February 28, 2006

Value Investor INSIGHT

The Leading Authority on Value Investing

Hating to Lose

To successfully buck the consensus you first have to fully understand what the consensus is. That's how Jon Jacobson and Highfields Capital excel.

After a successful run trading options on Wall Street, Jon Jacobson got his first portfolio to manage at Harvard University's investment company in 1990. "Back then you couldn't raise money without a track record," he says. "But they were willing to give me $100 million to manage the day I walked in the door."

An excellent decision. When he left Harvard in 1998 to start Highfields Capital, Jacobson had turned that initial stake and an added $200 million into $1.6 billion. Since starting Highfields, which now manages $8 billion, he and partner Richard Grubman have earned a compounded 15.4% annually, vs. 4.4% for the S&P 500.

Valuation "dislocations" remain plentiful, says Jacobson, who's finding opportunity in Europe, energy and media. See page 2

INVESTOR INSIGHT

Jon Jacobson
Highfields Capital Management

Investment Focus: Seeks companies trading at very low historical or competitive valuations – for reasons that are both fully understood and changeable.

Surgical Precision

Making smart subjective judgments first requires objective analysis of the information at hand – a particular strength of Spencer Capital's Ken Shubin Stein.

INVESTOR INSIGHT

Ken Shubin Stein
Spencer Capital Management

Investment Focus: Seeks companies for which temporary events obscure near-term prospects but do not materially affect long-term earnings power.

After several years pursuing in parallel his dual interests of medicine and investing, Ken Shubin Stein hung up his stethoscope for good in 2000 to manage money full-time. "I enjoyed medicine very much," he says. "But I just enjoyed investing too much not to make a career out of it."

Investors in Shubin Stein's Spencer Capital Management have reaped the rewards of that career decision. Since November 2000, they've earned a net 24.1% compounded annually, vs. an annual 2.1% loss for the S&P 500.

Shubin Stein's rigorous research process is unearthing many opportunities today, including those in big-name corporate underachievers as well as in companies he sees as potential hidden gems. See page 10

Inside this Issue

FEATURES

Investor Insight: Jon Jacobson

Jon Jacobson of Boston's Highfields Capital explains why he thinks energy stocks today are like those of homebuilders five years ago, why outsized private-equity-firm returns gall him, how hating to lose differs from loving to win and why he sees mispriced value in Penn West Energy, Saks Inc., Vinci and Lagardere.

Having started out as an options trader, describe how your value-investing style has evolved?

Jon Jacobson: I recognized that the markets were divided between those doing fundamental analysis and applying it only to buying stocks, and "quants" looking at mathematical relationships across different securities with no sense of fundamentals. It seemed to me there was an opportunity to combine the two to create investments that had asymmetric risk-reward characteristics and probability distributions with positive expected values.

We don't have any discernible edge determining whether IBM's earnings are going to beat the Street by a nickel, or whether the multiple should be 16, 18 or 20. We don't know where the price of oil is going or whether small-cap stocks are going to outperform large caps. These things are really unknowable and unpredictable. But there are a wide variety of situations in which there are dislocations – like mergers, spinoffs, short-term bad news, legal issues – where we think we understand why there might be a huge disconnect between supply and demand for a given security. Then if we can analyze what the true value of the business is and look across all the different securities on a company's balance sheet, we may be able to find something that's mispriced.

It's analogous to going to Las Vegas on Super Bowl weekend and betting on the game. By definition, the line on the Super Bowl is the most efficient on the board. Every piece of information is completely disseminated and the line is set by all the buyers and sellers coming together, of which there are thousands. The best bet on the board in Las Vegas is much more likely to be on a game between two college teams for which most people couldn't name the coach, any of the players, or even the team nicknames. But if you know one of the best players on a team is hurt, or that one team got in at 4 o'clock in the morning because there was a snowstorm – and the rest of the market doesn't know that – you have an edge making that bet.

What other sources of pricing dislocation do you tend to see?

JJ: We often see it in holding companies, where there are several disparate businesses and a single earnings multiple doesn't capture the true value. Or in companies that own a significant asset that may not currently be earning anything but is quite valuable.

Another is in companies – or even industries – that can trade at big discounts to their inherent growth rates because of the perception that the earnings are highly cyclical.

A perfect example of that is the homebuilding stocks over the past five or six years. They've always traded at 8x earnings because the market views the business as highly cyclical. But homebuilders have been growing earnings at 25% per year for as long as I can remember. At the slightest sign of softness, investors have declared the cycle to be over. At some point they will be right, but the reality is that they're running the businesses differently and it's more of a disciplined manufacturing business than it was historically.

Another good example is gaming. For quite a long time, the market valued gaming companies at 5-6x EBITDA, while hotel companies traded at double that. That didn't make sense. Gaming is a better business – you have profitable destination hotels with lots of services combined with a casino, where the margins are better than almost any business you can think of other than money management. This fundamental disconnect has

Jon Jacobson

Aligning Interests

You couldn't ask for a better referral than Jon Jacobson received from Harvard Management Co. upon leaving the firm in 1998. Among the $1.5 billion he initially raised for Highfields Capital, $500 million came from Harvard. "Jack Meyer's style is that if he trusts you, there's no further question," says Jacobson of Harvard Management's long-time CEO, who himself left last year to start his own private investment firm.

"Hooked" by Wall Street's lure while working at Philadelphia's Options Exchange during his senior year at the Univeristy of Pennsylvania, Jacobson worked at Merrill Lynch and Lehman Brothers before and after earning a Harvard M.B.A. He joined Harvard Management in 1990, attracted by its "cutting-edge" use of derivatives and its willingness to let him manage his own portfolio.

"In Jack Meyer's system, the interests of the organization and the people in it were perfectly aligned," says Jacobson. "That's been a huge influence on me. It works in asset management, in parenting, in running companies. Whenever we identify a management problem, almost 100% of time it's because management interests are not aligned with the interests of shareholders."

dissipated as both private and public market valuations for gaming assets have increased dramatically.

Are there any sectors currently exhibiting these kinds of disconnects?

JJ: Near the end of 2004 we started seeing a huge disconnect between the forward prices in oil and gas futures markets and how the oil and gas company equities were being priced. Given that, we came up with a methodology to value the companies, which basically consisted of comparing where they were trading relative to the net asset value you'd get if you assumed you put the whole company in run-off and liquidated their proven reserves, hedging everything forward, and then assumed some terminal value six or seven years out. It was harder, but we also tried to figure out how those valuations compared to what they'd been historically.

What we found was that, as a sector, the exploration and production companies in particular where trading at the highest discounts to net asset value since Boone Pickens made a run at Gulf Oil in the early 1980s. Given the lack of exploration success most of the major oil companies have had, we were convinced that the magnitude of these discounts couldn't persist. Either the market would recognize it, or M&A activity would rectify it as companies saw it made more sense to buy oil reserves on the floor of the NYSE than drill for it. We've actually had a combination of both those things start to happen.

How have you picked the specific companies to bet on?

JJ: We started by visiting most of the companies to develop a clear point of view on how good their assets are, what kind of operators they are and, very importantly, how they think about capital. For example, we'd ask management where they thought prices were going and they'd say, "Lower." So then we'd ask why they weren't hedging forward all their production given the high prices they could get at the back end of the forward market. Then they'd say, "Well, we could be wrong. We're risk averse." So we'd say, "If you're risk averse, you should be hedging." It made no sense.

Through all that we developed a point of view in terms of the quality of the assets and management teams. We developed the capability to track in real time how each company is valued both in an absolute sense and relative to each other. Over time, the ones we've owned have shifted as valuation gaps have closed and others relatively have opened.

ON CONSENSUS OPINION:

You cannot have an opinion on an investment unless you understand the consensus and can articulate why it's wrong.

Where do you see the opportunity now in energy?

JJ: It's shifted somewhat. The companies we originally bought were the big exploration and production companies like Kerr-McGee, Pioneer Natural Resources, Devon Energy and Burlington Resources, which have all moved to much higher percentages of their net asset values or been acquired.

Now we see more opportunity in the big integrateds, which have both resources and refining businesses. We invested in ConocoPhillips [COP] in the fourth quarter of last year, taking advantage of the fact that the market hated its agreement to buy Burlington Resources. One can argue whether the acquisition is the best use of capital, but from a strategic perspective, Burlington gives Conoco a significant presence in U.S. onshore natural gas and the combined company is exceptionally cheap – our model has it at 67% of NAV and only 6x next year's earnings – particularly given the quality of the assets. That's a huge margin of safety. These companies have historically traded near the market multiple – I'm not saying they should trade at that right now, but there's a lot of room between 6x and 19x. I see this as analogous to buying Toll Brothers, the homebuilder, five years ago.

What about the downside if oil prices plunge?

JJ: We're not making any bet on the price of oil. If we had a legitimate view on that, we should just trade the commodity and not complicate it by investing in stocks. There are deep, liquid energy futures markets going out five or six years with prices set by all the players in the market. Our view about energy prices is not going to be better than that. There is some art to how we do it, but we hedge against prices plunging by shorting the commodity. Our bet is that the inherent disconnect between the price of the stocks and the price of oil will close, not that prices will go up or down.

What does it take to be good at identifying dislocations between price and value?

JJ: One of the biggest things we struggle with in training people is driving home the fact that you cannot have an opinion about an investment unless you really understand what the consensus is and are then able to articulate why the consensus is wrong. If you think what everybody else thinks, it's already priced in. Back to betting on the Super Bowl, why is Pittsburgh being a 4-point favorite the wrong line if you want to bet on Seattle? You may not have to know if you're betting for fun on Sunday, but you sure better know if you're making decisions with $8 billion of your clients' money.

Warren Buffett has made the point many times that being contrarian really isn't the full answer – it's having conviction in your own opinion and filtering out the noise. If the market happens to be right, being a contrarian for the sake of being a contrarian isn't a very good strategy. You have to have the discipline to stick to the situations where you have an edge and sit out the rest of them.

You also have to be able to swing the bat when the pitches are fat. We're not as concentrated as some of the investors for whom I have the most respect, like Seth Klarman at Baupost or Glenn Greenberg at Chieftain, but we generally only own 40 to 50 positions at a time. Our top ideas have to be better places for us to put an incremental dollar than our 51st-best idea. That mutual fund managers run portfolios with 300-500 stocks just makes no sense to me.

Where do you find good ideas?

JJ: Absolutely everywhere. We look at all the usual valuation screens to identify stocks that are cheap relative to book value, earnings and cash flow. We look at the new-lows list for long ideas and the new-highs list for short ideas. I'm interested in companies whose margins are significantly higher or lower than they've been historically. I look at the 13F filings of 20-25 other investors I respect to see what they're buying and selling. Also, Bloomberg on a monthly basis has the highest-ranked and lowest-ranked stocks by sell-side analysts. I look at the lowest-ranked for buying opportunities and the highest-ranked for selling opportunities.

Those are the types of places I look for ideas, but everybody here has their own sources and we have a meeting everyday to discuss them. In general, we're looking for volatility – volatility creates ideas.

Once a potential idea has been identified, where do you focus your research?

JJ: Every industry has different relevant metrics we look at, but at the end of the day we're focused on a company's ability to generate cash flow and reinvest it. Every investor wants to find well-managed companies, with defendable market positions, that generate a lot of free cash flow that is reinvested intelligently. The problem is, those companies typically don't have valuations we can accept as value investors.

So we look for businesses that qualify on a few of the ideal characteristics and that we think can improve on the others. In most cases either the management is lousy or the company has had a very bad record in terms of capital allocation. To us, those are the easiest things to fix.

Our goal is to generate 15-20% annual gross returns with bond-like volatility, which we believe is achievable over time given our appetite for risk. We don't invest in things that could be a coin flip between doubling or going to zero. We want the downside of every holding to be no more than 10-15% and the upside to be at least 50%. The key for us is to not be wrong about the downside.

ON SHORTING:

It's been a challenge lately, but without being short we just couldn't sleep at night having the market exposure we do.

Where does the margin of safety tend to come from?

JJ: As many places as possible but primarily from the strength and sustainability of the business model, low valuations relative to book value or cash-flow multiples and undervalued hard assets or other assets on the balance sheet.

You mentioned running a concentrated portfolio, describe the current breakdown.

JJ: Our top 10 positions today make up 45% of our capital, all of which I'd characterize as the type of "strategic-block" investments Jeff Ubben described in your last issue [*VII*, January 31, 2006]. We have large positions and are working closely with the companies to realize value.

We're 125% gross long and 80% gross short. We have in the past held as much as 40% cash, but our long exposure is over 100% because we've found a lot of opportunities. Shorting has been a bit of challenge lately, so the logical question to ask is whether, if we're going to be 45% net long, why we don't just hold 55% cash.

Why don't you?

JJ: I still believe we should be able to make money at shorting. At the same time, without being short, we just couldn't sleep at night having the market exposure we have in owning the stocks we want to own.

Our short experience has been somewhat tainted by Enron. We nailed Enron and made more money shorting it than we'd made on any single investment, long or short, in a long time. We were short for about a year and a half before they finally went bust and endured a 50% rise in the stock from where we first started shorting before it started to unravel. There's something hugely emotionally gratifying to be right on something like that.

You recently described corporate activism as a "structurally undervalued area of the capital markets." Explain that.

JJ: Most shareholders of undermanaged or poorly managed companies vote with their feet rather than push for changes in management, board composition or strategy. So, poor management persists because shareholders aren't willing to do anything about it, which we think is an abdication of responsible ownership and fiduciary duty. But even if big shareholders have a willingness to take on a public company, most firms don't have the experience, resources or skill set to do so. We think the fact that we have that ability when others don't is a big opportunity.

The private-equity business is built around taking over companies and doing what shareholders should have gotten done, while they keep most of the money for themselves. Most private-equity firms do not possess secret sauce in terms of management expertise – they're financial engineers. The amazing thing is that the same shareholders who do nothing to effect change at a poorly managed company before a private-equity firm comes in to take over line up to pay a stupid multiple for the company when it comes public again.

You went so far as to make an offer to buy Circuit City [CC]. How did that position evolve?

JJ: We invested in it originally because we thought it was cheap, that the industry was in the early innings of a major upgrade cycle in TVs that will benefit them, and because there was a lot of optionality from correcting several years of bad management execution. We started buying around $9, when they had $6 per share in credit-card receivables and net cash on the balance sheet. That $3 net price was less than 10% of sales.

We filed a 13D because we wanted to upgrade the existing management, which we thought was badly misallocating capital. It also became apparent that the fairly dramatic operational and financial steps they needed to take could be easier to accomplish without the scrutiny that comes with being a public company. Finally, the market was persistently undervaluing the company's future prospects, in light of its past performance.

We got them to change the CEO, which was the most important thing. Our offer to buy the company [at $17 per share] was conditioned on the participation of the CFO and the incoming CEO. At the end of the day, they chickened out.

We would have loved to have bought it, but they've been doing the right things. Sales are better. They have been buying back shares. They've closed a fair amount of underperforming stores. I think we played a huge role in the stock going from $9 when we started buying to around $24 today.

Do you still see upside?

JJ: It's a completely different investment today. One Wall Street analyst upgraded it to a "buy" earlier this month, saying the company is in the first stages of a turnaround – which tells you something about Wall Street research. We often sell way too early, so he may very well be right on the stock at today's price, but that's not the type of investing we do. We sold a lot of our stake as the shares got into the $20s.

Tell us about Penn West Energy Trust [Toronto: PWT.UN], one of your largest energy holdings.

JJ: Penn West is the largest conventional oil and natural gas trust in Canada. It converted to a Canadian unit trust structure last May, which basically means earnings are untaxed at the corporate level and have to be paid out. They pay a monthly distribution that works out to about 10% annually.

The company produces 95,000 barrel-equivalents of oil per day and on a proven and probable basis has 370 million barrel-equivalents in reserves, two-thirds of which is oil and the rest natural gas. The founding shareholder is an excellent entrepreneur and investor named Murray Edwards, who we met with roughly a year ago when the stock was ridiculously cheap, around C$23.

With the stock now around C$39, the market appears to have caught on.

JJ: Unlike ConocoPhillips, which I mentioned earlier, Penn West trades fairly close on a proven-reserve basis to our estimate of net asset value. But in this case we're still attracted by the high quality of the company's assets, by the margin of safety in the 10% cash yield and by what we believe is huge optionality on the upside.

The primary option on the upside comes from Penn West's 40% ownership

INVESTMENT SNAPSHOT

Penn West Energy Trust
(Toronto: PWT.UN)

Business: Largest conventional oil and natural gas income trust company in North America, with production operations in five core areas throughout Western Canada.

Share Information
(@2/27/06, Exchange Rate: $1 = C$1.1404):

Price	**C$39.36 ($44.89)**
52-Week Range	C$25.43 – C$44.69
Dividend Yield	10.4%
Market Cap	C$6.5 billion ($7.4 billion)

Financials (TTM):

Revenue	C$1.9 billion ($2.2 billion)
Operating Profit Margin	35.2%
Net Profit Margin	30.1%

Valuation Metrics
(Current Price vs. TTM):

	PWT.UN	S&P/TSX
P/E	11.3	20.4

PWT.UN PRICE HISTORY

THE BOTTOM LINE

Jon Jacobson sees "optionality on the upside" from incremental oil recovery from the company's giant, 40%-owned Pembina oil field and the development of other undeveloped acreage. With a margin of safety from a current dividend yield above 10%, he believes the shares are worth C$60, 50% above today's price.

Sources: Company reports, other publicly available information

of the Pembina oil field in Alberta, which is the largest conventional old field in Canada, with nearly 8 billion barrels of light oil in place. They've initiated a pilot project in Pembina to increase the amount of oil recovery they can get from the field by using new CO2 technology they've successfully used elsewhere. If the technology works, and we believe it will, they can increase their asset base by up to 40%. If we use conservative operating-cost and capital assumptions, we think Penn West's interest in this field can be worth C$2.5 billion, which is C$15 per share on top of the current price of C$39.

They also have a significant amount of undeveloped acreage – three million acres of which they don't need to maintain production. They could joint venture with others to develop that three million acres, not tying up a lot of capital, which we estimate would be worth another C$3-5 per share.

So, overall, we see Penn West being worth as much as C$60 per share. If oil prices go up or down, that's obviously a moving target, but as I said, that's not something we take a view on. To the extent we can, we've hedged the commodity exposure.

We haven't spoken yet about retailers. What interests you about Saks Inc. [SKS]?

JJ: Saks is a restructuring story. The history is that Proffitt's, a mid-scale department store chain based in Tennessee, used its wildly-inflated shares in the late 1990s to buy the parent of Saks Fifth Avenue. It hasn't worked out well and they're now in the process of splitting themselves up. When they're done, they'll end up with what was the old Saks Fifth Avenue business alone, which has been a huge underperformer.

In 1997, Saks Fifth Avenue had $2.1 billion in sales, gross profit of $650 million and earnings before interest and taxes of $153 million. In 2005, it's estimated to have had $2.7 billion in sales, gross profit of $825 million and EBIT of only $100 million. So EBIT margins have gone from over 7% to about half that.

We see no reason why Saks, given its brand and locations, can't earn operating margins comparable to the 7-11% that competitors like Nordstrom and Neiman Marcus earn. Their gross margins are weak and their selling, general and administrative costs are way high relative to others. The key here is going to be blocking and tackling.

Do you have to believe the right people are in place to do the blocking and tackling?

JJ: Not at this price. They recently elevated the COO to CEO, but the jury's still out on whether he's a good operator. They do have a new CFO who came from AutoZone, where the stock rose five-fold during his time there, who is excellent. The stock now is just so cheap that you can afford to wait until they get it right.

With the stock trading at $19, how are you thinking about valuation?

JJ: The company today has a total enterprise value of $3.3 billion, which is an equity market value of $2.6 billion plus net debt of $700 million. We believe they'll get a total of $1.6 billion from selling their northern department stores to Bon-Ton – a deal that has already been

INVESTMENT SNAPSHOT

Saks Inc.
(NYSE: SKS)

Business: National department store retailer in the process of shedding diverse operations to focus on its core Saks Fifth Avenue luxury brand.

Share Information
(@2/27/06)

Price	**19.00**
52-Week Range	14.45 – 24.64
Dividend Yield	0.0%
Market Cap	$2.64 billion

Financials (TTM):

Revenue	$6.25 billion
Operating Profit Margin	2.6%
Net Profit Margin	1.9%

Valuation Metrics
(Current Price vs. TTM):

	SKS	S&P 500
P/E	22.6	22.2
P/CF	11.1	14.9

Largest Institutional Owners
(@12/31/05):

Company	% Owned
Southeastern Asset Mgmt	10.8%
Deutsche Bank	5.3%
Goldman Sachs	4.7%
Barclays Bank	2.8%
Oppenheimer Funds	2.6%

Short Interest (As of 2/8/06):

Shares Short/Float	3.9%

SKS PRICE HISTORY

THE BOTTOM LINE

A return of operating margins to even the low range of what competitors earn would result in significant upside for the company's shares, says Jon Jacobson, from both higher earnings and an increased multiple on those earnings. As a turnaround starts to take hold, he believes the shares could at least double.

Sources: Company reports, other publicly available information

announced – and from the sale of the Parisian specialty chain.

With that $1.6 billion from the sales of the businesses, you'll have $900 million of net cash, which gives you, at today's market price, an enterprise value of $1.7 billion. On that basis, the company is trading at only 7x EBITDA, at a time when margins are as little as one-third what other big-box retailers earn.

Where do you see the margin of safety?

JJ: Primarily from the stock trading at a depressed multiple based on depressed earnings. If they get their margins anywhere close to where the competitors are, the upside is very good because you'll also probably get a higher multiple.

The other margin of safety is that they own four million square feet of retail space, a quarter of which is in their three flagship stores in New York, Chicago and Beverly Hills. The midpoint of the sell-side consensus on what the real estate is worth is $850 million – that's a huge cushion relative to a $1.7 billion enterprise value.

If they can turn things around, we think the stock can pretty quickly at least double from where it is today. The numbers are going to be a mess this year and next year, as they sell off businesses and reorganize. I see this as being like Circuit City two years ago – now's the time to buy, when you've got a margin of safety. A year from now when the stock's over $30 and the Wall Street analyst writes the report that the turnaround has started, it won't be the same investment.

You've owned France's Vinci [Paris: DG] for five years and have made a lot of money on it. Why is it still interesting?

JJ: The short answer is because the earnings and cash flow have grown faster than the stock price. This is the best European management team we've ever met, in terms of thinking about returns on capital and how to reinvest in the business. They're very disciplined.

Vinci is the largest construction and concession company in the world, with €21 billion in sales. They take on huge construction projects and also run toll roads and parking lots – it's a pretty straightforward business.

So what's the market missing?

JJ: We think a few things. The company just agreed to acquire ASF, which is the major toll-road concession business in France, for €9.2 billion. With this acquisition, two-thirds of Vinci's revenue will be recurring, concession income, which fundamentally changes the profile of the company and, we think, the multiple it deserves.

The market also seems concerned about whether the construction backlog Vinci has is going to hold up. But our work tells us that not only are the levels of backlog real, but that the growth in construction spending is shifting to non-residential and public works – which is where Vinci is strong – and that there will be a lot more put out to bid on such projects in the next 18 months.

The company operates mostly in Europe, split roughly 50/50 between France and Western and Central Europe. Longer term, while we haven't factored this into our estimates, we think there's a huge opportunity for them as Eastern European countries are accepted into the European Union.

At around €78 per share, what do you see as the upside?

JJ: With synergies from the merger and other operating upside, we think they'll

INVESTMENT SNAPSHOT

Vinci SA
(Paris: DG)

Business: Design, engineering, construction and ongoing management of large-scale infrastructure projects and facilities.

Share Information
(@2/27/06, Exchange Rate: $1 = €0.8440):

Price	**€78.50 ($93.01)**
52-Week Range	€54.40 – €78.60
Dividend Yield	2.4%
Market Cap	€15.6 billion ($18.5 billion)

Financials (thru 6/30/05):

Revenue	€20.5 billion ($24.3 billion)
Operating Profit Margin	6.4%
Net Profit Margin	3.9%

Valuation Metrics
(Current Price vs. TTM):

	DG	CAC
P/E	16.2	16.0

DG PRICE HISTORY

THE BOTTOM LINE

The market underestimates Vinci's earnings potential from merger synergies and a growing project backlog, says Jon Jacobson. The P/E of 13x this year's earnings, he says, also doesn't appropriately reflect the recurring nature of two-thirds of total sales. With little downside, he believes the shares are worth at least €100.

Sources: Company reports, other publicly available information

earn more than the market is expecting, or about €6.00 next year. So for only 13x earnings – significantly less than multiples of competitors like Abertis and Ferrovial of Spain – we're buying an excellent business with a management team that we trust implicitly to do the right thing. We think the shares are worth at least €100, which is putting a 10x multiple on their €2.00 per share in construction earnings and a 20x multiple on their €4.00 earnings in concessions.

This is an inherently different type of idea than Saks. This will be a GDP grower in terms of revenue, but should grow earnings at 10-12% per year consistently with very stable cash flows. At 13x earnings, while the upside may not be as high, there's very little downside.

Describe the opportunity in another French company, Lagardere [Paris: MMB].

JJ: This is a classic family-controlled holding company where there's a perception that the family is not that shareholder friendly. So there's a discount for that on top of a holding-company discount. Discounts in such companies tend to persist, but one advantage to being a long-term investor is the ability to hold while the companies are changing.

Lagardere is basically a media company that also owns 15% of EADS, the publicly traded Airbus commercial and defense aerospace business. For every share of Lagardere, you get €29 of EADS, which is slightly less than half the current stock price.

They've owned this stake forever, but they're able to dispose of it next year at 0% capital gains tax. We've always thought that when it isn't onerous to do so, they would sell the EADS stake, which we expect to happen before the end of next year and possibly a lot sooner.

With the stock currently around €65, that leaves the rest of Lagardere trading at €36 per share. How do you value that?

JJ: Their media business has operating earnings of roughly €500 million, which consists of €215 million from book publishing, €140 million from magazines, €80 in distribution and retail, €50 million from broadcasting and €13 million from regional newspapers.

If we do a sum-of-the-parts valuation, using relevant comps in each of those businesses, we get to around €58 per share. Essentially, all the media assets are valued at way below market multiples, even though they have very high-quality assets. After buying Time Warner Books, they will be the #3 book publisher in the world. If their recently announced deal with Canal Plus goes through, they'll own 20% of the second-largest pay-television group in Europe. The have great global magazine brands like *Elle* and *Car and Driver*.

We also think the company is under-leveraged to the tune of about €3 billion. Over time, we expect them to put the right amount of leverage on the company, which will result in an additional kicker to the share price.

Do you have to believe the cloud hanging over media stocks will lift for Lagardere shares to prosper?

JJ: I don't think so. Our valuation is based on looking at the comps – what the market is valuing these businesses at now. To the extent multiples start to expand again, that would clearly help us, and vice versa. The operating results of the Lagardere media businesses have actually been pretty good, beating expectations.

The risk versus the reward here is just very low. There's a huge margin of safety in buying these type of brands at less than 7x EBITDA.

INVESTMENT SNAPSHOT

Lagardere
(Paris: MMB)

Business: Global media company with primary operations in book publishing, magazine publishing and pay television. Also owns 15% of aerospace company EADS.

Share Information
(@2/27/06, Exchange Rate: $1 = €0.8440):

Price	**€65.50 ($77.61)**
52-Week Range	€55.30 – €68.90
Dividend Yield	2.1%
Market Cap	€9.3 billion ($11.0 billion)

Financials (Latest Available):

Revenue	€13.0 billion ($15.4 billion)
Operating Profit Margin	6.7%
Net Profit Margin	4.3%

Valuation Metrics
(Current Price vs. Latest Available):

	MMB	CAC
P/E	14.4	16.0

MMB PRICE HISTORY

THE BOTTOM LINE

The company's successful media businesses are trading at discounts even to already depressed multiples of comparable companies, says Jon Jacobson. His sum-of-the-parts analysis shows the shares to be worth at least €87, including €29 for a 15% stake in aerospace company EADS that he expects soon to be sold or spun off.

Sources: Company reports, other publicly available information

You have several other media-related holdings that have been less than robust. Are you still optimistic?

JJ: Our media, cable and satellite holdings are completely out of favor, but we're still confident they'll pay off. What's frustrating is that the operating results have actually been quite good. We think the competitive threat posed by the phone companies, Google, Yahoo and Apple – to name today's favorites – is way overblown.

We bought a stake in Knight-Ridder [KRI] when the company agreed to explore strategic alternatives under pressure from large shareholders. This is an example of a company that probably shouldn't be public – the market's convinced newspapers are lousy investments, but cash flow is plentiful, operating margins are usually in excess of 20% and there are limited reinvestment needs.

You've said private-equity firms will make a fortune in the newspaper business over the next 10 years. Why?

JJ: My point is that public investors are worn out by owning companies that are perceived to be going the way of the dodo bird because of technological innovation. When that happens, there's an opportunity for the companies to be restructured and the likely way that will happen is for private-equity guys to come in, cut costs and shrink the companies to make them look like they can have growth going forward. Then they'll repackage them and take them public again at a higher multiple.

This process is not going to be easy. In a lot of the companies in which we agitate for change, the rank-and-file is rooting us on because they know the business is mismanaged. But in newspapers, the rank-and-file are often in it for altruistic reasons. This probably won't be a fight we'll lead, but you can expect it to be fought.

Why aren't you overly concerned by the competitive landscape for cable and satellite-TV companies?

JJ: We own Comcast, DirecTV and Time Warner. The perception is that an arms race with the phone companies to deliver multiple services will put pressure on price and that everybody's going to lose. That may be the case, but I think you're being more than paid to take that risk at today's valuations. Also, from an operating standpoint, I'd bet on the quality of the managements of the cable and satellite-TV companies over the RBOCs.

You were involved in the changes at Morgan Stanley [MS] – what originally interested you?

JJ: We looked at the company 12-18 months ago and saw the stock trading at 10x or 11x earnings. They were dramatically underperforming their peers in key businesses. People were quitting in droves and there was no succession plan. The fact that Phil Purcell had been the CEO for eight years and that most of the viable successors had left was an embarrassment. It was incredible that in this day and age you could have a *Fortune* 500 company with a board that was this insulated from what was really going on at the company.

Notwithstanding all the problems they had, many of their businesses were still earning 20% ROEs and most of the ones that weren't should have been.

ON MORGAN STANLEY:

It's a case that reminds me of one of my favorite Warren Buffett sayings: you don't get paid extra for degree of difficulty.

Are you happy with how things are working out?

JJ: It's been okay, but it's one of those cases that reminds me of one of my favorite Warren Buffett sayings: you don't get paid extra for degree of difficulty. The reality is that if we'd bought Goldman Sachs at the same time we bought Morgan Stanley, we would have made twice as much money. It's been the same thing with our holding in Janus. Janus has worked out all right over a long period of time, but had we bought Legg Mason or BlackRock or T. Rowe Price at the same time, we would have made two to three times as much.

But those types of investments – excellent companies doing relatively well – don't fit your M.O.

JJ: You're right. We generally can't see the margin of safety in those types of things.

We have a column this issue (*see page 22*) that describes an obsession with "the game" as a driving force for excellent investors. Is that important to you?

JJ: The competition aspect is very important to me. If you look at anybody who's been doing this for a long time, there's got to be something to it other than money, because there are a lot of ancillary negatives as well. The biggest negative for me is that it's very stressful to feel responsible for other people's money. This is a business where at the end of the day you know how you did – you have to like keeping score and wanting to come out on top.

I have no desire to stop doing this, but I have no desire to be mediocre either. If we went through some extended period where I was convinced we no longer had a competitive edge as a firm, I'd give the money back. I care about our long-term record and having Highfields Capital be mentioned with all the great firms out there.

So fear of failure is a big motivator?

JJ: More than anything else. There's a big difference between loving to win and hating to lose, which has a lot to do with one's approach to risk. Someone who loves to win is willing to take a lot of risks because the euphoria of winning outweighs the bad outcomes. If you hate to lose, though, any bad outcome is not acceptable. To be a great investor, I think you really have to hate to lose. VII

Investor Insight: Ken Shubin Stein

Ken Shubin Stein of Spencer Capital Management describes what he's learned from "autopsies" of his mistakes, how he's prepared for inevitable market dislocations, why apparel companies and retailers are often mispriced and what he thinks the market is missing in Foot Locker, Tyco, Resource America and Newkirk Realty Trust.

Your medical training put a lot emphasis on research and data analysis. How has that informed your investing style?

Ken Shubin Stein: Given all the cognitive biases that can affect investors, we think it's very important to follow a well-defined research process. It has to be flexible enough to handle different types of investment ideas, but it also has to be explicit and reproducible so we can constantly try to improve it.

We use detailed checklists during data analysis, make a systematic effort to seek out data contrary to our beliefs and do full "autopsies" of our mistakes. We try to avoid broad-stroke generalizations or even using inflammatory words. The more we can focus on data-driven decisions, the less prone we'll be to potential biases and careless errors.

This is particularly important with the types of stocks we tend to buy. When a stock has disappointed a great number of people, it tends to get a very negative bias, which then builds momentum. We try to be explicit about specifically what the problems are and to focus on collecting data that helps us analyze whether the problem is temporary or permanent.

What types of things are at the top of your checklists?

KSS: One of the first things we do is a credit analysis. Often what drives our investment decision is the credit quality relative to the sustainability of competitive advantage, stability of margins and need for capital. Looking at the amount of debt – whether it's fixed, long-term and with few covenants or variable, short-term and with many covenants – is essential to determining if the company has the wherewithal to fix its problems in the time period you expect.

We also focus a great deal on understanding the quality of management, which is best done by looking at their prior actions. Have they made rational capital allocation decisions? We look at share-repurchase decisions over time – are they just buying back stock to offset dilution from option grants or are they strategically buying back stock when it's cheap and buying none when it's not cheap?

The data you use will differ by industry. For example, with a property/casualty insurance company everything you see on the balance sheet is largely fictional because the liabilities are based on guesswork about the loss-development probabilities. But a concrete way to tell if management has been writing profitable policies that have been reserved correctly is to look over time at the growth in tangible book value per share. That will give you a very good sense of the quality of management.

We look at the shareholder base to understand the type of investors that currently own the company. We also seek out contrary data from people who are bearish on our idea and try to understand why. Sometimes we'll assign the task to one of our analysts of looking only at the negatives of an idea and nothing else – something we also do periodically for companies already in the portfolio.

Describe the typical opportunity you'll look into.

KSS: Generally we see opportunity where several events obscure a company's 12-month earning power but don't affect the company's long-term economics.

For many companies we invest in, you could bring the best investment minds together and get general agreement on what the problems are. There would be less consensus on whether the problems are permanent or temporary, and even less

Ken Shubin Stein

Scientific Method

Ken Shubin Stein's interest in medicine was certainly no accident. His father is an academic cardiologist, his mother an infertility specialist and his twin sister an orthopedic surgeon. His medical program at Albert Einstein College of Medicine took five years, to allow for extensive clinical and basic science research work – primarily in orthopedic medicine – on top of the regular medical school curriculum.

Wasted training for an investor? Not at all, he says: "How you go about the process of defining a working thesis, defining a strategy to collect data, collecting the data, analyzing and testing the thesis and then iterating is not materially different between doing basic science research and security analysis."

Shubin Stein maintains a keen interest in healthcare, both as an investor and a citizen. "Every year medical technology advances and we're better able to treat various illnesses and diseases, which obviously has enormous implications," he says. "I'd argue that how we as a country address providing healthcare to our population is the number one domestic issue in our lifetime."

agreement on the timing of the temporary problems being fixed. Lack of visibility on timing is one of the best things you can have as an investor with a long time horizon. We love situations where it's very difficult to model this year's earnings.

Our investment ideas are generally one of two types. The first are those with characteristics for which the high-case outcome would result in the shares doubling or tripling over three years, but if things go poorly we'll still get our money back over the same period. The second are quicker hits, ideas where we also expect to get our money back, but that might go up 50% in the next 12 months.

We take a probabilistic approach, looking at the value of an opportunity as the present value of future weighted probable outcomes. We define high-case, low-case and middle-case outcomes for every investment we look at. In particular, we want to make sure we always look at the reasonable worst-case things that can happen.

How do you generate ideas?

KSS: We have four lists we use to generate and track ideas. This helps us organize our time, because I think time management is one of the most important things to get right in our business.

The top list consists of ideas we currently own, for which we track closely all news on the company or industry. List two is very short, consisting of the two or three ideas we're actively moving through our research process. List number three is a long list of ideas that are interesting, but that we don't know a lot about. We pull ideas off this list when we have some research capacity. Our last list is our watch list, usually with things we've looked into but are waiting to revisit until some event happens or some price is hit.

How do ideas get on the lists?

KSS: We use qualitative and quantitative screens. The qualitative screens consist of doing word searches across news and SEC databases. The words might be someone's name, say a famous investor, to see in what context his name comes up. We also do searches on pairs of words or phrases, like "accounting scandal," "plan of reorganization rejected," "spinoff," "bankruptcy," or "recapitalization."

On the quantitative side, we're looking for companies that appear not to be doing well relative to how they've done in the past. For example, if you look for companies that have a high enterprise value to EBITDA for the last 12 months, but a low enterprise value to the EBITDA average of the past five years, you'd come up with a list of companies – good, bad or indifferent – that were making a lot more money in the past than they are now. We don't yet know why, but that's what further research is for. These types of searches can be an early guide to what the future earning power might become.

ON HISTORY:

Without a sense of historical context, it's very hard to think about probabilities of particular outcomes in the future.

This type of screen can be useful in sectors with short-term-oriented investor bases. For example, I look for retail and apparel companies that appear to be undervalued relative to historic levels. For someone with a longer time horizon, you can find excellent turnaround opportunities in this area because so many people care about short-term data points like monthly same-store sales or what's going to happen the next season. Beyond that, I look for companies with overcapitalized balance sheets – you don't want levered apparel companies or retailers – and those with management that really understands the volatile nature of the underlying business.

Are other screens bearing fruit today?

KSS: We're looking a lot for overcapitalized balance sheets or where earnings are being produced by a small amount of the balance-sheet capital. These are candidates for restructuring which can involve returning capital to shareholders and increasing returns on invested capital.

That's certainly relevant in today's activist environment.

KSS: It's important to think about how you'd capitalize a company if you could do it from scratch. You may not be able to do anything about it, but it's likely someone else who can is doing the same type of research. McDonald's is a great example of that. Bill Ackman [of Pershing Square Capital] pushed forward the conversation on "should they own restaurants or sell them off," which has been an important contribution to the discussion about McDonald's balance sheet and business.

You've said that understanding history is important to investing success. Why?

KSS: I think it's tremendously important to understand the history of a company and its industry. We regularly read biographies and autobiographies about pioneers in the industries we're investing in. Without a sense of historical context, it's very hard to think about probabilities of particular outcomes in the future.

Going back to McDonald's, a few years ago it was one of our biggest positions. We started buying around $15, buying all the way down to $12.75. I read everything I could on the company and on the restaurant and franchising businesses in the U.S. and how they developed in post-World War II America.

I learned that the problems McDonald's had in 2002, such as kitchen process problems and out-of-favor menu items, were in the normal course of business for quick-service restaurants over decades – and were all fixable. McDonald's clearly wasn't getting things right the first time, but these were all problems they could experiment with, change and improve.

The stock's over $35, so they seem to have fixed at least some of the problems. Why were they slow to get things right?

KSS: Tremendous inertia can set in at various points for companies and even industries, because there are many stakeholders who defend the old processes. But most of these things are measurable and a dispassionate, rational observer can look at the data and come to the right solution. Entrenched stakeholders are an addressable problem. That can take time, especially when you have several problems to address at the same time, as McDonald's did.

You described earlier your affinity for retailers. Tell us about Foot Locker [FL].

KSS: By a large margin, Foot Locker is the largest seller of athletic sneakers in the world. Two-thirds of their revenue is domestic, 26% international and 7% direct-to-customer.

This is a case where there's a structural expense built into the company that's decreasing slowly over time. In the late 1990's, they had pursued a strategy to increase their store sizes, opening superstores that turned out to be way too big. Sales per square foot plummeted. The problem with something like this is that once you've built out a new footprint, it's hard to reverse. You have to close stores, negotiate out of leases or wait until leases roll off. That takes years and affects operating margins all the way through.

This is a structural problem with clear and achievable solutions, but with a time frame necessary for it to work out that is longer than most people on Wall Street are willing to wait.

Are they having execution problems?

KSS: In fact, they're executing quite well. Through renovating, relocating and resizing underperforming stores, they've increased sales per square foot to $355, up from $316 in 2002. Trailing twelve-month EBITDA was more than $570 million, versus $425 million in 2002. They've paid down debt and now have net cash on the balance sheet.

Is anything else weighing on the shares?

KSS: Profit margins in Europe are under pressure, as the market has become acutely promotional in the past year. We're always asking if problems like this are temporary or permanent, and we believe this is temporary. Foot Locker has a real advantage in being the market leader with a much better balance sheet. As competitors capitulate because they can't afford the excessive promotion, Foot Locker can either grab market share or just benefit from a return to normal pricing.

People are also worried about the competitive threat of the Internet. If you think about the shoe-buying process – especially for kids, but for adults as well – there's good reason to expect that the human behavior of wanting to try shoes on first is not going to change quickly.

With the stock currently at $23.50, what upside do you see?

KSS: Over the next three years, we're assuming 1-2% annual expansion in retail square footage and 1-2% year-over-year growth in same-store sales and direct-to-consumer revenue. As the store-renovation process winds down, we expect operating margins to increase from around 7.5% now to 10% in three years. If that happens, they'll be earning $2.40 in annual free cash flow in three years and will have produced over $900 million in additional free cash from today.

If you assume they just hold the free

INVESTMENT SNAPSHOT

Foot Locker
(NYSE: FL)

Business: Largest global retailer of athletic footwear and apparel, operating approximately 3,900 stores in 17 countries in North America, Europe and Australia.

Share Information
(@ 2/27/06):

Price	**23.52**
52-Week Range	18.74 – 29.95
Dividend Yield	1.6%
Market Cap	$3.67 billion

Financials (TTM):

Revenue	$5.62 billion
Operating Profit Margin	6.9%
Net Profit Margin	4.6%

Valuation Metrics
(Current Price vs. TTM):

	FL	S&P 500
P/E	14.4	22.2
P/CF	10.3	14.9

Largest Institutional Owners
(@12/31/05):

Company	% Owned
Lord, Abbett & Co	9.4%
Sasco Capital	3.7%
First Pacific Adv	3.6%
Barclays Bank	3.3%
Hotchkis & Wiley	3.2%

Short Interest (@ 2/8/06):

Shares Short/Float	1.6%

FL PRICE HISTORY

THE BOTTOM LINE

An extensive and costly restructuring of Foot Locker's U.S. retail footprint is on track, but with a time frame longer than Wall Street is generally comfortable with, says Ken Shubin Stein. If operating margins return to normal levels and the company steps up share repurchases, he expects the stock to be worth up to $48 per share.

Sources: Company reports, other publicly available information

cash and put a 15x enterprise value to free cash flow multiple on the shares, you get a share value of $43. If they did the $500 million share repurchase we think they should, the shares would be worth $48.

We see this as both safe and cheap. The free cash flow yield is over 8% and growing, for a dominant specialty retailer with a strong balance sheet and shareholder-friendly management. They're highly likely to improve operating margins over the next three years and, while we don't build this in, they have tremendous growth opportunities in Europe and, especially, Asia, where their footprint is small.

Your next idea, Tyco [TYC], has behaved like a bit of a value trap in the past year.

KSS: It's clearly out of favor and the stock's been a disaster recently, but I see it as both an operational and balance sheet opportunity.

Tyco is a holding company with four divisions: fire/security, electronics, healthcare and engineered products and services. It's the result of a rollup by a crook, who, to his credit, was good at identifying excellent businesses. The normalized return on capital for the overall company is over 20%. They are the dominant worldwide leader in every division. One reason I have a preference for large distribution channels that are experiencing problems is because of the real long-term sustainability such businesses have.

The fire and security business is showing great momentum and has great growth potential. Just thinking about where the world is and the services they provide, it's clear they have real opportunity.

Overall, the company has invested a great deal in research and development in recent years, which we expect to start paying off in terms of new products and revenue growth. They've also hired a lot of salespeople, which you can safely assume will result in incremental sales.

Aren't the divisions other than fire and security having operational problems?

KSS: Yes. These have tended to be manufacturing and sales issues, which we view as completely addressable. We believe they have capable management to address the big issues, but in companies like this with many problems, you just need a few to be fixed for it to be a good investment.

What's the "balance sheet opportunity"?

KSS: The company is dramatically underleveraged. In two years, with the free cash flow they're generating, they'll have no net debt. We think they should take advantage of the great credit environment and the fact that they'd get very favorable debt terms and buy back $25 billion in stock, which is half the current market cap.

I think the reason they haven't done much on that front is because management, which has done a great job on corporate governance and generally in righting operations, was brought in during a scandal and is still in that mode. They need to think about the business as it stands today, not where they were coming from three or four years ago.

How does the breakup plan Tyco is contemplating affect your thesis?

KSS: They haven't given much detail, other than to say they plan to split into three parts, all with scale and worldwide leader-

INVESTMENT SNAPSHOT

Tyco International
(NYSE: TYC)

Business: Diversified manufacturing and services company with primary operations in electronics, fire and security, healthcare and engineered products.

Share Information
(@ 2/27/06):

Price	**26.16**
52-Week Range	24.65 – 36.11
Dividend Yield	1.6%
Market Cap	$52.72 billion

Financials (TTM):

Revenue	$39.83 billion
Operating Profit Margin	13.5%
Net Profit Margin	7.2%

Valuation Metrics
(Current Price vs. TTM):

	TYC	S&P 500
P/E	16.9	22.2
P/CF	8.9	14.9

Largest Institutional Owners
(@12/31/05):

Company	% Owned
Capital Res & Mgmt	9.4%
Davis Selected Advisers	5.1%
Fidelity Mgmt & Res	2.5%
State Street Corp	2.5%
Barclays Bank	2.4%

Short Interest (@ 2/8/06):

Shares Short/Float	1.4%

TYC PRICE HISTORY

THE BOTTOM LINE

Operational problems are pinching margins but are "completely addressable," says Ken Shubin Stein, who also expects new profit growth from investments made across many business lines under new CEO Ed Breen. Coupling operating gains with massive – and doable – share buybacks would make this "easily a $50-60 stock," he says.

Sources: Company reports, other publicly available information

ship positions. I agree this would create shareholder value and think it would only highlight how underleveraged they are.

With the stock just above $26 per share, how are you thinking about valuation?

KSS: The stock is trading for only 12x this year's free cash flow of more than $4 billion. With margin improvement from fixing some of their operational problems and incremental growth from the investments they've made, we think the shares are worth at least $40. If they also levered the balance sheet and bought back more stock, this could easily be a $50-60 stock.

Management is moving in the right direction, but there's a clear financial restructuring that should occur here and I think you'll see some of the big value-oriented shareholders like Bill Miller and Carl Icahn start agitating for change.

Tell us about one of your much lower-profile ideas, Resource America [REXI].

KSS: This company that has been run for many years by the Cohen family, first Ed and now his son Jonathan. They start businesses, grow them and sell them – and have proven that creating shareholder value is embedded in their DNA.

The last five public entities the Cohens have spun off or IPO'd have annualized returns of 26%, 29%, 22%, 25% and 129% since going solo. They usually retain interests in these companies to the ongoing benefit of Resource America, while they build new businesses within it.

The investment thesis here is straightforward. The market cap is $300 million. There are $150 million in excess assets on the balance sheet – not needed to support the business – in the form of cash, investments and income-producing real estate.

They also own a small-equipment leasing company, which will do over $500 million in loan originations by the end of this year. They lease things like telephone systems and high-end copiers for small businesses. In an interesting twist, Resource America built and sold the same type of business with the exact same management team in the 1990s. It was eventually owned by Citigroup, which released the management from their non-competes and they went back to REXI and started the same business all over again.

The leasing company alone is worth $200-250 million if they sold it, which they could do easily. They've already had people approach them to buy it.

So you're already seeing asset value above the current market price.

KSS: And that doesn't include their asset-management business, which I estimate is worth another $300 million. The company manages over $8 billion in a host of different types of funds – in things like private equity, real estate and collateralized debt obligations – that are sold through several channels, including independent financial planners and brokers. The business is growing nicely and should reach $10 billion in assets within two years.

The stock trades at $16.50 and you estimate the assets at more than twice that. Why the disconnect?

KSS: I think there are a few things. First, the businesses are a bit complicated. Some of the funds invest in pretty unusual stuff. One makes leveraged investments

INVESTMENT SNAPSHOT

Resource America
(Nasdaq: REXI)

Business: Specialized investment holding company with primary operations in U.S. money management, real estate and small-equipment leasing.

Share Information
(@ 2/27/06):

Price	**16.51**
52-Week Range	13.36 – 19.75
Dividend Yield	1.4%
Market Cap	$291.70 million

Financials (TTM):

Revenue	$62.96 million
Operating Profit Margin	27.8%
Net Profit Margin	22.6%

Valuation Metrics
(Current Price vs. TTM):

	REXI	S&P 500
P/E	31.8	22.2
P/Book	1.5	4.1

Largest Institutional Owners
(@12/31/05):

Company	% Owned
Cobalt Capital Mgmt	8.9%
Fidelity Mgmt & Res	7.0%
Omega Advisors	6.3%
Dimensional Fund Advisors	5.5%
Rockbay Capital	3.1%

Short Interest (@ 1/9/06):

Shares Short/Float	2.8%

REXI PRICE HISTORY

THE BOTTOM LINE

Ken Shubin Stein believes the market is dramatically mispricing Resource America's current assets as well as the wealth-generation track record of the founding company management. He estimates the company's assets today are worth as much $700 million, a 140% premium to its current market value of less $300 million.

Sources: Company reports, other publicly available information

in savings and loans through securities called trust preferreds. To value those, you have to understand some arcane aspects of S&L regulation and also understand what trust preferreds are.

In addition, the company is obscure and nobody follows it. On the last earnings call there were two people, Leon Cooperman [of Omega Advisors] and me.

There are also related-party transactions with the Cohens that make some people uncomfortable. We've put hundreds of hours into analyzing the data and we see nothing but a long and distinguished history of shareholder focus and value creation on their part.

This is just tremendously undervalued. It's an asset play you could break up and sell for a lot more than the market value. You also have great management, which provides call options on their continuing ability to create value and start new businesses we don't even know about yet.

Another rather obscure pick is Newkirk Realty Trust [NKT], where management's record is also a central part of the thesis.

KSS: Newkirk is a net-lease real estate investment trust run by Michael Ashner. He's an extremely smart and successful real estate investor with a fantastic long-term record of creating shareholder value. He started out doing private real-estate deals, buying distressed assets and operating them very well. He then started investing through a public vehicle, now called Winthrop Realty Trust [FUR], which he also runs and which owns nearly 7% of Newkirk.

What's Newkirk's strategy?

KSS: The historic portfolio of Newkirk is mostly plain-vanilla triple net leases, with over 80% investment-grade tenants. Triple-net-lease contracts are for tenants like Barnes & Noble, who don't want to subject their customer shopping experience to the speed or quality with which their landlord fixes problems that come up. Tenants have almost all the responsibility for the property – for taxes, maintenance, upgrades. For the property owner, it's like having a bond with the tenant's credit quality – all you do is collect the rent.

What they're going to do going forward are more special-situation triple-nets that are unusual, complicated or hairy, say, in leases where it's harder to get comfortable with the tenant's credit or the property needs redevelopment work. Michael Ashner is a proven expert at sourcing and structuring these types of deals.

So is it just another bet on management?

KSS: It's more than that. We believe the Newkirk portfolio has a liquidation value of around $20 per share. With the shares currently trading below at $17.50, you already have a margin of safety on an asset basis.

The other people involved are the cream of the crop when it comes to real estate. The two largest shareholders are Apollo Real Estate Advisors, which owns around 36%, and Vornado Realty Trust, which owns 16%.

So I see this as having very little downside, with a free call option on Michael Ashner creating value – and he has a multi-decade history of creating tremendous value in real estate. You can buy him at a discount to liquidation value. He's highly incentivized to make the

INVESTMENT SNAPSHOT

Newkirk Realty Trust
(NYSE: NKT)

Business: Real estate investment trust investing in traditional and special-situation triple net leases. Run by well-known real estate investor Michael Ashner.

Share Information
(@ 2/27/06):

Price	**17.45**
52-Week Range	15.00 – 17.61
Dividend Yield	9.2%
Market Cap	$338.09 million

Financials (TTM):

Revenue	$249.62 million
Operating Profit Margin	76.9%
Net Profit Margin	9.2%

Valuation Metrics
(Current Price vs. TTM):

	NKT	S&P 500
P/E	n/a	22.2
P/Book	1.3	4.1

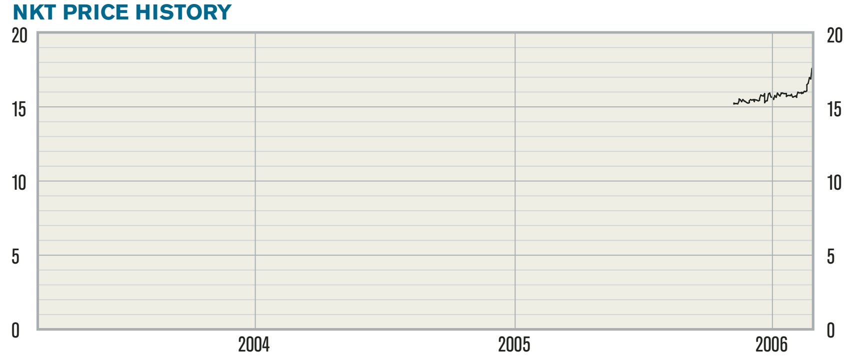
Largest Institutional Owners
(@12/31/05):

Company	% Owned
Apollo Real Estate Inv Fund III	36.3%
Vornado Realty Trust (and affiliates)	15.8%
Limited Partners of Newkirk MLP	14.7%
Winthrop Realty Trust	6.8%
Security Capital Mgmt Group	5.9%

Short Interest (@ 1/10/06):

Shares Short/Float	1.9%

NKT PRICE HISTORY



THE BOTTOM LINE

Newkirk shares currently trade at a 13% discount to Ken Shubin Stein's estimate of its portfolio liquidation value. That and a dividend yield of more than 9% provides a significant margin of safety, he says, and a "free call option" on the talents of accomplished real estate investor and Newkirk CEO Michael Ashner.

Sources: Company reports, Spencer Capital Management, other publicly available information company grow, because he gets a very high promote on profits above a certain level. It has to do very well for him to get paid, but if it does very well, he gets paid a fortune.

We also like that Ashner has been in the public markets recently buying a lot of stock around today's prices.

What are you seeing that the market isn't?

KSS: The main reason the stock trades at a discount is the concern that the dividend will decline over the next several years. To sustain the current $1.60 per share annual dividend – equal to a more than 9% yield at today's stock price – we estimate they need to do $1.2 billion in triple-net-lease deals over the next five years. Figuring that out involves estimating not only the amount of deals they do, but also what spread they earn – the cost of capital vs. the cap rate [the ratio of yearly net income to the property value] – on doing them.

The market is essentially waiting for them to do some deals. Once they do and people get more confident that the dividend will be supported by the new deals, the stock will go up. The company is going to do deals opportunistically, which is what you want from management – to only do deals when there are great values.

Risks?

KSS: The biggest risk would probably be if interest rates rose sharply, which would make the current yield less attractive.

We're comfortable they can sustain the current $1.60 per share dividend and that it will even grow. So at today's price, you're collecting a better than 9% yield for something trading at 13% below liquidation value. If the stock just gets to liquidation value, you have a greater than 20% return in one year.

Given your background, are you looking for opportunities in healthcare?

KSS: Given ongoing advances in medical technology and demographics, the percentage of the population over the age of 60 is going to increase significantly. Healthcare services, technology and drugs are obviously going to be in high demand and very expensive.

The drug companies today are everyone's favorite villain. But beyond public-health initiatives like the provision of potable water, I'd argue nothing has done more in the history of humanity to improve our overall condition than the development of pharmaceutical companies. It takes $500 million to $1 billion – and 10 to 15 years – to discover, develop and distribute an important drug. The capital employed in that endeavor deserves a high return.

ON DRUG COMPANIES:

They are so important to global healthcare that I think they'll still have to be paid well to take the development risks they do.

That said, the drug companies went too far in taking advantage of their privileged position, so you'll continue to see margin pressure on them. But I do believe they're in a unique position. In my lifetime we're not going to see many more global pharmaceutical companies – scale in doing what they do is very important. And what they do is so fundamentally important to global healthcare that I think they'll have to continue to be paid well to take the risks of drug development.

We pay particular attention in looking at healthcare companies to the profit margins for their products or services, who's paying for them and whether, over time, the benefits justify the costs. We also think the "processors" of healthcare, which includes insurance companies, are likely to do very well.

Biotech?

KSS: The biotech industry was basically a way to take basic research off the balance sheets of global pharmaceutical companies and have public shareholders underwrite the research. That's often benefited the big pharmaceutical companies, who end up doing joint-venture development and marketing deals on the drugs that show the most promise.

You've spoken of the importance of preparing for inevitable market dislocations. How do you do so?

KSS: Every couple of years there's a crisis, in one industry or across markets. When those happen, a lot of cognitive biases come into play – as markets fall, there's social proof that something is wrong, people overweight near-term data and, in general, fall victim to uncertainty and doubt.

We think it's very important to have buying power going into something like that, which we always have either through holding cash or having significant borrowing power. Without the ability to buy in the middle of a crisis, you'll suffer the volatility of it but won't be able to buy the cheap assets that result from it.

It's also important in a crisis to have a library of ideas on which you've already done careful asset-valuation work that you can quickly update. It's very difficult to do *de novo* research in a crisis.

The toughest part is having the emotional constitution to buy during a crisis. Even if you have the emotional wherewithal, you might have career risk from your boss or clients thinking you're crazy. This is when it's very important to stay focused on the expected values of what you believe something is worth, regardless of what's just happened to the stock price.

You mentioned earlier the "autopsies" you do on mistakes. Describe the process and what you've learned from them.

KSS: People naturally try to discount their mistakes and forget about them as soon as possible. I actually modeled this process on the morbidity and mortality reviews that hospitals do after serious, unexpected adverse events occur. We formally analyze the mistake, including the research and theses that led to the investment, what occurred to reveal the mistake, how we dealt with the problem and what lessons can be learned.

One reason why examining credit is at the top of our research checklist is the lesson I learned from investing a couple years ago in Adelphia, after the scandal came out.

I had analyzed the known asset and liability values and concluded the company was undervalued, even with the scandal overhang. What I didn't account for adequately was both the size and makeup of the debt the company had, which was a particular problem as the very creative types of fraud they committed were further exposed. It gave me a healthier appreciation for the margin of safety required when you're looking at any highly-leveraged situation.

We've also looked carefully at why we so often sell investments too early. People tend to give you a pass on that, saying you invested in the safest part of the profit cycle. But I have to say, people have made a lot of money buying stocks from me. Over an investment career, that's not a good thing.

ON SELLING TOO SOON:

Investments that do better than expected after I've sold are consistently in superior businesses or with superior managements.

What I discovered is that the investments that have done much better than I expected – after I sold – are consistently those in superior businesses or with superior managements. That's why we now spend so much time analyzing management's prior actions and their results in creating shareholder value. If you're a long-term investor, how well retained earnings are managed and existing capital deployed mean everything to what your eventual return is going to be.

Investing provides plenty of mistakes from which to learn – if you pay attention.

KSS: The nice thing about security analysis – and medical research, for that matter – is that there's an accretive nature to the effort. As you learn, you start to ask better questions and develop faster and better insights about risks and opportunities in the future.

I once read a quote saying how portfolio managers make every mistake possible in their first five years and then spend the rest of their careers trying to avoid making the same mistakes. There's a lot of truth to that.

Funds managed by Co-Editor Whitney Tilson own Foot Locker, Tyco, Resource America and Winthrop Realty, which owns a stake in Newkirk Realty Trust. A partner in Tilson's money-management business is an investor with Spencer Capital.

Brand-Name Preference

Based on last quarter's trades by superstar investors, big appears to be better for finding today's compelling market opportunities.

Co-Editor Whitney Tilson and partner Glenn Tongue last summer made the investment case for Microsoft, noting that "in today's shockingly complacent market, our favorite investments continue to be mega-cap, blue-chip stocks" – which, according to a study by GMO, were then trading at their lowest relative valuations ever (*VII*, July 29, 2005).

This quarter's ***VII SuperInvestor Report***, in which we analyze the portfolios of more than 25 of the most successful value-oriented hedge-fund managers we know of (plus Berkshire Hathaway), shows that finding value in brand-name stocks is clearly catching on. As shown in the table below, at least three superinvestors made significant new bets – defined as establishing a new position or adding more than 20% to existing share positions

ABOUT

VII SuperInvestor Report

Institutional money managers with discretion over $100 million or more must file a Form 13F with the SEC listing all publicly-traded U.S. equities held – including the number of shares owned and the fair market value – no later than 45 days after the end of each calendar quarter. From these filings, we track and seek insight from the holdings of an elite cadre of hedge-fund managers (plus Berkshire Hathaway), ranging from better-known investors such as Omega Advisors' Leon Cooperman and Baupost Group's Seth Klarman to those less well-known like Stephen Mandel of Lone Pine Capital. The list of investors tracked evolves as we add names of those we believe bear watching. This quarter, new superstars added include past *VII* interviewees Larry Robbins of Glenview Capital, Jeffrey Ubben of ValueAct Capital and Lisa Rapuano and Jeff Berg of Matador Capital.

VII SuperInvestor Report: "Big" Appetite

VII SuperInvestor Report tracks the portfolios of many of the best money managers in the business. Below are stocks in which at least three superinvestors established new positions or increased existing share positions by more than 20% during 2005's fourth quarter. Unlike in previous quarters, big-cap stocks rule.

Company	Ticker	Industry	Price@ 2/27/06	Q4 2005		% Change In Total Shares Held
				Low	High	
Advanced Medical Optics	EYE	Medical Devices and Products	44.41	32.04	44.00	36.60%
Altria Group	MO	Tobacco and Consumer Products	72.72	68.60	75.20	123.74%
CKE Restaurants	CKR	Fast-Food Restaurants	17.18	11.57	14.13	204.88%
Corning	GLW	Diversified Technology	24.91	16.61	21.62	78.41%
Covanta Holding	CVA	Waste and Energy Services/Insurance	17.98	10.41	15.06	1,200.18%
DaVita	DVA	Dialysis Services	59.07	45.87	53.90	68.41%
General Electric	GE	Diversified Industry	33.32	32.67	36.34	44.04%
International Coal	ICO	Coal	8.84	9.16	13.10	All new positions
McDonald's	MCD	Fast-Food Restaurants	35.25	31.48	35.69	169.86%
Microsoft	MSFT	Computer Software/Services	27.05	24.25	27.73	52.78%
Pfizer	PFE	Pharmaceuticals	26.60	20.27	25.18	72.90%
Reliant Energy	RRI	Wholesale Energy	10.19	8.65	15.65	47.07%
Wal-Mart	WMT	Retail	45.76	43.30	50.87	38,098.28%

Sources: Forms 13F filed with the Securities and Exchange Commission for holdings as of December 31, 2005.

– in each of 13 stocks in last year's final quarter. In a departure from previous quarters, more than half the list consists of "mega-cap, blue-chip" stocks: Altria, Corning, General Electric, McDonald's, Microsoft, Pfizer and Wal-Mart.

As is often the case, adversity appears to have also attracted superstar investors, in particular to two flagging energy stocks, International Coal and wholesale energy provider Reliant Energy.

International Coal is the latest roll-up vehicle of savvy investor Wilbur Ross, who has made similar successful forays in both the textile and steel industries. Company shares retreated steadily after a large $11-per-share secondary offering and their listing on the New York Stock Exchange in November. (Shares were hit further in January after a fatal accident at the company's Sago Mine in West Virginia.) Reliant Energy shares performed even more poorly in the fourth quarter, falling 34% as the company struggled with high debt, regulatory sanctions and heavy operating losses.

Healthcare has also attracted quite a bit of smart-money investment – in Pfizer, dialysis-services company DaVita and eye-care-product company Advanced Medical Optics. DaVita shares are up five-fold in the past five years, driven by average annual growth in revenue and net income of 15% and 65%, respectively. Valued for the company's strong position in the burgeoning market for renal care, DaVita shares continue to rise sharply, up 17% so far in 2006.

TYPICAL ATTRACTION:

As is often the case, adversity appears to have attracted superstar investors, in particular to two flagging energy stocks.

The story is less rosy for Advanced Medical Optics, which announced an extensive reorganization and repositioning plan in last year's fourth quarter at the same time net profit fell 77% year-over-year. At a recent $44.41, the shares have barely budged over the past 18 months.

Wal-Mart's appeal to superstar investors should come as no surprise to *Value Investor Insight* readers. Last year Whitney Tilson and Glenn Tongue argued that the giant retailer's growth potential and operating leverage were not being appropriately valued by the market (*VII*, April 27, 2005). In addition, they explained why they believed Warren Buffett's Berkshire Hathaway was likely to be a big buyer of Wal-Mart shares, citing Buffett's admiration for the company and Wal-Mart's fitting of Buffett's definition of an "inevitable" that could be expected to dominate its field for an investment lifetime.

Wal-Mart shares remain depressed, which perhaps explains increased investment from three of our superinvestors last quarter. The 38,000% increase in shares held was skewed by one giant new investment of nearly 20 million shares. The buyer? None other than Berkshire Hathaway. VII

Funds managed by Co-Editor Whitney Tilson own Berkshire Hathaway, CKE Restaurants, International Coal Group, McDonald's, Microsoft and Wal-Mart.

Coming Up Short

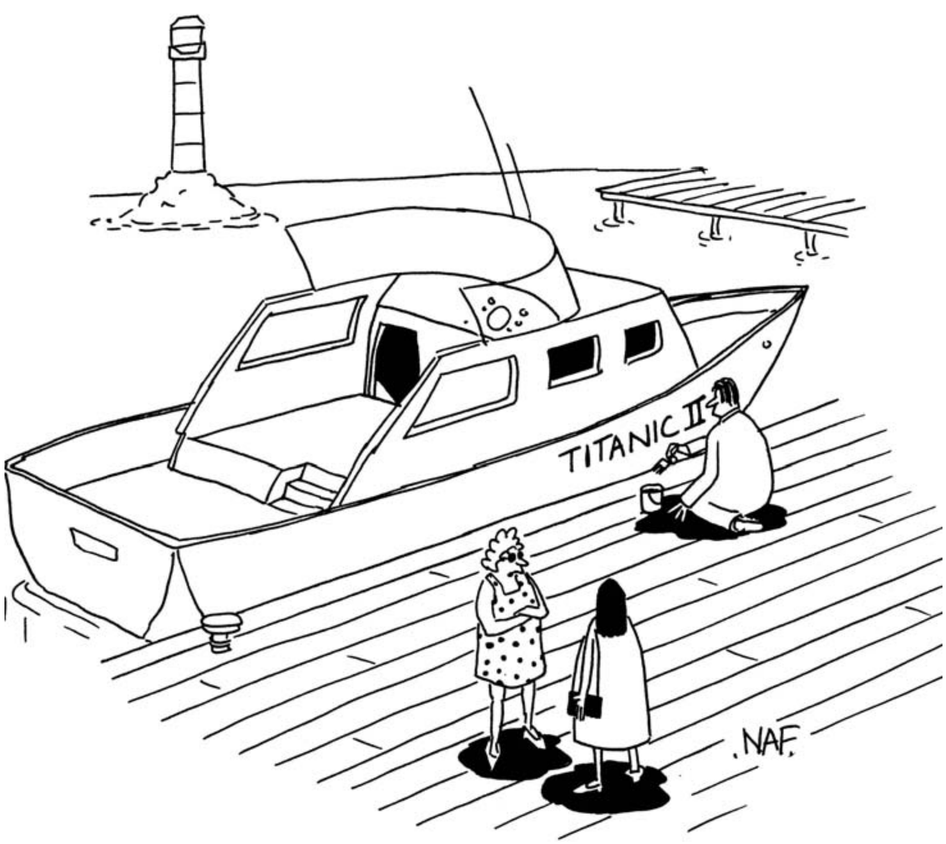
Short selling shares two key traits with the airline industry: New players keep coming into the business … and net industry profits over time are below zero. ***By Joseph Feshbach***

Editors' Note: *In our last issue (VII, January 31, 2006), Whitney Tilson and Glenn Tongue argued that bearish bets through short sales and put options are potentially viable money makers and a sound way to hedge risk. This prompted a response from Joseph Feshbach, who sees short-selling as a loser's game. Given that Joe, along with brothers Kurt and Matt, ran the largest short-only investment fund in the 1980s, we were eager to hear this counter argument.*

"Investing is most intelligent when it is most businesslike," wrote Benjamin Graham, a sentiment that Warren Buffett has described as containing among the nine most important words ever uttered about investing. Given that, how would you judge an investing strategy with the following fundamental economic characteristics:

1) Limited potential returns, but unlimited potential losses
2) Skyrocketing competition
3) Tax inefficiency
4) Aggregate net losses over its history
5) The elimination of a significant source of income in recent years
6) Risk of asset repossession at creditors' whim

Having spent 15 years of my career doing nothing but short selling – with periods of great prosperity and other periods of fast, painful losses – I can argue with some authority that, as an investment strategy, shorting suffers from each of these characteristics of a bad business.



"I thought buying the boat would make him more optimistic about the future but apparently not..."

Nothing in my investing career has been more satisfying than identifying and profiting from the emperor-has-no-clothes opportunities we repeatedly found in the 1980s. But I've come to believe that the game has become so stacked against the short seller that it's just not worth the periodic emotional and monetary high that comes from being right with a bearish bet.

The business of shorting has only gotten tougher since my brothers and I left it in the early 1990s. Rebates on the short credit – a share of the interest earned on the short-sale proceeds – used to be a significant source of income for short sellers, but have all but disappeared due to low interest rates and even "negative rebates" on hard-to-borrow stocks. There are now a few thousand hedge funds looking at the same short opportunities, versus a few dozen 20 years ago. The tax inefficiency is more pronounced than ever: short-sale profits are taxed at a short-term capital-gains rate that is approximately 2.5 times the rate for long-term gains. The landscape is littered with the carcasses of short-only funds that never made money, while long-term winners are about as numerous as those in the airline industry.

Whitney Tilson and Glenn Tongue are in good company with the poor performance of their bearish bets. According to the investor presentation Carl Icahn used in launching his activist hedge fund last year, his returns from a mere 15 long positions from 1996 to 2004 generated $1.5 billion in profits. Conversely, his 24 short positions produced a comparatively small $150 million in profits, 85% of which came from a single position, Conseco (a stock, by the way, that I shorted about ten years too early!). Given that this period included three years of a gut-wrenching bear market, even Icahn himself must be questioning the real benefit of shorting.

Whitney and Glenn offer a key argument for making bearish bets: hedging. Specifically, they see such bets as "insurance" against their portfolio of "80-cent dollars," and take comfort in the analogy that "The fact our home didn't burn down doesn't mean we're upset that we lost 100% of our 'investment' in home insurance."

But any insurance only makes sense at a given cost, which I'd argue is too high when it comes to short-selling. Great short-sellers like Michael Steinhardt and Edward "Rusty" Rose have made significant profits over the course of their careers from shorting, but from my interactions with each, it was always clear that their motives in shorting were not as "insurance," but as a vehicle to create high absolute profits in every single position, in up markets or down.

Are put options a better alternative than shorting for making bearish bets? They do take away the risk of unlimited loss and aren't susceptible to short squeezes, but they suffer from two additional major flaws. First, other than during the Internet bubble, I've found that the most overvalued and hyped stocks are small- or mid-caps, for which puts usually aren't available or are extremely expensive. Second, puts require that you be right not only on the fundamentals, but also on timing. Payday may arrive, but your options may already have expired.

So if making bearish bets is the costly game I think it is, how should value investors address issues of risk management, preservation of capital and periods of underperformance? I like Icahn's description of his risk-management approach as "fundamentally driven by the underlying value of the company rather than prevailing market conditions." In other words, nothing beats getting the value proposition right on a stock-by-stock basis as your best protection from permanent capital loss. I am still looking for and finding 50-cent dollars and would argue that the 80-cent dollar offers both inadequate downside protection as well as insufficient upside potential. I also insist on growth as a key component of the investment thesis – value accreting over time further enhances the risk-reward equation.

Don't worry about short-term swings in performance. Contrary to modern portfolio theory – and as legendary value investors such as Buffett and Joel Greenblatt have well articulated – portfolio volatility and risk are not remotely synonymous. Tweedy, Browne's Chris Browne studied the long-term performance of seven of the greatest value investors in history and found that they under-performed market averages between 28% and 40% of the time – sometimes accompanied by hair-raising asset drawdowns – while still trouncing the averages over long periods. My unsolicited advice: Embrace volatility – you'll make more money in the long run.

There will, of course, be many market swoons to come and short selling may help mitigate losses during the toughest times. But for my and my investors' money, the structural disadvantages of shorting make it too un-businesslike to pursue. VII

Joe Feshbach runs Joe Feshbach Partners, which invests primarily in companies facing some type of crisis – from accounting scandals to government investigations.

Common Traits of Uncommon Investors

Given that investing skill is part nature and part nurture, what is it that truly sets the great investors apart? ***By Mark Sellers***

You wouldn't know it from the breathless mutual-fund advertising selectively touting stellar performance, but the majority of professional investors, over reasonable periods of time, underperform the market. Based on screens I've run recently using Morningstar data, 58% of all large-cap equity mutual funds – excluding sector and other "specialty" funds – underperformed the S&P 500, after expenses, over the past five years. Over ten years, 63% of such funds lagged the market. Among small-cap funds the relative performance is even worse, with 65% below the Russell 2000 index over the past five years.

It's a safe bet that managers of these funds have advanced degrees, above-average IQs, a team of research analysts at their disposal and professional traders to efficiently buy and sell. Yet, in the end, only a minority of them do better than a dart-throwing monkey.

This state of affairs highlights the unique nature of investors who do manage to outperform the markets consistently over long periods of time. As a long-time student of such great investors, allow me to highlight four common traits I believe they share:

Trait #1: The willingness to go against consensus opinion

Social psychologist Solomon Asch performed a series of fascinating experiments in the 1950's to test the effects of social pressure on individual perceptions. Many study participants gave obviously incorrect answers to simple questions only because other members of the groups – who were planted by Asch – first gave the same incorrect answers. Subjects assumed that the consensus answers must be correct and they wanted to "fit in" by going along with the crowd.

Maintaining one's conviction in the face of conventional wisdom isn't easy. Humans are social creatures and are often rewarded socially for going along with others. Money managers face serious negative consequences for going against consensus and being wrong, including investor redemptions and even job loss. As a result, few managers are willing to maintain strong conviction in the face of adverse opinion. Even harder is to stand firm when markets, as they often will, initially go against you.

Yet the ability to maintain conviction in the face of adversity is a clear trait of the Warren Buffetts and Bill Millers of the investing world. A simple test of your own positions can shed insight on your crowd-following propensity: For each of the stocks you own or want to buy, check the consensus analyst opinion. If virtually all analyst ratings are "buy" or "strong buy," you may want to reconsider the position.

Trait #2: An open, skeptical mind

The strong convictions of great investors don't mean they're blindly contrarian. In fact, the best investors constantly keep an open mind and look to separate fact from spin. They're information sponges, but distinguish themselves from the pack by constantly assessing what they read and hear against the facts and their own judgment. They do not ignore new, conflicting information because they want to "believe." If they conclude they're wrong, they correct mistakes and move on.

Dispassionate humility, openness to contrary opinions and the ability to admit a mistake and correct it are remarkably rare traits in investors. I worked as an analyst at Morningstar near the end of the dot-com bubble and was amazed by the number of angry responses – even death threats – that the technology analysts received when they put a sell rating on a stock. While it's easy to dismiss such people as crackpots, I've found that some form of this self-delusion afflicts many investors.

Trait #3: A well-developed sense of when to bet – and when not to

Their ability to learn from investing experience gives outstanding investors a unique ability to recognize patterns. This is critical when information is incomplete – or unknowable – which is always the case in trying to predict future events. But once great investors recognize a pattern, they form opinions about the probabilities of various outcomes and make bets accordingly. For example, many veteran value investors knew how the dot-com bubble would ultimately end – because they had lived through previous manias – even if they didn't know exactly when.

When no pattern is recognized, the great investor declines to make any bet at all. Buffett calls this staying within one's "circle of competence" – a simple concept that can take years for investors to truly internalize, if they ever do.

Trait #4: An obsession with "the game"

In my experience, superior investors view investing first as a high-stakes competition, and only secondarily as a job or career. Even if they made little money doing it, they would play the game because they enjoy the challenge and like to win. It's no coincidence that this type of person is attracted to an endeavor in which you're judged by a "score" that can be measured at the end of each day.

When I was a teenager, I was obsessed with playing video games and even made it to the finals of the North American Video Game Olympics. I ate, drank and slept video games. Investing is now the same way for me. This is one trait I can confidently say I share with great investors – as for the others, I'm still working on them. VII

Mark Sellers is a former equities strategist at Morningstar and now manages Chicago-based hedge fund Sellers Capital, in which Co-Editor Whitney Tilson owns a stake.

Pro-Activism

The subject of shareholder activism is clearly top-of-mind on Wall Street today. Nearly all of the investors we've featured in interviews over the past six months are either increasingly activist themselves in dealing with company management or boards, or are basing many investment decisions on the potential upside from others' activism.

We'd argue that the rise of shareholder activism is a natural – and long overdue – product of the times. Shareholders blissfully slumbered through the boom years of the late 1990s while a not-insignificant number of companies fudged their numbers, leveraged their balance sheets pursuing pie-in-the-sky growth – often via ill-conceived acquisitions – and compensated their top executives to a nauseating degree. When the bubble popped, corporate managements and boards, for the most part responsibly, de-levered their balance sheets and started piling up cash.

The result today is that corporate America, as a whole, is overcapitalized relative to the stable economic conditions of the day. A high-class problem, to be sure, but a vitally important issue nonetheless. How this capital is allocated is understandably front and center in investors' minds and much of today's activism stems from fundamental disagreements between large shareholders and company management over how this abundance of capital should be deployed.

The battle lines over increased shareholder activism are sharply drawn. Highfields Capital's Jonathan Jacobson, whose interview is featured in this issue, states the investor case plainly: "Poor management is able to persist because shareholders aren't willing to do anything about it," he says. "To us, that's an abdication of both responsible ownership and fiduciary duty."

New York law firm Wachtell, Lipton, Rosen & Katz, on the other hand, pulls no punches in stating the anti-activist position: "(Do) not allow the attackers to achieve the moral high ground by wrapping themselves in the cloak of good governance," it wrote in a recent memo to corporate clients. "Expose the attackers for what they are, self-seeking, short-term speculators looking for a quick profit at the expense of the company and its long-term value."

We're not so naive as to believe all shareholder activism will be productive. As ValueAct Capital's Jeffrey Ubben described to us recently (*VII*, January 31, 2006): "Much of what you see today is 'buy shares today and tomorrow throw a hissy fit.' You'll need to be more than a yeller and screamer whose biggest asset is that you don't care what anybody thinks about you." But shareholder activism is not a passing fad. As investors learned in the early years of this decade, the stakes are too high to stand idly by while companies fritter away billions of dollars.

Well-managed companies with independent boards will have nothing to fear from increasingly activist shareholders. In those many cases, however, of poor management and/or passive, entrenched boards, expect to hear a lot more from the owners whose money is at stake. Which, for our money, is exactly as it should be. VII

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Co-Editor-in-Chief

Whitney Tilson
Co-Editor-in-Chief

Value Investor Insight™ is published monthly at www.valueinvestorinsight.com (the "Site"), by Value Investor Media, Inc. Chairman and Co-Editor-in-Chief, Whitney Tilson; President and Co-Editor-in-Chief, John Heins. Annual subscription price: $349.

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