

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



Edited by the  
**Manual of Ideas  
Research Team**

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

## Top Five Ideas In This Report

|                                              |       |
|----------------------------------------------|-------|
| <b>Gravity Co.</b><br>(Nasdaq: GRVY) .....   | p. 20 |
| <b>I.D. Systems</b><br>(Nasdaq: IDSY) .....  | p. 24 |
| <b>LookSmart</b><br>(Nasdaq: LOOK) .....     | p. 28 |
| <b>Market Leader</b><br>(Nasdaq: LEDR) ..... | p. 32 |
| <b>Maxygen</b><br>(Nasdaq: MAXY) .....       | p. 36 |

## Also Inside

|                                            |        |
|--------------------------------------------|--------|
| <b>Editor's Commentary</b> .....           | p. 4   |
| <b>Superinvestor holdings update</b> ..... | p. 6   |
| <b>Interview with Allan Mecham</b> .....   | p. 8   |
| <b>Interview with Toby Carlisle</b> .....  | p. 14  |
| <b>Ben Graham-style investing</b> .....    | p. 18  |
| <b>98 Deep Value Stocks</b> .....          | p. 100 |

## About Portfolio Manager's Review

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 managing editor John Mihaljevic is a member of Value Investors Club, an exclusive community of money managers, and has won the Club's prize for best investment idea. John is a trained capital allocator, having studied under Yale chief investment officer David Swensen and served as research assistant to Nobel laureate James Tobin. John holds a BA in Economics, *summa cum laude*, from Yale and is a CFA charterholder.

## BEN GRAHAM-STYLE INVESTING: THE DEEP VALUE REPORT

- ▶ Snapshot of 98 deep value investment candidates
  - ▶ 20 companies profiled by MOI research team
- ▶ Proprietary selection of Top 5 candidates for investment
  - ▶ Plus: Exclusive interview with Allan Mecham
  - ▶ Plus: Exclusive interview with Toby Carlisle
  - ▶ Plus: Superinvestor holdings update

*Companies mentioned in this issue include*

A. H. Belo, A.C. Moore Arts, Acorn International, Actions Semiconductor, Adaptec, Agria, Albany Molecular, American Railcar, Ascent Media, Ascent Solar, Audiovox, Avatar Holdings, Axcelis Technologies, Breakwater Resources, BRT Realty Trust, Callaway Golf, Cardero Resources, Cascade Microtech, Century Casinos, China Techfaith, Comverse Technology, CONN'S, Conrad Industries, Creative Technology, Crexus Investment, dELiA\*s, Denison Mines, Deswell Industries, Duckwall-ALCO Stores, EchoStar, ePlus, ExpressJet, Five Star Quality, Flexsteel Industries, Formula Systems, and Express, Gencor Industries, Global Industrial, Global Environmental, Hardinge, Harvest Natural Products, Harsco Corporation, Hurco, I.D. Systems, Ingram Micro, Ingram Micro, Kimball, L.S. Starrett, LookSmart, Luby's, Movado Group, Ninetowns International, PC Connection, Providence Water, Rewards Network, Sycamore Networks, Tecumseh Products, TravelCenters of America, Web.com

*Inside:*

**Exclusive Interview with  
Toby Carlisle,  
Eyquem Global Value**

*With compliments of  
The Manual of Ideas*

(profiled)

## Exclusive Interview with Toby Carlisle

We recently interviewed Toby Carlisle, author of the widely followed *Greenbackd* value investing blog and founder of the newly launched Eyquem Global Value fund. The name Eyquem derives from Michel Eyquem de Montaigne (1533-1592), “one of the most influential writers of the French Renaissance, known for popularizing the essay as a literary genre. He became famous for his effortless ability to merge serious intellectual speculation with casual anecdotes...”<sup>1</sup>



**Toby Carlisle**  
Eyquem Global Value

**The Manual of Ideas:** Tell us a little about your background—what drew you to deep value-style investing?

**Toby Carlisle:** I’m a recovering corporate advisory and securities lawyer. I’ve practiced in Australia and San Francisco, California. I became interested in value investing and the stock market generally at the end of my undergraduate studies when a friend introduced me to Warren Buffett’s Berkshire Hathaway shareholder letters. I read Roger Lowenstein’s book *Buffett: The Making of an American Capitalist*, reverse engineered Buffett’s investment methodology, read the 1951 edition of *Security Analysis* in a desultory fashion and then started investing in a similarly desultory fashion. I had predictably poor results. I say “predictably” because I wasn’t doing nearly enough work, and wasn’t nearly patient enough. Regardless, at the time I figured it was because there was something wrong with my methodology. That dissatisfaction with my results and my methodology meant that I was open to something else.

I started down the deep value road when I began working as a lawyer in 2002. One of my first big matters was a defense against two reasonably well-known greenmailers from the ‘80s. They had acquired a blocking stake in a going-private management buy-out and were trying to squeeze out an extra \$1 from the bidders. Around the same time I noticed a number of investors taking positions in busted dot coms and making money raiding the cash. None of these investments were comprehensible in the context of the investment methodology discernable from Buffett’s letters, where he regularly pooh-poohs these stocks as cigar butts. I revisited *Security Analysis*, this time the 1934 edition, studied it properly, found the chapter on liquidations, and I’ve been doing that ever since.

I started working in a deep value sometimes activist fund manager in 2008. I’ve now launched my own firm, Eyquem Fund Management. I’ve raised some modest seed capital from outside investors for the maiden fund, Eyquem Global Value. The fund’s focus is similar to *Greenbackd*, which is to say deep-value-with-a-catalyst, including sub-liquidation value stocks, and activist and private equity targets. It’s a pretty prosaic strategy. I’m not trying to reinvent the wheel. I’m just looking for overwhelming value and a good chance I’ll get my money back in the foreseeable future.

“I’m not trying to reinvent the wheel. I’m just looking for overwhelming value and a good chance I’ll get my money back in the foreseeable future.”

<sup>1</sup> Source: Wikipedia, [http://en.wikipedia.org/wiki/Michel\\_de\\_Montaigne](http://en.wikipedia.org/wiki/Michel_de_Montaigne)

**MOI:** You have studied extensively the historical performance of Ben Graham's "net net" investment strategy. Tell us what you've found.

**Carlisle:** It's a testament to Ben Graham's genius that his net current asset value strategy should be so robust, by which I mean that it should continue to work in different markets, both temporally and geographically, 76 years after it was first published. The strategy has been the subject of numerous papers. Two notable papers are Professor Henry Oppenheimer's *Ben Graham's Net Current Asset Values: A Performance Update* and James Montier's *Graham's Net-Nets: Outdated or Outstanding?* Professor Oppenheimer studied net current asset value stocks in the U.S. between 1970 and 1983, finding a mean return of 29.4% per year against an index return of 11.5%. Montier looked at the performance of net current asset value stocks globally between 1985 and 2007, finding a mean return of 35% per year against an index return of 17% per year.

**MOI:** Returns of 29-35% certainly sound mouthwatering. Have you looked at the robustness of the underlying data, for example in terms of the number of companies that could have been bought and the amount of capital that could have been deployed. It seems that especially during the period from 1985 through 2007, the bull market significantly narrowed the field of available "net nets." Do we know what the geographic distribution of net current asset value stocks looked like during that time period?

**Carlisle:** That's an excellent question, and it really gets to the heart of why the net current asset value opportunity persists despite the fact that the strategy is very well known. There is a natural limit to the amount of capital that can be invested in net current asset value stocks because they are so few, small and illiquid. The natural limit is quite low. I would suggest that it is so low that most professional fund managers wouldn't even consider it worthy of study. I have read a comment from Joel Greenblatt that professional net current asset value investors eventually outgrow the strategy, by which he means that sooner or later their capital exceeds that low natural limit, and they get bored with it. I have fairly modest aspirations for my fund, and it's only one of the strategies that I pursue, so I don't foresee that being a concern for me.

One solution to the problem is to expand the markets under consideration to those outside the U.S. Montier's research suggests that by investing outside the U.S. you increased your net current asset universe threefold. Approximately 30% of all net current asset value opportunities were in the U.S., more than 50% were in Japan, and the remainder were in South-East Asia and Europe.

**MOI:** Conceptually, buying stocks for less than liquidation value makes sense because there is a legal mechanism to recovering more cash than needs to be invested to set this mechanism in motion. However, in some countries, let's say Japan, the legal mechanism may be non-existent or not enforceable. Is a strategy of investing in net current asset value stocks still appropriate in such countries?

**Carlisle:** That's the million dollar question. The *prima facie* answer would have to be "no" because the entire basis for the strategy as described by Graham is the shareholder's ultimate right to wind up the company and retrieve her or his capital. This is, almost by definition, capitalism at work. Seth Klarman has written in his book *Margin of Safety*:

*"There is a natural limit to the amount of capital that can be invested in net current asset value stocks because they are so few, small and illiquid... I have read a comment from Joel Greenblatt that professional net current asset value investors eventually outgrow the strategy, by which he means that sooner or later their capital exceeds that low natural limit..."*

“A liquidation is, in a sense, one of the few interfaces where the essence of the stock market is revealed. Are stocks pieces of paper to be endlessly traded back and forth, or are they proportional interests in underlying businesses? A liquidation settles this debate, distributing to owners of pieces of paper the actual cash proceeds resulting from the sale of corporate assets to the highest bidder. A liquidation thereby acts as a tether to reality for the stock market, forcing either undervalued or overvalued share prices to move into line with actual underlying value.”

Without a culture that elevates the rights of shareholders to their own capital over other “stakeholders” rights, however, there’s a strong argument that Grahamite liquidation value investing won’t work.

*“...as Seth Klarman points out, a liquidation analysis is a theoretical exercise in valuation, but not usually an actual approach to value realization... In my experience, most ‘net net’ companies have been turned around, rather than liquidated.”*

The caveat to the *prima facie* position is threefold. First, as Seth Klarman points out, a liquidation analysis is a theoretical exercise in valuation, but not usually an actual approach to value realization. The assets of a company are typically worth more as part of a going concern than in liquidation, so liquidation value is generally a worst-case outcome. In my experience, most “net net” companies have been turned around, rather than liquidated. Although he wasn’t considering this point for this reason, I think Montier’s research suggests that “net nets” are liquidated in only around one-in-twenty cases (Montier actually says that “net net” stocks suffer a permanent loss of capital – defined as a stock price that drops 90% or more in a year – in around 5% of cases. Although I’m not sure how he constructed his data, it’s possible that these losses are in fact stock prices dropping following a liquidating distribution. It’s also possible that these losses indicate nothing more than a permanent loss of capital, as Montier suggests.) Together, this might suggest that a culture accepting liquidation as a natural part of a company’s lifecycle is not necessary for acceptable returns to sub-liquidation value stocks.

Second, the data seem to suggest that net current asset value is predictive of investment returns in Japan, and in the same order of magnitude as it is in the U.S. and other western countries. I hesitate to raise that data in support of an investment in Japan because I believe that, as a general rule, the data should follow the logic, rather than the other way around. That said, I believe the fact that the returns are in the same order of magnitude as the U.S. and other western countries is significant. It lends some credence to the theory that net current asset values are predictive of returns in countries like Japan, where shareholders are considered to be but one of many stakeholders interested in the company.

Finally, activist investors – predominantly foreign, although there are some local activists – seem to be making some headway in Japan. It’s possible that the Japanese market is opening up to change. I think this is the weakest of the arguments for a “net net” investment strategy in Japan, but nonetheless worth considering as a possibility. There are many counterpoints to suggest that the market is as hostile to external capitalists as it has always been.

**MOI:** It would seem that the strategy of buying “net nets” and embracing an activist approach to investing go hand-in-hand. What is your view of activism and do you intend to pursue it?

**Carlisle:** Activist investors are absolutely essential to the operation of a healthy market. They’ve worn some brickbats for their more extreme tactics, and a few dusted a lot of investor money in the crash, but I believe they’ve provided a net benefit to the market. Like short sellers, activists identify and police the more egregious examples of management waste and self-dealing. They also foment catalysts in otherwise neglected stocks. Both of these roles are important in the universe of small to micro companies outside the glare of analysts and the media, which is the universe inhabited by “net net” investors.

I will always support an activist where it makes sense to do so, but I think it’s highly unlikely that I will enter a position with the intention of being the lead activist. That’s a personal choice for me. I don’t have the personality for activism. I am prepared to be the lead activist where the activist strategy is used as a shield, but I would need another activist to take the lead, not to mention a very compelling value proposition with a clear path to unlocking the value, to consider using it as a sword. That latter strategy – riding the coattails of activist investors – is essentially the one I pursued with *Greenbackd*, and, with some refinements, it’s one I’ll be pursuing in the fund.

*“Activist investors are absolutely essential to the operation of a healthy market. They’ve worn some brickbats for their more extreme tactics, and a few dusted a lot of investor money in the crash, but I believe they’ve provided a net benefit to the market.”*

**MOI:** The strategy of investing in net current asset value stocks seems almost ideally suited for a purely quantitative approach. Most “net nets” are companies that have a lot of “hair” and uncertainty, making it tough for emotional investors to set aside their cognitive biases. How does judgment help you improve upon the results that might be achieved by an algorithm-driven approach?

**Carlisle:** My view is that it doesn’t help much, and might even hurt the results. That view is based upon the numerous studies identified in James Montier’s excellent article, *Painting by Numbers: An Ode to Quant*. Montier’s thesis is that simple statistical or quantitative models consistently outperform expert judgments. This phenomenon persists even when the experts are provided with the models’ predictions. Montier argues that the models outperform because humans are overconfident, suffer from “inertia,” which is an unwillingness to change, and, as you have identified, struggle to put aside cognitive biases. The theoretical conclusion to be drawn from this research is that the model’s output should be favored over expert judgment, meaning discretion should be limited. In practice this is an exceptionally difficult thing to do. I think the proper place for judgment is in refining the model, rather than in waving off any of the model’s predictions.

**MOI:** Toby, thank you very much for your time. To butcher the Chinese proverb, *May you live in “net net”-laden times!*

The *Manual of Ideas* research team is gratified to have won high praise for our investment idea generation process and analytical work.

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