

Superinvestor

DIGEST

The Best Ideas, Practices and Jokes from the World's Best Investors

Seth A. Klarman:

The Art of Deep Value Investing

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COMING UP

SID Premier:
Special Situation Investing According to Joel Greenblatt and Seth Klarman (Synthesized & Distilled by SID with a focus on techniques and procedures)

Seth A. Klarman, President of The Baupost Group, averaged about 20% per year for 24 years with only one negative year. This digest of Seth A. Klarman's investment strategies and practices, in our unique SiD bullet-points format, is mainly based on a guest lecture by Seth Klarman at Columbia Business School and his book, *Margin of Safety*. Many sections here are not Klarman's exact words, but our digest of the distilled essence of his investment methods.

LOOK FOR MISPRICING

◆ "If only one word is to be used to describe what Baupost does, that word should be: 'Mispricing'. We look for mispricing due to over-reaction," said Seth Klarman.

◆ "At Baupost, we constantly ask: 'What should we work on today?' We keep calling and talking. We keep gathering information. You never have perfect information. So you work, work and work. Sometimes we thumb through ValuLine. How you fill your inbox is very important," said Klarman.

◆ Look for forced selling and supply-demand imbalance.

◆ "Investors can not predict when business values will rise or fall. Valuation should always be performed conservatively, giving considerable weight to worst-case liquidation value and other methods."



Superinvestor: Seth Klarman

maintain a high degree of risk aversion.

◆ He religiously follows the commandments of Benjamin Graham and Warren Buffett: "Rule number one: Don't lose money. Rule number two: Never forgot Rule number one."

◆ Klarman believes that the primary goal of value investors is to avoid losing money.

◆ There are three key elements of Klarman's value-investment strategy:

1. A bottom-up approach, searching via fundamental analysis.

2. Absolute return strategy.

3. Pay attention to risk.

◆ If you have \$1 million and we flip a coin: head, you win an additional \$1 million. Tail, you lose your \$1 million. In terms of probability, this is a fair bet. But few people would be willing take this bet due to the possibility of losing everything.

Handwritten note: what would you do if a coin flip?

◆ "A margin of safety is achieved when securities are purchased at prices sufficiently below underlying value to allow for human error, bad luck, or extreme volatility in a complex, unpredictable and rapidly changing world," wrote Klarman.

FOCUS ON THE RISK BEFORE FOCUSING ON THE RETURN

◆ Seth Klarman's foremost principle of operation is to

◆ [SiD Notes] The key is (1) to limit your bets on situations

KLARMAN: "I THINK GROWTH INVESTING IS A STUPID STYLE."

where the probability of winning is way above 50% and (2) the downside is significant less than a total wipe out.]

- ◆ Cash is the ultimate risk aversion. But clients are uncomfortable about it. Why people should pay a money manager to hold cash? They are paying the manager to wait for the opportunity to invest.
- ◆ Think of the asset-under-management as if it is your own money. What other people think doesn't matter any bit. Ignore questions like "How does it look to our clients and peers?"
- ◆ Keep some cash in the side pocket so there will be no forced liquidation. The duration of the investment should be equal to the duration of the capital.

RISK = (AMOUNT OF LOSS) X (PROBABILITY OF LOSING)

- ◆ Klarman defines risk as both (1) how much is the potential loss and (2) what is the probability of losing.
- ◆ An investor can counteract risk by (1) diversification, (2) hedging (when appropriate), and (3) invest with a margin of safety.
- ◆ To Klarman, using beta and volatility to measure risk is nonsense. "The beta is 0.7. What the hell doesn't that mean?" Klarman joked.
- ◆ Most investor looks at a falling stock and think that things are getting worse and the uncertainty or risk is going higher. That kind of herd mentality must be reversed for an investor to become successful. As a stock falls big time, the risk should be less. As the stock goes lower and lower, the risk would become less and less. If you back up the truck and buy 51% of the company, you would be able to force the outcome with control. That's the benefit of averaging down.
- ◆ However, if you short a stock, your loss would be bigger and bigger. The amount of your potential loss is infinite.
- ◆ Klarman doesn't do "long and short". When bearish on Korea, they bought puts on Korean Government Bonds to sell the bonds at par.
- ◆ The greater the risk, does not necessarily mean the greater the return. Risk erodes returns because of losses.
- ◆ Klarman believes that the long-short crap is trying to make things too complicated.
- ◆ Klarman stresses that the future is unpredictable. Investors must be prepared for any eventuality, such as the worse-case liquidation value. The river may overflow its banks only once

or twice in a century, but you still buy flood insurance.

- ◆ An investor, looking for a specific return over time, does not make that goal achievable. Targeting investment returns leads investors to focus on potential upside rather on downside risk. Rather than targeting a desired rate of return, even an eminently reasonable one, investors should target risk.

THINKING ABOUT "AUTHENTIC" VALUE INVESTING

- ◆ "I think growth investing is a stupid style. Bet on the two horse at Philadelphia Park and you'll do well from time to time," said Seth Klarman.
- ◆ Beware of value pretenders. These investors apply a dip strategy. They buy what's down, not what's cheap.
- ◆ Look at investments as "fractional ownerships" of businesses.
- ◆ No book or lecture alone will turn anyone into a successful value investor. Value investing requires a great deal of hard work, unusually strict discipline and a long-term investment horizon. [SiD Note: ...plus continuous study and review using SiD.]
- ◆ Klarman believes that his book, *Margin of Safety*, is a blueprint that, if carefully followed, offers a good possibility of investment successes with limited risk. He describes the book as one about "thinking about investing."
- ◆ Understand why things work. Memorizing formulas is not enough.
- ◆ Study the behavior of investors and speculators. Their actions "often inadvertently result in the creation of opportunities for value investors."

THREE WAYS TO INVESTMENT PROFITS

- 1) From the free cash flow generated by the underlying business, which will eventually be reflected in a higher share price or distributed as dividends.
- 2) From an increase in the multiple that investors are willing to pay for the underlying business as reflected in a higher share price.
- 3) Or by closing the gap between share price and underlying business value.

WHERE TO SEARCH FOR VALUE

- ◆ Spin-offs: complete lack of information in spin-offs.
- ◆ Forced sellings by index funds.

KLARMAN'S COMPLEXITY VS. BUFFETT'S SIMPLICITY

- ◆ **Forced sellings by institutions:** Big mutual funds are often forced to sell tainted names.
- ◆ **Disaster De Jour:** accounting fraud, earnings disappointment, SEC investigation...
- ◆ **Bankruptcy:** Unfavorable leases can be terminated. Bond investors tend to sell the recycled equity in a hurry.
- ◆ **Graham-and-Dodd deep value:** Discount to breakup value, or P/CF < 10.
- ◆ **Catalysts:** tender, Dutch auction, spin-off. There are now lots of competition from many event-driven hedge funds. Savings and loans conversions are often undervalued because they are only available to depositors and insiders.
- ◆ **Real estate:** During the slump of 1992, the government had not been sophisticated sellers of real estate. You could buy properties at half of building costs. And there are far less competition in real estate due to geographic limitations.
- ◆ **No self-imposed constrains.** No capitalization requirements.
- ◆ While Buffett likes certainty, Klarman thinks that uncertainty and adversity create opportunity.

VENTURE INTO COMPLEXITY

- ◆ **If the security is hard to understand and time consuming,** many of the analysts and institutions will shy away from it. Klarman identifies this as "fertile ground" for research.
- ◆ **Spin-offs:** The goal of a spin-off is for the former parent company to create greater value as a whole by spinning off businesses that aren't necessarily in their strategic plans. There is complexity and the 2 to 3 month time lag of data flow to the computer databases.
- ◆ **Bankruptcies:** Look for Net Operating Losses as a potential benefit. The beauty of investing in bankrupt companies is again the complexity of the analysis. During a bankruptcy, costs get leaner and more focused, cash builds up and compounds with interest. This cash buildup can simplify the process of reorganization because all agree on the value of cash.

MICHAEL PRICE'S THREE STAGES OF BANKRUPTCY

1. Immediately after bankruptcy. This is the most uncertain stage, but also one of the greatest opportunities. Liabilities are not evident, there is turmoil, financial statements are late or unavailable and the underlying business may not have stabilized. The debtor's securities are also in disarray. This is accompanied by forced selling at any price.

2. The negotiation of a reorganization plan. By this time, many analysts have pored over the financials and the company. Much more is known about the debtor, uncertainty is not as acute, but certainly still exists. Prices will reflect this available information.
3. The finalization of the reorganization and the debtor's emergence from bankruptcy. This stage often takes 3 months to a year. Klarman thinks that this last stage most closely resembles a risk-arbitrage situation.

BANKRUPTCY PLAYS: BUY BONDS, SHORT STOCKS.

- ◆ Investors should typically shy away from investing in common stock of bankrupt companies. There is an occasional home run, but "as a rule investors should avoid the common stock of bankrupt entities at virtually any price; the risks are great and the returns are very uncertain," said Klarman.
- ◆ The market for bankrupt bonds is illiquid and traders take advantage of unsophisticated investors. Caution is the order of the day for the ordinary investor.
- ◆ For bankruptcy plays, Klarman uses the same investment valuation techniques he would use for a solvent company.
- ◆ Examine if the companies are intentionally "uglifying" their financial statements. Example: Expensing rather than capitalizing certain expenses.
- ◆ Look at off-balance sheet arrangements such real estate stated below market value and over-funded pension plans.
- ◆ When any investment area becomes popular, be extra careful. Most of the money is made based on the emotional and uneconomic behavior of other investors.

INCOMPLETE INFORMATION VS. THOROUGH RESEARCH

- ◆ No matter how

Editor's Note: Superinvestor Digest (SiD) differentiates itself by moving away from the traditional interview format presented by our competitors. We will work to bring you synthesized, distilled and digested summaries of the best ideas and practices of the superinvestors we truly respect. Our work will usually cover multiple lecture notes, numerous interviews, private conversations and countless hours of investigative journalistic work.

RE-INSPECT THE BARGAINS FOR POSSIBLE FLAWS

extensive your research, no matter how diligent and smart you are, the diligence has shortcomings. Some information is always elusive; hence you need to live with incomplete information. Knowing all the facts does not always lead to profit.

- Don't need!*
- ◆ Use the "80/20 rule." The first 80% of the research is gathered in the first 20% of the time spent finding that research.
 - ◆ Business information is not always made available, and it is also "perishable." "High uncertainty is frequently accompanied by low prices. By the time uncertainty is resolved, prices are likely to have risen," said Klarman.
 - ◆ Klarman believes that you can make decisions quicker, without all of the information, and take advantage of the time others use to look and delve into the same information. This extra time can cause the late and thorough investor to pay a higher price for a clearer and cheerier consensus.
 - ◆ "Investment research is the process of reducing large piles of information to manageable ones, distilling the investment wheat from the chaff. There is, needless to say, a lot of chaff and very little wheat. The research process itself, like the factory of a manufacturing company, produces no profits. The profits materialize later, often much later, when the undervaluation identified during the research process is first translated into portfolio decisions and then eventually recognized by the market," wrote Seth Klarman in *Margin of Safety*.
 - ◆ Research today, will provide the fruits of tomorrow. While Buffett thrives on "masterful inactivity" and sitting on a few permanent investments, Klarman believes that an investment program will not succeed if "high quality research is not performed on a continuing basis."

WATCH WHAT THE INSIDERS ARE DOING

- ◆ If the managers of internet funds had their own money in the funds, they probably won't buy the high flyers.
- ◆ The motivation of company management can be a very important force in determining the outcome of an investment.
- ◆ "At Baupost, we eat our own cooking," said Klarman.

FOCUS ON ABSOLUTE RATHER THAN RELATIVE RETURN

- ◆ Value investors look for absolute performance, not relative performance. They look at the longer term. They are willing to hold cash reserves when no bargains are available. Value investors focus on risks as well as returns.
- ◆ You can't spend relative performance.
- ◆ Baupost looks for absolute returns in a number of analytical

divisions such as: spin-offs, bankruptcies, index fund selloffs, disaster de jour, etc.

YOUR OWN PSYCHOLOGY CAN BE YOUR WORST ENEMY

- ◆ Beware of what you think and what you think your clients think.
- ◆ You may be scared of what your clients would be doing. You may be afraid to let the clients see a certain position.
- ◆ When you are worried, it's tough to follow your disciplines.
- ◆ Stay unemotional in business and investing!
- ◆ "Successful investors tend to be unemotional, allowing the greed of others to play into their hands. By having confidence in their own analysis and judgment, they respond to market forces not with blind emotion but with calculated reason," Klarman wrote eloquently.

SMALL COMPANIES OUTPERFORM

- ◆ Big institutions are the best friends of value investors. Many of them are forced to sell low-priced stocks.
- ◆ Institutions artificially constrain themselves by setting selection requirements like minimum market capitalization, exchange listing, 5-year history, 10-year financials, etc. These restrictions cause mispricing in small companies that fall through the cracks.
- ◆ Year-end tax selling also creates opportunities.
- ◆ "Value investing is, in effect, predicated on the proposition the efficient-market (EMT) hypothesis is frequently wrong." Klarman believes that market pricing is less efficient with smaller capitalization companies.

RE-INSPECT THE BARGAIN FOR POSSIBLE FLAWS

- ◆ If you see a company selling for what you consider to be a very inexpensive price, ask yourself, "What is wrong with this company?" Just like Charles Munger advised: "Invert, always invert."
- ◆ "A bargain should be inspected and re-inspected for possible flaws," advised Klarman.
- ◆ Possible flaws might be the existence of contingent liabilities or maybe the introduction of a superior product by a competitor.
- ◆ Value investing by its very nature is contrarian. They are typically initially wrong, since they go against the crowd, and the crowd is the one pushing up the stock prices. Value investor

LIQUIDATION VALUE AS DOWNSIDE PROTECTION

are reflected in stock prices, whereas George Soros' theory of reflexivity shows how stock prices can significantly influence the value of businesses. Investors must not lose sight of this possibility.

- ◆ Management could manipulate earnings and growth rates, and that one had to be wary of using earnings in valuation. *SKL resort* Look at the quality of earnings. Interpret cash costs versus non-cash costs. Learn how to normalize earnings.
- ◆ It is important to remember that the numbers are not an end in themselves. Rather they are a means to understanding what is really happening in a company.
- ◆ Book value is not very useful as a valuation yardstick. Book value provides limited information to investors. It should only be considered as one component of a thorough analysis.

NET PRESENT VALUE (NPV) ANALYSIS

- ◆ NPV is the discounted value of all future cash flows that the business is expected to generate.
- ◆ Use this method when earnings are reasonably predictable and a discount rate can be intelligently chosen. This is often a guessing game. Things can go wrong. Things change. Even management can't predict future changes. "An irresolvable contradiction exists: To perform present value analysis, you must predict the future, yet the future is NOT reliably predictable." This should be dealt with using "conservatism."
- ◆ NPV and IRR are great tools for summarizing data. But they can be misleading unless the future cash flows are contractually determined, and when all payments are received when due. Otherwise, "garbage in, garbage out."
- ◆ The intrinsic value of a business is a range of values, and not a precise number.
- ◆ When choosing the discount rate, a generic number, like 10%, is an easy round number people like, but not necessarily the best choice. Be conservative. The less the risk of the investment, the less the time frame, the less the risk-free interest rate, the less the discount rate should be.
- ◆ Various DCF and NPV scenarios should be used. Investors should discount earnings or cash flows as opposed to dividends, since not all companies pay dividends. Of course, one wants to understand the quality of the earnings and their reoccurring nature.

LIQUIDATION VALUE ANALYSIS

- ◆ Understand the difference between an orderly liquidation

versus fire sale.

- ◆ Keep in mind that operating losses deplete working capital.
- ◆ Do not forget to look at off balance sheet liabilities, such as under-funded pension plans and subsidiaries loaded with debt.
- ◆ While Buffett recognizes the value of intangibles, Klarman have doubts about the value of intangible assets. Tangible assets often have alternative uses, hence providing a margin of safety.

SUM-OF-PARTS STOCK MARKET VALUE ANALYSIS

- ◆ Estimate the price of the company, or its subsidiaries considered separately, as it would trade on the stock market. Add up the public or private market values of various parts of a business. This method is less reliable than the other two and should be used only as one of the yardsticks.
- ◆ Private Market Value (PMV) does give an analyst some rules of thumb. When using PMV, be wary of certain periods of heated acquisition activities or non-cash transactions. Look at historic multiples. Investors relying on conservative historical standards of valuation in determining PMV will benefit from a true margin of safety, while others' margin of safety blows with the financial winds.
- ◆ Use market value analysis to determine what you would pay for the business, not what others would pay to own them.
- ◆ At most, PMV should be used as one of several inputs in the valuation process and not the exclusive final arbiter of value.

CONSTANTLY RE-ASSESS THE INTRINSIC VALUES

- ◆ It is hard to get pulse of a real business. We don't have access to the internal books. Companies like Enron have black holes of information about more than 1,000 subsidiaries.

Close your eyes and you will see clearly. Cease to listen and you will hear the truth. Be silent and your heart will sing. Seek no contacts and you will find union. (Lao Tzu)

When you learn to love hell, you will be in heaven. (Thaddeus Golas)

He is a wise man who does not grieve for the things which he has not, be rejoices for those he has. (Epictetus)

HOW TO PICK MONEY MANAGERS

- ◆ "We are at our best when there's little information," said Klarman. "We love a seller who doesn't know what to think."
- ◆ Determining value is not a science. A competent investor cannot have all the facts, know all the answers or all the questions, and most investments are dependent on outcomes that cannot be foreseen.
- ◆ All investors must come to terms with the relentless continuity of the investment process.
- ◆ Investors should pay attention not only to *whether* but also to *why* current holdings are undervalued. Remember the reason you bought the investment, and if that no longer holds true, then sell the investment. Look for catalysts, which might assist in surfacing or adding value. Look for companies with good management and insider ownership.
- ◆ Klarman recommends that, if you could not commit the requisite time and attention to investing on your own, you should adopt a value-investment philosophy and find an investment professional with a record of value-investment success.

PORTFOLIO MANAGEMENT AND TRADING PRACTICES

- ◆ Portfolio management requires paying attention to the portfolio as a whole, taking into account diversification, possible hedging strategies, and the management of portfolio cash flow. Proper portfolio management serves to reduce risks for investors.
- ◆ Liquidity is important. A portfolio manager can buy a stock and subsequently find out he or she made an error, or that a competitor has a stronger product. With that said, the portfolio manager can typically sell that situation. In an annuity or limited partnership, when investors do not demand compensation for bearing illiquidity, they almost always come to regret it. Unexpected liquidity needs do occur. New opportunities do emerge. Investors should demand a greater form of compensation for the liquidity sacrifice.
- ◆ Liquidity can be illusory. Watch out for situations that are liquid one day, and illiquid the next. This can happen in market panics.
- ◆ "Investing is in some ways an endless process of managing liquidity." When a portfolio is in cash only, the risk of loss is non-existent. The same goes for the lack of gain when fully invested in cash. Klarman wrote, "The tension between earning a high return on the one hand, and avoiding risk on the other, can run high. This is a difficult task."
- ◆ Diversify your holdings and hedge when it is financially attrac-

tive to do so.

- ◆ Klarman suggests that, as few as ten to fifteen different holdings should suffice for diversification. His view is that an investor is better off knowing a lot about a few investments than knowing only a little about each of a great many holdings. Diversification, after all, is not how many different things you own, but how different the calculated risks in the things you do own.
- ◆ The single most crucial factor in trading is the developing the appropriate reaction to price fluctuations. Investors must learn to resist fear, the tendency to panic, when prices are falling, and greed, the tendency to become overly enthusiastic, when prices are rising.
- ◆ Klarman believes that leverage is neither necessary nor appropriate for most investors.

YOU NEED INTEGRITY TO HAVE A LONG LIFE

- ◆ Money management is a business with all sorts of temptations.
- ◆ Klarman thinks the two tests from Warren Buffett are very powerful:
 - (1) The Middle of the Course Test. When you play football, stay close to the center. Life is too short to run close to the line.
 - (2) *The Wall Street Journal* Test. What if an intelligent and unfriendly reporter writes about what you are doing on the front page of *The Wall Street Journal*?

HOW TO EVALUATE A MONEY MANAGER

- ◆ Personal interviews are absolutely essential.
- ◆ Do they eat their own cooking? This is the most important issue according to Klarman. "You probably would not choose to dine at a restaurant whose chef always ate elsewhere. You should be no more satisfied with a money manager who does not eat his or her own cooking."
- ◆ Are all clients treated equally?
- ◆ Examine the manager's track record during different periods of varying amounts of assets managed. How has the advisor performed as his or her assets have grown? If assets are shrinking, try to examine the reason.
- ◆ Examine the investment philosophy. Does the advisor worry about absolute returns, about what can go wrong, or is the advisor worried about relative performance?

BUYING THE MOST TAINTED NAMES

- ◆ Does advisor have artificial constraining rules? Examples of this could be the requirement to always be fully invested.
- ◆ Thoroughly analyze the past investment performance. How long a track record is there? Was it achieved in one or more market cycles?
- ◆ How did the clients do in falling markets?
- ◆ Have the returns been steady over time, or have they been volatile?
- ◆ Was the track record from a steady pace, or just a couple of successes?
- ◆ Is the manager still using the same philosophy that he or she has always used?
- ◆ Has the manager produced good long-term results despite having excess cash and cash equivalents in the portfolio allocation? This could indicate a low risk approach.
- ◆ Were the investments in the underlying portfolio themselves particularly risky, such as shares of highly leveraged companies? Conversely, did the portfolio manager reduce risk via hedging, diversification and senior securities?
- ◆ Make sure you are personally compatible with the advisor. Make sure you are comfortable with the investment approach.
- ◆ After you hire the manager, monitor them on an ongoing basis. The issues that were addressed prior to hiring should be used after hiring.

ADOPTING A VALUE INVESTMENT PHILOSOPHY

- ◆ While value investors focus on intrinsic value and margin of safety. Speculators are obsessed with predicting and guessing the direction of prices.
- ◆ Value investors pay attention to financial reality in making their investment decisions. Investing is serious business, not entertainment.
- ◆ Understand the difference between an investment and a collectible. An investment is one, which is able or will eventually be able to produce cash flow.
- ◆ Security prices sometimes fluctuate, not based on any apparent changes in reality, but on changes in investor perception.
- ◆ When a price of a stock declines with no apparent reason, most investors become concerned. They worry that there is information out there, which they are not privy to. "Heck, I am going through this now with a position that is thinly traded,

and sometimes I think I am the only purchaser out there." The investor begins to second-guess him or herself. It is easy to panic and just sell. "Yet, if the security were truly a bargain when it was purchased, the rationale course of action would be to take advantage of this even better bargain and buy more," wrote Klarman.

- ◆ Don't confuse the company's performance in the stock market with the real performance of the underlying business.
- ◆ Think for yourself and don't let the market direct you.
- ◆ All market fads come to an end. But it is only fair to note that it is not easy to distinguish an investment fad from a real business trend.
- ◆ Value investors are students of the game; they learn from every pitch, those at which they swing and those they let pass by. They are not influenced by the way others are performing; they are motivated only by their own results. Klarman advises value investors to cultivate "infinite patience."
- ◆ Do not invest in companies that you don't understand. The changes in technology are often hard to keep pace with. The net assets of commercial banks and property and casualty companies are often difficult to analyze.
- ◆ For a value investor, a pitch must not only be in the strike zone, it must be in his "sweet spot." "Above all, investors must always avoid swinging at bad pitches," said Klarman.
- ◆ Facing complex situations, investors could demand a greater discount than usual. "Probably let more pitches go by."

CASE STUDIES

- ◆ Bought News Corp at \$15 in October of 2005. Australian index funds are selling. Breakup value is \$20-\$23. At \$15, if you strip out the value of subsidiaries, the free cash flow yield of the core operation is 10%. There is no catalyst.
- ◆ Bought Enron's senior debt during its bankruptcy saga. There can't be a more tainted name. Big mutual funds are selling like mad because they don't want their investors to see the position. Mr. Market overestimated the liabilities of the 1,000 subsidiaries. Enron's senior debt was complex with a lot of negativity. One of their analysts dedicated 4 years to study Enron bonds. Using the assets/liabilities ratio, they first estimated that they would get \$0.17 on a dollar. Then they adjusted the estimate to \$0.30. The end result is \$0.50 on one dollar of senior debt. They have increased their 7% position to a 17% bet. At that time, they felt the safest thing to do is to buy the Enron debt because there were so few buyers.



THE MOST IMPORTANT CHAPTER OF THE MOST IMPORTANT INVESTMENT BOOK

Bible Study Time

Warren Buffett said: you only need two courses to become a good investor: (1) how to think about the market, and (2) how to value a business. And for the first course, he recommended chapter 8 of Benjamin Graham's classic *The Intelligent Investor*. (<http://astore.amazon.com/zenway-20>) Here is our digest of this most important chapter of the most important investment book according to Warren Buffett.

Stock Market History Promises the Investor Two Things:

- 1) the long-term appreciation of a portfolio held relatively unchanged through successive rises and declines,
 - 2) the possibilities of buying near bear-market lows and selling not too far below bull-market highs.
- However, the interest in market fluctuations involves the very real danger that it will lead him into speculative attitudes and activities. It is easy for us to tell you not to speculate; the hard thing will be for you to follow this advice.

The Rules of Speculation:

- 1) speculate with your eyes open, knowing that you will probably lose money in the end;
- 2) be sure to limit the amount at risk, and
- 3) separate it completely from your investment program.

Two Ways to Profit from the Pendulum Swings of the Market:

1. **Timing:** the endeavor to anticipate the upward (or downward) action of the stock market, and to buy (or sell) accordingly. Stock brokers' emphasis on timing and market forecasting leads to speculative activities. But an investor feels that the brokerage research forecast is at least more dependable than his own. Also, timing is of great psychological importance to the speculator because he wants to make his profit in a hurry. However, emphasis on timing and market forecasting will lead to poor speculative results.
2. **Pricing:** (1) the endeavor to buy stocks when they are quoted below their fair value and to sell them when they rise above such value; or (2) simply make sure that you do not pay too much for your stocks as an essential minimum of attention to market levels. We are convinced that pricing of either type can produce satisfactory results.

Buy-Low-Sell-High Approach Is Not Easy

- **Procedure:** Determine buying and selling levels of the general market, based on either value factors or percentage movements of prices or both. However, market history shows no pattern. It is difficult for investor to buy at low levels in bear markets and to sell out at high levels in bull

markets.

- **Recommended Policy: Tactical Asset Allocation.** Make provision for changes in the proportion of common stocks to bonds in the portfolio according to whether the level of stock prices appears less or more attractive by value standards.
- **Characteristics of nearly all the bull markets:** (1) A historically high price level, (2) High price/earnings ratios, (3) Low dividend yields as against bond yields, (4) Much speculation on margin, (5) Many offerings of new common-stock issues of poor quality.

Looking for an Easy System to Make Money Is a Waste of Time.

- In stock-market affairs the popularity of a trading theory has itself an influence on the market's behavior which detracts in the long run from its profit-making possibilities. The moral seems to be that any approach to moneymaking in the stock market which can be easily described and followed by a lot of people is by its terms too simple and too easy to last. "All things excellent are as difficult as they are rare."
- By missing "ran away" markets, we had painful long waits with our own "central value method" of determining indicated buying and selling levels.

Market Fluctuations of the Investor's Portfolio

- In general, the shares of second-line companies fluctuate more widely than the major ones. But conservative investors should limit their holdings to those of large prominent and conservatively financed corporations.
- A substantial rise in the market is at once a legitimate reason for satisfaction and a cause for prudent concern. It may bring a strong temptation toward imprudent action. Investors become infected with the enthusiasm, the overconfidence and the greed of the great public, and make larger and dangerous commitment near the top. Even the intelligent investor is likely to need considerable will power to keep from being swept away by greed and following the crowd.
- What is the right kind of investor? We favor some kind of mechanical method for varying the proportion of bonds to stocks in the investor's portfolio. The chief advantage is that when the market advances he will from time to time make sales out of his stockholdings, putting the proceeds into bonds; as it declines he will reverse the procedure. Such investor will take added satisfaction from the thought

DOUBLE STATUS = DOUBLE OPPORTUNITIES

that his operations are exactly opposite from those of the crowd.

The double status of a shareholder, and with it the privilege of taking advantage of either at his choice:

- (1) The financial result of a minority shareholder or a silent partner depends on profits of the enterprise or on a change in the underlying value of its assets.
- (2) The common stock investor holds a piece of paper, which can be sold in a matter of minutes at a price which varies from moment to moment.

Business Valuations versus Stock-Market Valuations

- The investor should demand (1) a stock can be bought at close to its asset value, (2) A satisfactory ratio of earnings to price, (3) A sufficiently strong financial position, (4) The prospect that its earnings will at least be maintained over the years.
- **POLICY:** Do not pay high multipliers of both earnings and tangible assets. Be willing to forgo brilliant prospects because they are often priced too high.

As long as the earning power of his holdings remains satisfactory, he can give as little attention as he pleases to the vagaries of the stock market. More than that, at times he can use these vagaries to play the master game of buying low and selling high.

The A&P Case Study

- 1929: \$494 per share at the peak of the historic bull market.
- 1932: \$104 (Earnings as good as that of 1929)
- 1936: \$121 (Largest retail enterprise in America, 12 times 5-yr average earnings)
- 1938: \$36 (Business Recession and Bear market. Equity was given away without takers. Net current assets of \$134M is more than \$126M market capitalization) Why?
 - 1. Threats of special taxes on chain store, an exaggerated and eventually groundless fear.
 - 2. Net profits fell off in the previous year (Temporary)
 - 3. General market was depressed (Temporary)
- 1939: \$117 (grocery chain's shares rose with the general market)
- 1961: \$705 (30 times P/E ratio versus 23 times for DJIA,

public was clamoring at ridiculous price)

- 1962: \$340 (quick loss half market value and no bargain quality that showed in 1938)
- 1972: \$180 (Reported 1st quarterly deficit in the history, not well-run and attractive, with substantial further decline yet to come)
- **Lessons:** (1) how wide can they be the vicissitudes of a major American enterprise in little more than a single generation. (2) with what miscalculations and excesses of optimism and pessimism the public has valued its shares.

The Wild Ride of both Price and Value

- Stock market often goes far wrong, and sometimes an alert and courageous investor can take advantage of Mr. Market's patent errors.
- Most business change in character and quality over the years, sometimes for the better, perhaps more often for the worse. The investor need not watch his companies' performance like a hawk; but he should give it a good, hard look from time to time.

Advantages and Disadvantages of Market Fluctuations

- The true investor scarcely ever is forced to sell his shares, and at all other times he is free to disregard the current price quotation. He need pay attention to it and act upon it only to the extent that it suits his book, and no more. Thus the investor who permits himself to be stampeded or unduly worried by unjustified market declines in his holdings is perversely transforming his basic advantage into a basic disadvantage.
- That man would be better off if his stocks had no market quotation at all, for he would then be spared the mental anguish caused him by other persons' mistakes of judgment. In depression days, there was a psychological advantage in owning business interests that had no quoted market.

Distinction between the Investor and the Speculator

- The investor's primary interest lies in acquiring and holding suitable securities at suitable prices. The market quotations are there for his convenience, either to be take advantage of or to be ignored.
- The speculator's primary interest lies in anticipating and profiting from market fluctuations. They emphasize price movements first and underlying values second.

*Observation
great
cost
great prices
could cause
opportunities*

THE VOLATILE MR. MARKET

- Hold off buying until low market levels may involve a long wait, very likely the loss of income, and the possible missing of investment opportunities.
- If he wants to be shrewd he can look for the ever-present bargain opportunities in individual securities.

THE PARABLE OF THE MANIC-DEPRESSIVE MR. MARKET

- You invested \$1,000 in some private business.
- One of your partners, named Mr. Market, is very obliging indeed. Every day he tells you what he thinks your interest is worth, and furthermore, offers either to buy you out or to sell you additional shares based on his quote.
- Sometimes his quote appears plausible and justified by business developments and prospects as you know them.
- Often, on the other hand, Mr. Market lets his enthusiasm or his fears run away with him, and the value he proposed seems to you a little short of silly.
- Will you let Mr. Market's daily communication determine your view of the value of your \$1,000 interest in the enterprise?
- Mr. Market brings you two benefits: (1) the daily and changing appraisal of your holdings, for whatever that appraisal may be worth, (2) you are able to increase or decrease your investment at the market quote—if you choose to. The existence of a quoted market gives the investor certain options that he does not have if his security are unquoted.
- Price fluctuations have only one significant meaning for the true investor. They provide you with an opportunity to buy wisely when prices fall sharply and to sell wisely when they advance to a ridiculously high price.
- Forget about the quote from Mr. Market. Form your own ideas of value of your holdings based on full financial reports from the company.
- Neither be concerned by sizable declines nor become excited by sizable advances.
- Never buy a stock because it has gone up or sell one because it has gone down.
- Motto: "Never buy a stock immediately after a substantial rise or sell one immediately after a substantial drop." [SiD Note: Warren Buffett framed this quote in his office.]
- Always remember that market quotations are there for his

convenience, either to be taken advantage of or to be ignored.

Fluctuation in Bond Prices

- The investor should be aware that even though safety of its principal and interest may be unquestioned, a long-term bond could vary widely in market price in response to changes in interest rates.
- There is inverse relationship between bond prices and interest rates.
- Nothing important in Wall Street can be counted on to occur exactly in the same way as it happened before. But "The more it changes, the more it's the same thing."
- The price fluctuations of convertible bonds and preferred stocks are the resultant of three different factors: (1) variations in the price of the related common stock, (2) variations in the credit standing of the company, (3) variations in general interest rate.
- Many convertible issues have been sold by companies of questionable quality. In the typical case, the investor would delude himself to find in convertible issues that ideal combination of (1) the safety of a high-grade bond and price protection plus (2) a chance to benefit from an advance in the price of the common.

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Buffettology Distilled

How to make money investing in businesses?

(Based on a private talk by Warren Buffett)

- ◆ Remember three things: (1) Mr. Market, (2) Margin of Safety, and (3) Moat.
- ◆ Take advantage of Mr. Market's patent errors. Don't get swept by his emotions.
- ◆ Learn how to value a business and buy at a good discount.
- ◆ The moat of a business either comes from (1) a low-cost position or (2) from pricing power, the latter of which usually results from a strong brand.
- ◆ It's like going into business with a partner, make sure that they are (1) a passionate and ambitious fanatic who has devoted their life to the business, and that (2) they don't lie, cheat, or steal.
- ◆ Sticks to issues that are knowable and important to your business. You don't have to understand why long-term interest rates rise or fall.
- ◆ That's about it. As Buffett puts it, you don't need an eleventh commandment; it's all spelled out in the first ten.

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THE MOST ENLIGHTENING FINANCIAL LINKS

Value Investing Seminars at Columbia University by
Michael Price, Andrew Weiss, Thomas Russo Christopher Browne, Glenn Greenberg, Lewis Sanders:
http://www1.gsb.columbia.edu/valueinvesting/research/class_recordings.html

How to Start Your Own Hedge Fund
http://biz.yahoo.com/weekend/hedge_1.html

PBS Charlie Rose Show on Warren Buffett
Part 1 Warren Buffett: The Man
<http://video.google.com/videoplay?docid=6701318343299922276>
Part 2 Warren Buffett: The Business
<http://video.google.com/videoplay?docid=-6208910876057109785>
Part 3 Warren Buffett: The Gift
<http://video.google.com/videoplay?docid=-4846290947664386236>

Columbia University Students: A Day With Warren Buffett - March 24 2006
<http://www.columbiabottomline.com/current.pdf>

Joe Mansueto and Bill Nygren: The Importance of Having Conviction [Please keep in mind the BRKNEWS Disclaimer]
<http://advisor.morningstar.com/products/conference/conversation.htm>
<http://advisor.morningstar.com/articles/Doc.asp?docId=4490>

Charlie Munger's View on "Cost of Capital":
<http://www.businessday.co.za/articles/markets.aspx?ID=BD4A251640>

Charlie Rose interviews Rupert Murdoch (Jun, 26, 2006)
<http://video.google.com/videoplay?docid=8220054890220213491>

Charlie Rose Interviews Lee Scott of Wal-mart (Aug 1, 2006)
<http://video.google.com/videoplay?docid=-367692995527405484>

Charlie Rose Interviews Rick Wagoner, CEO of GM (June 15, 2006)
<http://video.google.com/videoplay?docid=400820385277927310>

Brian Williams Interviews Eric Schmidt, CEO of Google & Ivan Seidenberg, CEO of Verizon:
<http://video.google.com/videoplay?docid=5078924020791361373>

Charlie Rose - "Road to Innovation": George Clooney & Michael Eisner
<http://video.google.com/videoplay?docid=1593891634022817892>

"The Age of Fallibility" - George Soros speaks at Google
<http://video.google.com/videoplay?docid=6150320548187842685>

Investment Outlook by PIMCO's Bill Gross (September 2006)
<http://www.pimco.com/LeftNav/Late+Breaking+Commentary/IO/2006/IO+September+2006.htm>

How Does Warren Buffett Get Married? Frugally, It Turns Out
<http://www.nytimes.com/2006/09/01/business/01buffett.html>

Happiness: A User's Manual
Twenty strategies adapted from the scientific research and applied to New York living.
<http://www.newyorkmetro.com/news/features/17574/>

[Share the insights! Please email the treasure you recently discovered to: zenway.us@gmail.com]



HIDDEN TREASURES WATCH LIST

Name	Symbol	Ideal Price	Key Insights
Quanta Capital Holdings	QNTA	\$1.9	Trading at 40% of BV after the biggest disaster in insurance industry. Significant insider buys. Two-superinvestor buys: Klarman and Brandes. Looks like they reserved more than enough this time.
<u>Timberland Co.</u>	<u>TBL</u>	\$27	High return on asset and tangible capital. High earnings yield. Consistent earnings record over the years. Brand power among the party goers.
Fairfax Financial	FFH	\$110	Current trading at 0.8 times book value. The CEO, with a solid investment management track record, think FFH deserve 1.5 times book value, the market average for insurance companies. There is no clear evidence that the \$7 billion reinsurance recoverable is fake.
Dell	DELL	\$24	A company with high return on capital was caught in the slow down of PC industry. Valuation near the low end. Recently planning to open pilot retail stores signaling a change in strategy.
Footstar	FTAR	\$5.2	High earnings yield and high return on tangible capital. Hidden value in net operating loss carried forward. Emerging out of bankruptcy. Bad stores closed out.
H&R Block	HRB	\$21	Caught in a mortgage industry slow down and a Spitzer lawsuit. But clients for tax reporting and financial services tend to be sticky.
Symantec	SYMC	\$15	Threat from Microsoft's entry. CEO compensation too high.
Gannett	GCI	\$58	Reasonable valuation with no catalyst in media industry. Free cash flow still declining.
Star Gas	SGU	\$1.6 Risky	Normalized CF can be \$0.7 per share. Huge debt is removed by a recent re-capitalization plan.
Boston Communications	BCGI	\$1	Trading below net-net-cash. Huge legal liability will bankrupt the firm, but insiders are buying. What do they know that we don't.

MODEL PORTFOLIO

Name	Symbol	Cost	Date	Action	Key Insights
Sears Holdings	SHLD	\$118	12/28/05	Strong buy	Hidden really + subsidiary values > \$120, with the "Next Buffett" milking cash and liquidating assets. ESL's past moves and ideas are impressive.
Tyco Int'l	TYC	\$26.3	1/20/2006	Strong buy	Pending spin-offs could inject new competitive juice. Strong cash flow despite of slower growth. Insider buys. Purchases by multiple superinvestors.
Montpelier RE	MRH	\$18	12/13/05	Buy	Near tangible BV, smart insurance veterans from White Mountain (WTM), BRK holding. Reserved more than enough this time. Insider buys.
Berkshire Hathaway	BRK.b	\$2766	8/26/05	Strong buy	Valuation at historical low. Most conservatively stated BV & EPS. Just like Sam Walton and John D. Rockefeller, a genius like Buffett has already set up his firm to fly so he can smile from Heaven. Deep pool of talents.
Microsoft	MSFT	\$25.8	9/21/2005	Strong buy	People waiting for "64-bit" to do major upgrades next year. Users imprisoned because they don't want learn a new "Word" or "Excel" even if they are free. MSN search is now producing better results than Google.
Pfizer	PFE	\$24.9	8/26/05	Buy	Leader in an industry depressed for too long. New pipeline cycle will begin soon. Management determined to boost valuation via corporate events.
Wal-mart	WMT	\$45.4	8/26/2005	Buy	City Councils in China giving WMT the best locations and they are just beginning. More global expansions are yet to come. Amazing corp culture.
Anheuser-Busch	BUD	\$44.2	8/26/2005	Strong buy	49% market share in USA can be duplicated in China. Impressive pricing power. Learning to compete with wine by saying light drinking is healthy.
Coca-Cola	KO	\$41.9	11/17/05	Strong buy	Impressive cash flow. A no-brainer at reasonable valuation. Their sport drinks market share jumped from 1% to 20%. New management shuffles created new energy and sense of urgency to deliver results.
Walt Disney	DIS	\$24	10/13/05	Strong buy	Global theme park expansion with local government putting up the land thus lowering CapEx has huge potential. New CEO was the understudy of a Tom Murphy, a CEO admired by Buffett.
Washington Post	WPO	\$740	11/11/2005	Buy	Reasonably valued during a slump of all media stocks. Great managers with Buffett on the Board. Strong underlining growth at education unites.
QLT Inc.	QLTI	\$6	2/1/06	Added from watch list	Near tangible BV, cash flow positive, corporate buyback and buying by insiders and superinvestors, hidden value in real estate, possible upside surprise in the pipelines.
Marsh & McLennan	MMC	\$29	12/2/04	Buy	Normalized earnings power can go higher after all the disasters at Marsh and Putnam. Still a great toll bridge business for the insurance industry.

NOTABLE ACTIVITIES OF SUPERINVESTORS 09/01/06

Superinvestors	Bought (Bold = Interesting. Underline = Significant %)	Sold
BAUPOST: Seth Klarman	AQR,HAC,JKA,LI,ELOS,DHBT,GAV,CDS,WLT,GLA,GFN,NAO,POR,EDA,CRB,QNTA	AQR'U,GLA'U,HAQ,NVL
BERKSHIRE HATHAWAY Warren Buffett, Lou Simpson,	SNY,IRM	GPS,LXK,JNI,HRB (28%)
BRANDES: Charles Brandes	SLE,TMS,ITP,DLX,SGTL,CQB,TSN,DRL,INTV,WNC,DELL,T LB,QLTI,CPWM,HRB,MA,BGG,QNTA	DCNAQ,HIT,NWS'A,AMR,POL,HPQ,RCII,C V,FBR
CNA Financial Corp James Tisch, Joe Rosenberg	AZS,GEL,EPD,RGNC,CLMT,TGP,MWE,ETP,PPX,KMR,MM LP,NMP,XTEX,CPNO,MIC	GLD,SFN,PHG,LINTA,UUAU,SSP,RBN,KW D,APF
PETER CUNDILL	LCAPA,NTL,PFE	BAM
DAVIS Selected Advisors Chris Davis, Ken Feinberg	PG,BBKY,LCAPA,DTV,YSI,TSN,AMT,TOL,UHS,SHLD	FITB,TWX,SVM,PBI
EINHORN, David Greenlight Capital	MSFT,DHI	LEAP,IPS,BC,GLD
ESL: Edward S. Lampert	SHLD (Buyback at \$143)	AN
FAIRHOLME: Bruce Berkowitz	PD,EMN	MDC,WMB,ETH,CGI,GDW
GAMCO: Mario Gabelli	WGR,LCAPA,TRZ,IMGC,ABB,LACO	DCNAQ,ION,BSX,STX,LNC
GRANTHAM, Jeremy	LUKOY,WMI,BRCD,AL,LVLT,DTV,NITE,MMM	VNT,MAR,TAM,PWAV,CY
GOTHAM: Joel Greenblatt	LEA	
ICAHN Group JANA Partners Carl Icahn, Barry Rosenstein	SYMC,CI,TTWO,RYL,FAL	MU,CNX,BSX,THX
LEUCADIA NATIONAL	LU,EMN	UUAU
HARRIS ASSOC: Bill Nygren	LCAPA,WSH,THC,PRM,TV,DOW	CCE,RMK,HGT,ADP,MCO
OLSTEIN: Robert Olstein	BLT,ANF,AAPL,NAFC,PBI,AXP,AVY	GTN,PTEN,FTD,PACR
COOPERMAN, Leon, OMEGA	WMB,NOK,FL,UNH,VIA'B,EXC,HNZ,CG,GLW	BSX,CNO,XRX,MCD,SCT
PRIVATE CAPITAL Sherman	ISSX,FULT,IBM,NTBK,IWM,SPY,SKS	MGAM,LINTA,FBN,AMP
PROSPECTOR PARTNERS John D. Gillespie	GPK,AXS,IBM,RAMR,AET,DYN	ORH,CCC,NRG,FED,TSFG
PZENA, Richard	ROIAK,ZZ,SFCC,TWP,BPOP,CRLAERT,DVN	RBN,AMH,CIT,MGI
RUANE CUNNIFF: Bob Goldfarb	BBBY,MA,GTRC,LOW,RYL,XOM,HDB	MICC,MOVE,PCLN,UPL
SOUTHEASTERN: Mason Hawkins	CHK,LCAPA,WEN,IDT	HAS,MNI,EQ,SVN
THIRD AVENUE Funds Marty Whitman	INTC,JRN,MSFT,XEC,NZT,TRB,SAFM,LSBK	KEM,DBRN,TQNT,LENS
TWEEDY BROWNE Spears	BOL	MGP,SGP,HNZ
WEITZ FUNDS: Wallace Weitz	CMCSA,CNVR,CECO,APOL,C	CAH,CNC,OSI,Q

WARNING: Let's face it, the best laughs are sometimes from jokes that are dirty. But if you hate those types, please skip this section.

GOOD FOR THE HEART (GROSS & HILARIOUS: DO NOT READ AFTER MEAL!)

After being told by his doctor that beans are good for the heart, a wealthy money manager developed a terrible passion for baked beans which always had a somewhat lively effect on him stomach. After he met the beautiful woman of his dreams, he made the supreme sacrifice and gave up the beans; he couldn't imagine subjecting his new wife to his beastly emissions.

On his birthday, his car broke down, so he called his wife and told her he'd have to walk home. He walked past a cafe and the wonderful aroma of baked beans overwhelmed him. Since he was still a couple of miles from home, he figured he could indulge, and then walk off any ill effects. So he had three extra-large helpings of

beans, and he "put-putted" all the way home.

His wife met him at the door and seemed somewhat excited. She exclaimed, "Darling, I have the most wonderful surprise for you for dinner tonight!"

She blindfolded him, and led him to his chair at the head of the table, making him promise not to peek. At this point, he was beginning to feel another one coming on. Just as she was about to remove the blindfold, the telephone rang and she went to answer it.

While she was gone, he seized the opportunity. He shifted his weight to one leg and let go. It was not only loud, but ripe as a rotten egg. He gasped and felt for his napkin and fanned the

air about him. He had just started to feel better, when another urge came on. This one sounded like a diesel engine revving, and smelled worse. He tried flapping his arms, to clear the air. But another one snuck out, and the windows rattled, the dishes on the table shook, and a minute later, the flow-ers on the table were dead.

When he heard his wife ending her conversation, he neatly laid his napkin on his lap and folded his hands on top of it. He was the picture of innocence when she walked in.

Apologizing for taking so long, she asked if he had peeked at the dinner. He assured her he had not, so she removed the blindfold and yelled, "Surprise!!!"

To his shock and horror, there were twelve dinner guests seated around the table for their money manager's surprise birthday party.



Superinvestor Digest (SiD)

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