15 positions.

After Mr. Lepercq passed away, I had the chance to work with Francois Sicart, the Founder of Tocqueville Asset Management, a very well respected contrarian investor. He too advocated using bottom-up fundamental research to arrive at the proper value of companies. However, Mr. Sicart was also a student of behavioral finance and was acutely aware of the influence of "crowds" on stock prices. Believing that over the short/medium term share prices are influenced more by momentum (positive or negative), I learned from him that going against the crowd (avoiding hyped companies and buying quality businesses when they were totally unloved) was a good way to mitigate risk and improve the overall returns of a concentrated portfolio. All three of my former colleagues and mentors were well-respected global/international equity investors.

In 2006, I joined Klingenstein, Fields & Co., L.L.C to broaden their ability to cover domestic multinationals and companies headquartered outside of the U.S. Since then I have worked with Fred Klingenstein and Ken Fields who have built a successful business based upon investing in leading companies at attractive prices. Therefore, with a predisposition toward fundamental research, an innate refusal to "pay-up" to purchase stocks and the entire world to find deep value opportunities, we have developed an investment strategy that is ideal for investors interested in capital appreciation – without taking on excessive risk.

MOI: What are the key principles underlying your investment philosophy?

Getsos: The key tenants of our investment philosophy are: Look at what others have left, analyze not just the company's current financial position, but the one that should most likely exist in a normalized environment and never pay-up, regardless of how compelling the situation is. Therefore, we are looking at good companies (cash generating machines), which are currently out of favor and that we are able to purchase at significant discounts (40-50%) to intrinsic value with 50-100% appreciation potential over a period of 3-5 years.

MOI: How do you generate investment ideas?

Getsos: Investment ideas come to us from all directions. Firm wide we have 12 investment professionals that spend the majority of their time watching our portfolio companies and thinking about new ideas. Our firm culture is very collaborative; therefore, the idea flow is quite robust. As it relates to our Global and International Value Strategies, in addition to me, we have 3 other investment professionals that are like minded with regard to deep value/contrarian investing. We visit two different management teams, on average, every day and are constantly on the lookout for situations that have become oversold or otherwise attractively priced. In addition, we plumb the list of companies making 52 week lows and dissect from it those organizations that are financially strong (minimal debt loads) and generating excess free cash flow for a closer look. From a numerical perspective, we like to purchase businesses that are trading at low multiples to earnings (P/E less than 10x) and cash flow (EV/EBITDA less than 8x) with minimal debt service (EBITDA/interest expense greater than 5x) and free cash flow yields in excess of 7%.

MOI: Help us understand the process you go through from idea generation to the investment decision — which factors and issues do you consider to be of critical importance?

Getsos: Of critical importance is the notion of intrinsic value. We are on the lookout for companies that can be purchased at 40-50% discounts to intrinsic value – defined as the private market value of a business and/or the longer-term earnings potential. To arrive at an intrinsic value number requires a lot of work. We insist that this is done for all of our positions, as the number not only helps us to determine the most advantageous range of purchase prices, but also provides a longer-term price target at which we would begin to sell. For private market estimates, we can look at recent M&A activity, the insured replacement value of a company's assets or conduct a sum of the parts analysis – if it is a multiline business. As you can imagine, these techniques are easier to apply to manufacturing companies, therefore, the industrial part of the economy tends to be an area that we are quite comfortable with. We also look at the past financial performance of a company during normalized market conditions. Much of this information can be used by us to model feedback that we are given by management, to arrive at what the longer-term earnings prospects of a business can be once remedial actions have taken place and/or industry conditions improve. Underlying all of this is our perspective as long-term investors with decades of experience.

You can learn a lot from history, especially in the boom/bust cycles that affect economically sensitive businesses. For example, the old adage "nothing cures high energy prices like high energy prices" has led to over-production of natural gas, depressing prices and in turn wreaking havoc on the stocks of related companies. Low natural gas prices have already led to substitution in the power generation industry, and are beginning to move into the transportation sector as well. With this thesis in mind, we began to look at the suppliers that were most advantageously positioned to benefit from a bottoming and subsequent improvement in natural gas prices and increased capex by the producers.

Vallourec SA (VK.PA) was one company that fit the bill. Based in France, but with key facilities located around the globe, Vallourec is a global leader in the field of premium tubing (tubulars) that is used for completing natural gas wells. Hydraulic fracturing and horizontal drilling have opened-up entirely new reserves of natural gas trapped in shale rock – once thought to be uneconomic due to the extreme temperatures and pressures where the gas was trapped. Given the extreme conditions, it is critical that natural gas producers use the highest grade tubulars available. Vallourec is one of two companies in the world that dominate the market for these casings, with approximately 85% of global production capacity between them.

The stock is currently trading at €40, having fallen by 55% from 2011's high of €90. Earnings topped out at €9.39 per share in 2007 on the back of a boom in power and industrial usage, but these markets fell off sharply post the financial crisis, particularly in Europe. Even in the relatively strong oil and gas business, the shift from drilling gas shale to oil shale has resulted in a less attractive mix for Vallourec. The company had also embarked on an aggressive and expensive capacity expansion, which is now behind them. Looking forward the reduction in capital expenditure and the incremental contribution from the new, highly efficient facility should add significantly to free cash flow.

Nevertheless, with key end markets and geographies still depressed, estimates for 2014 EPS are €2.75 per share, a mere fraction of the prior peak. Longer-term, we project revenue of €7 billion and margins returning to the higher teens, on the recovery in the power and industrial markets coupled with more robust gas drilling. Over the next five years, Vallourec should see earnings return to €5.00 – 5.50. We believe that given the long-term growth prospects of their end markets, a 15x EPS multiple is warranted on this longer-term EPS, resulting in an €80 stock price.

You state that you apply top down and bottom up approaches in your investment process. On the other hand, value investors are typically not comfortable with top down approaches. What makes you comfortable to include a top-down view and how does a top-down view help you be a better investor?

Top down analysis does not play a significant role in our work. We are truly bottom-up stock pickers and do our utmost not to be distracted by the big picture. To the extent that macro analysis does have a bearing on our work, it is purely to understand why a particular country, sector or industry is out of favor and if the stock market has overreacted to the downside – potentially giving us the opportunity to buy otherwise healthy businesses at aberrantly low prices.

MOI: How do you assess the quality and incentives of management?

Assessing the quality of management requires a lot of meetings, listening to quarterly conference calls and watching their presentations at industry conferences. For better or worse, there is no substitute for this. I do listen to other investors that I respect and read a lot of publications, but when it comes to evaluating management there is nothing more effective than meeting with the people and figuring out whether or not they are equipped to carry out their goals. Much can be learned from looking at prior quarterly performance and the CEO's ability to deliver vs. disappoint. When there are disappointments, it is crucial to understand the reason and what was learned and done to prevent the situation from happening again. It is also important to understand their orientation toward the business. Are they owner/innovators or figureheads? Regarding incentive programs, there is no right combination between cash, stock or options. Ideally you have programs that reward long-term goals. However, with stock incentive plans, there could be too much attention paid to share performance which could be at odds with the longer-term needs of the business.

Let's stay on the topic of management for a moment. You stated that you meet or speak with more than 250 management teams per year – what do you aim to get out of speaking with management that you couldn't get otherwise from annual reports etc.?

Discussions with management teams are an indispensible part of our work – especially given our penchant for managing focused portfolios of 25-35 positions. Sitting down with the people that manage publicly traded companies gives us the chance to test our knowledge of the business, while having the corporate leaders discuss their plans for the future. During these sessions, we can do a better job of benchmarking their progress to past guidance and ask specific questions about their competitive position. This allows us to garner more information on competitors, suppliers and customers, some of which might be publicly traded and also of interest to us. Lastly, you have the chance to develop a qualitative "gut check" as to the caliber of the people that you are entrusting capital to (or considering for an investment). After enough of these meetings, your instincts can become remarkably sharp.

MOI: How do you protect your portfolio from permanent loss of capital, and what is your take on holding cash?

Getsos: For our fully discretionary portfolios, we are able to hold cash and will allow it to become up to 25% of an account. However, cash is not specifically used for defensive purposes, it is more a residual from trimming and/or eliminating positions that have reached our price targets or have become too large of a weighting relative to the other holdings in our portfolios (greater than 6% triggers a reduction). Cash is redeployed as we find attractively priced investment opportunities. Sometimes they present themselves during a market sell-off, therefore, a corollary to our deep value strategy is the likelihood that cash positions will grow as the portfolio appreciates in value and be reduced during market sell-offs. In addition to the self correcting use of cash, we do our utmost to insure a sense of balance within our portfolios. For our Global Value Strategy, we typically maintain a 50/50 split between domestic and international positions, individual sectors will not represent over 40% of an account, industry positions are maxed-out at 30% and individual holdings can be no more than 8%. Last and most important, conducting a thorough review of the company prior to purchase and throughout our involvement with the business is the single factor which truly helps shield the portfolio from a permanent loss of capital.

MOI: Can you recommend one or two books on investing?

Getsos: My favorite investing book, which I require all of my interns to read before coming to work with us is, *The Little Book of Value Investing* by Christopher H. Browne of Tweedy, Browne Company LLC.

MOI: Jerry, thank you very much for sharing your insights.