THE MANUAL OF IDEAS ™

Value-oriented Equity Investment Ideas for Sophisticated Investors

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

Investing In The Tradition of Graham, Buffett, Klarman

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

Top Ideas In This Report

Also Inside

About The Manual of Ideas

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

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

UNDERAPPRECIATED BALANCE SHEET VALUES

- ► Screening for companies with strong asset values
- ► 20+ companies profiled by *MOI* research team
- ► Proprietary selection of three candidates for investment
- ► Plus: Superinvestor holdings update
- ► Plus: Exclusive interview with the Chanticleer team
- ► Exclusive interview with Paul Johnson of Nicusa Capital

Balance sheet bargains mentioned in this issue include
Arbor Realty Trust, A.C. Moore Arts & Crafts, AEGON, Alvarion,
Aegean Marine Petroleum, Alliance One, ARC Wireless, Avatar Holdings,
Aircastle, Asia Pacific Wire, Asset Acceptance Capital, Books-A-Million,
BIDZ.com, Bluegreen, Constellation Energy, Chromcraft Revington,
Coast Distribution, CSS Industries, Catalyst Paper, Crimson Exploration,
Crexus Investment, Dover Downs Gaming, Ditech Networks, DryShips,
Deswell Industries, Diana Shipp ... negy,
Exceed Company, Eagle Bulk S ... itime,
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General Maritime, Genco Sh ... e,
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Ingram Micro, Imation, ...
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Inside:

Exclusive Interview with Paul Johnson, Founder and Portfolio Manager of Nicusa Capital

With compliments of The Manual of Ideas

Interview with Paul Johnson

We are pleased to present an exclusive interview with Paul Johnson, portfolio manager of Nicusa Capital and adjunct professor at Columbia Business School.

The Manual of Ideas: Tell us about the background and history of your firm.

Paul Johnson: I launched Nicusa Capital Partners on April 1, 2003. My goal was to combine my experience analyzing companies as a sell-side research analyst with my investment philosophy developed while teaching as an adjunct professor to execute a long-term-oriented investment strategy.

From the beginning, we have tried to buy great businesses cheaply. Finding great businesses with attractive valuations takes time and work. We run a concentrated portfolio because not many companies fit our criteria. Because the fund is relatively small we can invest in small- and micro-cap companies, a segment of the market offering great investment opportunities if one is willing to do the work. Our holding period is long by Wall Street standards, which adds to the importance of buying great businesses.

My experience running the fund has reinforced three lessons: investing in high quality businesses is critical to being able to own them long term, our entry price is the key determinant of our return, and our investment thesis almost always takes longer than hoped to unfold.

MOI: As adjunct professor of finance at Columbia for nearly two decades, you've probably seen some of your students go on to become great investors. Do the latter share any traits that stood out while they were still your students?

Johnson: There will always be a few naturals, but most successful investors are made, not born. For the rest of us, the 10,000-hour rule seems to apply. I believe that investing can be learned, but it takes discipline, focus and a willingness to stick through years of practice.

Interestingly, it is not always the students with the best technical skills in class that ultimately become the best investors. I have found that the students with the greatest desire to acquire all of the necessary skills and to master the discipline seem to become the most successful investors in practice.

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MOI: When it comes to stock selection, what are the key criteria you look for?

Johnson: There are two key criteria to our investment decisions. The first is that we buy businesses with strong underlying fundamentals that we are able to get to know extremely well. To us, a business with strong fundamentals generates lots of free cash, operates with low capital intensity and requires relatively little additional investment to grow cash flow. Quantitatively, we measure these fundamentals through return on invested capital and qualitatively, we look for barriers to entry such as scale and customer captivity. These fundamentals can point to a sustainable competitive advantage and longer cash flow duration. Unless we can research a company deeply enough to understand all aspects of its business, we cannot own its stock for the long term because we could not be confident enough to withstand short-term volatility.

Our second criterion is valuation. We buy cheap stocks because they feature a high cash yield initially and can generate even greater returns if investors reward their strong fundamentals with a higher multiple. Also, a cheap valuation provides a margin of safety in the event some part of our thesis is wrong.

MOI: How do you judge the sustainability of competitive advantage at small companies that often operate in small niche segments of larger industries?

Johnson: We invest in market leaders. Many of these companies are relatively small, but they are much stronger competitors than most appreciate. Although it is tempting to dismiss these industries as market niches vulnerable to entry by larger companies, many are actually distinct markets with high barriers. Larger companies may occupy neighboring markets, but it would be difficult for any of them to successfully enter and steal market share from the industry leaders.

It is critical to find industries with high barriers based on strong economic forces that will keep the barriers in place over time. We have found that the most sustainable barrier is a combination of economies of scale and customer captivity. It is extremely difficult to unseat an incumbent with these advantages no matter how large the challenger may be.

MOI: You have become more active with your portfolio companies, letting managements know what actions they should take to improve value. How receptive have senior executives in general been to your suggestions? Could you discuss the case of **Metropolitan Health Networks** (MDF) in particular?

Johnson: Company leadership is important to our investment process. We rarely invest in a company unless we can develop a strong relationship with management and they share our views on corporate governance.

Many small-cap management teams do not have much experience in capital allocation, corporate communications and compensation. We offer to share our expertise in these areas and have found most managers receptive to our perspective, insights and advice.

Our role as an active shareholder has evolved over time. Although we have always communicated regularly with our companies, we have grown to appreciate the positive impact a more active role can have. We approach them in a friendly manner and have been active in almost all of our investments, albeit usually behind the scenes. We will be more aggressive if necessary to protect our interests, but accept that being an activist carries a responsibility to all shareholders. We view these interventions as an integral part of our process.

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We have owned MDF since June 2004. In December 2009, the Board unexpectedly forced CEO Mike Earley to resign. In January 2010 we wrote the Board requesting that they reinstate Mr. Earley and then step down. We challenged the Board because we believed that Mr. Earley had a better strategic vision for the company. After filing our letter publicly that February, we were approached by several sympathetic large shareholders. Collectively, we owned more than half of the company. In March we nominated six Board candidates and notified the Board of our intention to solicit proxy support. The Board was not receptive but as we, and they, canvassed shareholders, it was clear that our nominees would win the election. On April 23, the sitting Board resigned, and our nominees were installed. The new Board then reappointed Mr. Earley.

The stock had been stuck in a tight trading range for several years prior to 2010. It was cheap, but the old Board had limited management's ability to execute. The stock has doubled since January 2010. In June 2011 MDF announced that it was acquiring **ContinuCare** (CNU), which will make MDF the largest Medicare services provider in Florida and one of the largest in the

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country. The old Board would have never supported this transaction despite the fact that it will create significant value.

MOI: How do you generate investment ideas?

Johnson: We are always on the lookout for new opportunities. We source many of our investments from screens and sometimes we get ideas from the Street. We are also constantly reading the news and investment forums.

We run a low-turnover, concentrated fund with approximately 12 core positions. As such, we only need to find a few great ideas a year. We have a clear sense of our target investment and can filter ideas quickly. Few make it past the initial screening, but those that do get intense scrutiny.

MOI: Tell us about the portfolio-level hedging you implemented in 2010. How do you think about the cost-benefit tradeoffs of such a hedge?

Johnson: 2008 showed us that we need portfolio-level hedging to protect against severe market disruptions. Although not a perfect hedge, we now own a series of out-of-the-money puts. In a bullish market this type of hedge becomes expensive and less effective, but we view it as essential to protect against the type of market we saw in the second half of 2008. It is insurance, pure and simple. You hate to pay for it, but you are happy you did if you ever need it.

MOI: To what extent do you employ short-selling, and how do you manage the exposure risk of short positions that move against you?

Johnson: We want to generate alpha with our shorts and do not view them as a hedge. We are most interested in terminal shorts and our most successful shorts have been companies that ultimately disappeared. Because shorts are inherently riskier, we keep the position sizes small and diversified. Since the financial crisis, shorting has become much more difficult, but it is integral to what we do.

MOI: What is the biggest mistake that keeps investors from their goals?

Johnson: The single biggest mistake is not having the discipline to stick with your investment process, particularly when it is not working in the short term. Change in the corporate world always takes longer than investors believe it will. Corporate time is dictated by people and events, which operate more slowly than investors can trade stocks. All successful investment strategies require patience and none work perfectly well in all environments, but you must have the confidence to be true to your process.

MOI: At the website www.capatcolumbia.com, you recommend books that investors should read to improve their craft. Could you highlight one or two?

Johnson: *The Most Important Thing*, by Howard Marks, is the best recent investment book and will become a classic. Marks brings a wealth of experience and a perspective matched by few. He is also a terrific storyteller. The book provides an excellent overview of the critical skills all investors must master.

Two books, *The War of Art* by Steven Pressfield and *Making Ideas Happen* by Scott Belsky, have changed the way I think about organization and project flow. Although written for creative types, I have found helpful parallels between those professions and mine. Pressfield articulates strategies for staying focused day-to-day, while Belsky outlines how to keep projects moving forward. They have helped me increase my productivity, both personally and professionally.